

PORTABILITY OF THE UNUSED SPOUSAL EXCLUSION

Consider Incorporating in Your Existing Estate Plan



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Portability of the Unused Spousal Exclusion

Consider Incorporating Into Your Existing Plan

Portability, a taxpayer-friendly provision, is now a permanent estate and gift tax provision as a result of the American Taxpayer Relief Act of 2012 (ATRA). As is the case with any new planning provision, new ideas arise, which in turn lead to new or better ways on how to plan. Portability is no exception.

There is no “one-size-fits-all” estate planning tool. Many planning tools work well for a majority of couples, some work well for many, others work well only for a few. Portability is one of those planning tools that would work well for a great majority, but not for all couples.

Congress’ desire was for portability to “simplify” estate planning. For the most part, portability will likely simplify plans, however, contrary to Congress’ intent, it brings yet another layer of complexity.

With portability, married couples may be wondering whether they should revise their existing estate plans. Generally, couples should have their plans reviewed to determine the impact of portability. We believe, in most cases, it will be beneficial.

Initially, portability was touted as a “post-death” planning tool that would “simplify” planning. However, those original statements were generalizations. It is true, for some, it will be a post-death planning tool, and for some it will simplify planning. However, for many couples, it will be a lifetime planning tool, which may keep the same level of complexity in a couple’s plans or in some cases make it more complex. Regardless of simplification, it will generally be better to have a plan that incorporates portability.

A number of years ago, most estate tax planning focused on the impact of estate, gift and GST taxes, and more often than not de-emphasized income taxes. It is not to say that the planner was not cognizant of income taxes, rather, it was that the potential income tax liability often paled by comparison. Because of the recent increases in the applicable exclusion amount and the lower estate tax rates, for many estates, the estate tax liability is much less than it may have been a dozen years ago. For instance, a couple with \$12 million who properly planned to take advantage of the estate tax exclusions in 2001 would have paid about 47% of their wealth in estate taxes. That same couple in 2014 would pay roughly 4.5% of their wealth in estate taxes. Thus, the estate tax for that couple has decreased about ten-fold as a result of the

new tax regime brought about by ATRA. Conversely, that same couple's income taxes will have increased if they had the same income when comparing those same years because of higher marginal rates and the so-called 3.8% surtax resulting from the Affordable Care Act. Thus, today, income taxes play a bigger role in estate planning by comparison to prior years.

When combining those tax changes with the introduction of portability's permanence, one can see that the planning becomes a bit more challenging. Taking it one step further, since portability is an elective provision and since other taxes (such as GST taxes and state death and income taxes) and issues (such as second marriages, asset protection concerns and the like) come into play, structuring a portability-type plan, may be a bit more challenging than before.

What Is Portability?

Portability, an estate and gift tax provision, allows the personal representative (or executor) of a deceased spouse to make an election on the decedent's estate tax return to transfer or "port" such deceased spouse's unused exclusion amount (called the "DSUE amount") to the surviving spouse.

How Is the DSUE Amount Calculated?

As stated above, the DSUE amount is the decedent's "unused" exclusion amount. The new law provides us with a formula on how to determine the amount of the "unused" exclusion.

The law provides that the DSUE amount is the lesser of: (1) the basic exclusion amount in effect in the year of the decedent's death; or (2) the excess of the decedent's applicable exclusion amount over the combination of the decedent's (a) taxable estate, and (b) adjusted taxable gifts. This somewhat complicated formula is generally the amount of one's lifetime exclusion amount that the first spouse to die not use during life or at death. The following example illustrates this point.

Example 1: Assume that Bill and Mary are married and are U.S. citizens. Assume further that in 2009, Bill made a lifetime taxable gift of \$1 million to their only son, Jordan. Assume that in 2014 Bill died. Up until the time of his death, Bill's "unused" lifetime exclusion is \$4.34 million (i.e., Bill's lifetime exclusion amount of \$5.34 million less the \$1 million of taxable gifts).

To calculate the DSUE amount that "ports" to Mary, one would have to determine how much of Bill's unused lifetime exemption is "used", not only during Bill's life, but also as a result of Bill's passing. The following example incorporates the use of Bill's exemption at his death.

Example 2: Let's continue the facts from Example 1, and assume that Bill leaves his entire \$5 million estate to Mary. This gift to Mary qualifies for the unlimited marital deduction, thus, at the time of Bill's death, he would have used none of his remaining "unused" lifetime exemption. Therefore, Bill's DSUE amount, which ports to Mary, will be \$4.34 million (i.e., Bill's basic exclusion amount of \$5.34 million less the combination of any lifetime taxable gifts (\$1.0 million in this example) and any amounts used at death (\$0 in this case)).

How Do You Determine the Surviving Spouse's Lifetime Exclusion Amount?

Calculating the DSUE amount is only the first part of the analysis. After the DSUE amount is determined, the survivor's new lifetime exemption amount is then determined.

The survivor's new lifetime exclusion amount is the combination of two amounts: (1) the survivor's basic exclusion amount; and (2) the ported DSUE amount. Technically, the sum of those amounts is called the survivor's "applicable exclusion amount". The applicable exclusion amount is seen in the following mathematical formula:

$$\begin{array}{rcccl} \text{Applicable} & & \text{Basic} & & \\ \text{Exclusion} & = & \text{Exclusion} & + & \text{DSUE Amount} \\ \text{Amount} & & \text{Amount} & & \end{array}$$

The following example, which builds on the previous two examples, illustrates the calculation.

Example 3: Let's assume the same facts as Example 2, and that Mary made no lifetime gifts prior to Bill's death. In this case in 2014, immediately after Bill's death, Mary's "applicable exclusion amount" is \$9.68 million (i.e., the sum of Bill's ported DSUE amount of \$4.34 million and Mary's \$5.34 basic exclusion amount).

Mary, the surviving spouse, may use her applicable exclusion amount to shelter future lifetime gifts as well as transfers at her death. Continuing with the above examples, we can see how this works.

Example 4: Assuming the facts from Example 3, let's also assume that later in the year (i.e., 2014) Mary gifts \$1 million to their only child, Jordan. In this case, Mary's gift will be applied against her DSUE amount first, reducing it to \$3.34 million. Mary's new applicable exclusion amount is \$8.68 million, consisting of Bill's ported DSUE amount of \$3.34 million and Mary's \$5.34 million basic exclusion amount.

Let's explore this further, and see what happens when a surviving spouse dies.

Example 5: Assuming the facts from Example 3, let's assume that Mary does not make a gift to Jordan, and later in the year (i.e., 2014) Mary dies leaving her \$12 million estate (i.e., the \$5 million she inherited from Bill and her \$7 million that she had in her name) to Jordan. In this case, Mary can shelter up to \$9.68 million (i.e., Mary's applicable exclusion amount) from estate taxes, thus, only \$2.32 million (i.e., \$12 million – \$9.68 million) would be subject to estate tax.

Why Is Portability a “Game-Changer”?

Not since the major change in 1981, which among other provisions introduced the “unlimited marital deduction,” has there been such a significant change in the estate tax laws. Portability represents a breakthrough in estate planning, because it potentially eliminates the risk of losing part or all of the lifetime exclusion of the first spouse to die, if it was not fully used at the death of the first spouse.

What Happened Before Portability?

Before portability, each spouse was forced to use his/her lifetime exclusion either before or at the time of his or her death. If the lifetime exclusion was not used, it was lost! In other words, before portability it was a “use-it-or-lose-it” proposition.

What Does Portability Change?

Now, with portability the couple is not relegated to consuming the first spouse's lifetime exclusion at his/her death. Portability extends the time to both spouse's exclusion until the survivor dies. That expansion of time changes the estate planning game (if you will ... it is a ‘game-changer’). In certain cases, this time expansion could lead to more advantageous planning for couples.

Portability's Limitations

Portability is limited. It does not apply to generation-skipping transfer (GST) taxes, and almost all states that have an estate tax have not adopted portability with respect to the state death tax exemption.

Portability and GST Taxes

Even though many advocated to have portability apply beyond the gift and estate tax regime to the GST tax regime, Congress failed to expand portability to GST taxes.

In light of that limitation, future planning should be accomplished in a way that takes advantage of portability for estate and gift taxes, while not giving up the benefit of the GST exemption (which is \$5.34 million in 2014).

Portability and State Death Taxes

Portability was originally only a Federal estate and gift tax rule. Although some states have eliminated their state estate tax, a number of states impose a separate state estate tax and, for the most part, with the exception of a couple of states (at the time of the writing of this paper),¹ these states have not adopted the portability concept with respect to their state estate tax exemptions. Thus, when planning, advisors need to consider the impact of the state estate tax exemption in light of portability.

Why Use a Portability-Type Plan?

What Is a Portability-Type Plan?

We use the term “portability-type” estate plan to distinguish such plan from those that do not incorporate portability. We will refer to those plans that don't incorporate portability as “traditional plans.”

A portability-type plan, could be as simple as having the spouses own all of their property jointly with right of survivorship (or in states that provide, they hold their property as tenants by the entireties).

Alternatively, the portability-type plan could be as complex as having a plan designed to allow the spouse to take all the property at death, or allow it to pass into trusts for his/her benefit, and have the spouse make certain elections that take advantage of the unlimited marital deduction and also take advantage of the \$5.34 million GST exemption.

Basically, a “portability-type” plan can run the gamut from being very simple to ultra-sophisticated.

¹ Thus far, only Hawaii and Delaware have adopted a portability provision.

The key to the plan is that it allows the family to make decisions that would allow them to take advantage of the portability provision, if needed.

Why Implement a Portability Plan?

One would generally implement a portability-type plan to achieve better results than a traditional plan. For instance, in a traditional plan, the decedent typically leaves his/her assets in a “by-pass” trust to the extent of the decedent’s unused lifetime exclusion available at his/her death, and the balance goes to the surviving spouse. And, typically, the “by-pass” trust would consume the decedent’s unused lifetime exclusion amount, so that there is no DSUE amount that can be ported (or transferred) to the surviving spouse.

Later, upon the surviving spouse’s death, the by-pass trust’s assets will likely not get a step-up in tax basis. Therefore, when those by-pass trust’s assets are sold, assuming that there was appreciation from date of the first spouse’s death to the date of sale (after the survivor’s death), a capital gain is triggered. By using a portability-type plan, depending upon a number of factors, including the size of the couple’s estate and the amount of appreciation, one may be able to avoid the potential capital gains tax.

A portability-type plan could yield the same estate tax exposure as a traditional plan, while minimizing the income tax associated with potential capital gains. Therefore, the portability-type plan could possibly reduce the overall tax exposure, when compared with a traditional plan.

Different Ways to Plan

With portability’s introduction, planners are now realizing that the traditional plan, which was very effective before portability, may not be the most efficient and effective plan for the couple. In fact, in certain circumstances, it may be a less desirable plan today.

Accordingly, in the future, clients will probably see a wide variation of plans. They may see plans where one spouse’s documents may not mirror the other spouse’s documents. They may see plans where assets are no longer held in separate trusts, but may be held jointly by the spouses. They may see plans, where the planner suggests that a lifetime marital trust be created for one spouse (called an “Intervivos QTIP Trust”). They may see plans where all of the assets are left in a marital trust for the survivor, who will then make a gift to an irrevocable trust for the benefit of

the descendants. The irrevocable trust may be structured to be a “grantor trust” for income tax purposes so that there is a further benefit to the descendants.

Clients may also see plans that incorporate disclaimer provisions (i.e., that allow the surviving spouse to forego benefits directly and allow assets to pass the assets at death either to a trust for the survivor’s and/or the descendants’ benefit). Additionally, they may see more trusts with special elective clauses allowing a trust to have certain provisions if a trust is for the benefit of the spouse or other provisions if the benefit is for the spouse and/or descendants (i.e., co-called Clayton clauses).

As a result of portability, soon to be gone will be the traditional plan which does not take portability into consideration. Also, on the chopping block will be the almost-automatic advice to a couple to divide their assets and have separate trusts. Instead, the planner would have to be more thoughtful, providing alternatives that may be similar to or may be totally different from the ways that planners planned for the past thirty-plus years.

Effective use of portability could yield significantly better results for many couples, and, as a result, changes estate planning today.

Analysis of Portability-Type Plans

In determining whether a portability-type plan, or any other planning vehicle, is beneficial, one must “run the numbers.” When comparing a portability-type plan to a traditional plan, we noted that the same three factors that affect most plans, also affected portability-based plans, that is: (1) time, (2) taxes and (3) rates of return. We find that the benefits /detriments of one plan over another depended primarily upon those three factors.

What Do the Numbers Show?

The results demonstrate if (1) one looks purely from a tax saving perspective, (2) where assets appreciate over time, and (3) there are no “non-tax” reasons for the particular plan², that in almost all scenarios a portability-type plan would be economically more beneficial than a traditional plan. The major reason for this is that portability allows one to have an income tax advantage under most circumstances, over a traditional plan. Thus, with the additional income tax benefit, the portability-type plan outpaces the traditional plan.

² Non-tax reasons would include items such as second (third, fourth, fifth, etc.) spouse concerns or asset protection issues.

Given the Tax Savings, Why Not Always Use a Portability-Type Plan?

There are a number of reasons why portability-type plans should not automatically be used. The primary rationale for this is based on the modified time-tested adage, “Don’t let the tax-tail wag the dog!” In other words, estate planning is not just “tax planning” ... it is much more than that; estate planning is planning for tax and non-tax considerations. Thus, even though a portability-type plan may be the most tax efficient, there may be reasons not to implement this type of plan.

By example, the husband may be on his third marriage, and he and his new spouse may have a prenuptial agreement with provisions that would be inconsistent with a portability-type plan. Or, it may be that the wife may not trust the husband to make the necessary post-death actions to effectuate the benefits of the portability-type plan. Suffice it to say, when planning, all of the non-tax, as well as tax, reasons should be thoroughly explored before implementing any type of plan, whether a portability-type plan (or some other plan).

Losing the Ported DSUE Amount

Assuming that a surviving spouse ports the decedent spouse’s DSUE amount and makes it his/her own (i.e., it becomes part of the survivor’s applicable exclusion amount, sometimes referred to as the “lifetime exclusion amount”). It is possible for the surviving spouse to lose the DSUE amount in one instance.

The DSUE amount can be lost if the surviving spouse marries another spouse (the “2nd Spouse”) and that 2nd Spouse predeceases the surviving spouse.

The reason for this is the statute provides the surviving spouse can get the benefit of the DSUE amount of such surviving spouse’s “last deceased spouse”. When 2nd Spouse dies, s/he becomes the last deceased spouse of the surviving spouse, so the DSUE amount of the surviving spouse’s first spouse disappears and is replaced by the 2nd Spouse’s DSUE amount (if the 2nd Spouse’s personal representative makes an election, and if there is a DSUE amount in that 2nd Spouse’s estate.

Importantly, if a surviving spouse is considering marriage (i.e., a second, third, etc.), and if such surviving spouse has ported DSUE amount, the survivor should plan on how to mitigate the possibility of losing the benefit of the ported DSUE amount.

Generally, in these cases there are a few different solutions that are available to the surviving spouse. First, the surviving spouse could make a gift of assets sufficient to consume the ported DSUE amount. Clearly, one would have to determine if the surviving spouse has the wherewithal to make the gift and determine whether it will affect his/her lifestyle. Second, the surviving spouse could purchase a life insurance policy on 2nd Spouse’s life so that should 2nd Spouse predecease the surviving spouse, the insurance policy would provide a benefit similar to the benefit of losing the first spouse’s ported DSUE amount. Third, the surviving spouse and the new spouse could enter into a marital agreement where they can negotiate how to compensate the surviving spouse for any of his/her loss of ported DSUE amount.

We discuss other issues that arise in subsequent marriages that relate to portability below.

Portability and Prenuptials

In general, when one is considering marriage, whether for the first, second, third or the nth time, one should consider whether to have a prenuptial agreement. Generally, when considering marriage, those who have an estate, who have the capability of building an estate or are future beneficiaries of an estate, should consider consulting their estate planning or marital lawyer to address the efficacy of a prenuptial agreement.

When considering marriage, there are a number of issues that could arise because of portability. For instance, if the intended is a surviving spouse who has a ported DSUE amount from a prior deceased spouse, it is possible that the survivor-intended could lose the benefit of the ported DSUE amount. Thus, this factor alone would weigh in favor of a prenuptial agreement. Portability raises other issues, too, that could potentially lead to divisive situations. For instance, it is important for the couple to address many issues, including some the following:

- Whether both parties agree that upon the death of the first to die that portability will be elected.
- In the event that the marriage is not the first marriage for either or both parties, the parties should agree on who pays for the portability election to claim the DSUE if no estate tax return is required to be filed for the deceased spouse.

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- Providing a mechanism to ensure that the surviving spouse (who may not be the nominated personal representative of the other spouse's estate) will cooperate with the personal representative (and vice-versa) in making the portability election.

Addressing these issues potentially avoids conflicts that may arise at the time of the spouse's death. Thus, having a thorough discussion and further embodying a client's decisions on those issues in estate planning or pre-marital documents is particularly recommended in situations where the parties have been married before or have complex family structures.

Eligibility and Election of Portability

Not everyone can take advantage of portability. For instance, it is not available to unmarried persons. There are other requirements, too, as we discuss below.

When enacting portability, Congress imposed many statutory requirements and relied on the Internal Revenue Service to give guidance on some of the gaps that Congress may have left open in the new statute.

Consistent with Congress' directive, the Internal Revenue Service issued guidance in the form of temporary and proposed regulations to interpret and implement the portability rules. For instance, the new regulations make it clear that portability is only available for US citizens or residents at the time of their death.

Further, the regulations also clarify that portability is not available to surviving non-resident aliens (except if the survivor is a resident of a country that has an applicable treaty with the United States). For example, John, a U.S. citizen, is married to Suzie, an Australian citizen and a non-resident of the U.S. If Suzie dies, John may not use any of Suzie's unused exclusion. This is the case, even if Suzie is subject to some estate taxes in the U.S. Likewise, if John dies, Suzie will be unable to utilize John's DSUE amount, since she is neither a citizen nor a U.S. resident (i.e., she is a non-resident alien).

The regulations also provide many rules regarding how and when the portability election may be made. The regulations provide that a deceased spouse's DSUE may only be preserved when a portability election is made on a "timely filed" estate tax return. Timely filed is defined as a return filed on or before the due date of the return (including extensions).

There are some special rules that apply to smaller estates, which allow for reduced reporting of asset values in certain circumstances. Generally, however, because this reporting would not properly report the income tax basis of the assets passing from the decedent's estate, we anticipate that many will forego the limited reporting.

Additionally, the new rules explain how to calculate the DSUE amount of a surviving spouse, when the surviving spouse has been married more than once. These rules are very taxpayer friendly.

Portability and Same Sex Couples

In light of the recent U.S. Supreme Court cases that effectively have allowed same-sex couples to have the same Federal rights as opposite-sex couples, the IRS recently provided guidance that portability applies to all married couples (whether same- or opposite-sex couples).

Conclusion

Portability may have initially been viewed as the simple solution in situations where there was the potential for loss of the applicable credit amount of the first spouse to die. While this is a valuable benefit, the impact and potential planning opportunities for portability go well beyond this important, but somewhat limited, scope. Estate planning today and for the future requires a deeper understanding of how portability works and how it can be integrated into clients' estate plans.

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