By Jeffrey A. Baskies

Estate Tax Exemption Portability?

It would provide a valuable bailout
for certain clients—but could hurt others

Most everyone expects estate tax reform in the not-too-distant future. There have been many ideas shared and even seminars sponsored to address the topic, but at this point nobody knows for sure what will come.

One relatively new part of the reform debate seems to have flown mostly under the radar: estate tax exemption portability. Essentially, estate tax exemption portability would allow the unused estate tax exemption that belonged to the first spouse who died to pass to and benefit the surviving spouse.

In the world of trusts and estates, this potential reform would be monumental.

Portability looks like it might be a bailout for those who did not bother to create estate plans. For example, a married client who didn't plan could use both his and his dead wife's estate tax exemptions—a clear benefit. Moreover, for some clients who have only qualified retirement assets with which to plan, portability of the exemption might add income tax flexibility.

But portability likely will do no good for many clients who need to plan. It may even wind up hurting those who should plan but, because of portability, don't. And in some circumstances, it actually could generate more tax revenue for the government.

What Is It?

Portability seems to have surfaced relatively recently as a viable part of the estate tax reform debate. The idea is to permit the unused estate tax exemption of the first spouse to die to pass to the surviving spouse, without the need for credit shelter trust planning. There are many issues regarding the concept, including if it should be limited to only one transfer (to avoid serial marriages for exemption purposes), and if a special election should be made or a return filed after the first death.

Regardless of some potentially problematic aspects, support for portability as a part of any estate tax reform is gaining momentum. (See "On the Table," p. 17 for a comparison of Congressional bills.)

Initially, on Jan. 14, 2009, Representative Harry Mitchell, D-Ariz., included portability in H.R. 498, the bill known as the "Capital Gains and Estate Tax Relief Act of 2009." In addition to allowing for portability, this bill provides for:

(1) reunifying the gift and estate tax exclusions;

(2) annually increasing the estate tax exclusion amount between 2010 and 2015 (starting at \$3.5 million in 2009 and increasing by \$250,000 every year thereafter until 2015), when it becomes permanently set at \$5 million, adjusted for inflation in \$50,000 increments;

(3) reducing the estate tax rate for estates under \$25 million;

(4) eliminating the state death tax deduction; and

(5) making permanent the 15 percent capital gains tax rate enacted by the Jobs and Growth Tax Relief and Reconciliation Act of 2003.

Portability also is part of S. 722, the "Taxpayer Certainty and Relief Act of 2009" introduced on March 6, 2009 by Senator Max Baucus, D-Mont. Some of the highlights of the Senate bill are that it:

(1) reunifies the gift and estate tax exclusions;

(2) locks in the \$3.5 million applicable exclusion

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amount, while adjusting that amount for inflation in $10,000 increments;

(3) establishes a maximum estate tax rate of 45 percent;

(4) makes permanent reductions in individual income tax rates, capital gains and dividend tax rates enacted by the Economic Growth and Tax Relief Reconciliation Act (EGTRRA);

(5) makes permanent the marriage penalty relief provisions from EGTRRA;

(6) increases the dependent care, adoption assistance, and earned income tax credit;

(7) makes permanent the increased alternative minimum tax (AMT) exemption amounts and the offsets against such tax for nonrefundable tax credits while adjusting such AMT exemption amounts for inflation after 2009; and

(8) adopts portability.

Finally, portability was included in H.R. 2023 introduced on April 22, 2009 by Rep. Jim McDermott, D-Wash., who's a member of the House Ways and Means Committee (home base for any tax reform proposal.) This bill, the "Sensible Estate Tax Act of 2009:"

(1) unifies the estate and gift tax exemptions at $2 million (the level the estate tax exemption was prior to Jan. 1, 2009), adjusted for inflation in $10,000 increments;

(2) reinstates progressive estate tax rates by adding two brackets, (50 percent rate for more than $5 million and a 55 percent rate for more than $10 million);

On the Table

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Description	H.R. 2023	H.R. 498	S. 722
Reunifies estate and gift tax exemptions?	Yes	Yes	Yes
Requires filing an election for portability?	Yes	Yes	Yes
Caps the amount of deceased spouses' unused credit that can be used by surviving spouse?	Yes	Yes	Yes
Exclusion amount	$2 million, indexed for inflation in $10,000 increments	$3.5 million increasing by $250,000 annually up to $5 million in 2015 indexed for inflation in $50,000 increments	$3.5 million indexed for inflation in $10,000 increments
Restores state death tax credit?	Yes	No	No
Repeals deduction for state death tax?	Yes	Yes	No

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(3) restores the state death tax credit and repeals the deduction for state death taxes; and

(4) adopts portability.

Planners—note that all of these bills have some similar characteristics relating to portability:

• All require a positive election to be made on a timely filed estate tax return filed on behalf of the first deceased spouse's estate to avail the surviving spouse of the portability benefit. This may present a big trap for the unwary, as it may require an estate tax return to be filed for an estate of a deceased spouse that would not otherwise be required to file an estate tax return, solely for the purpose of making this election. Moreover, the statute of limitations for the Internal

Revenue Service to challenge this election does not begin to run until the death of the surviving spouse, meaning that record keeping may become a more daunting task.

- The bills all cap the sum of unused exclusion amounts "ported to" a surviving spouse at the applicable exclusion amount, without adjustments for cost of living (for example, none of them increase the exemption to keep up with the Consumer Price Index). Therefore, the bills limit the benefit a surviving spouse of multiple marriages can receive to the applicable exclusion amount.

> Clients may hear that portability simplifies matters and might fear planners are making things needlessly complex solely to generate fees.

- The portability bills also introduce these new terms:
  (1) What we now think of as the "estate tax exemption amount" is referred to as the "basic exclusion amount."
  (2) The amount of a deceased spouse's basic exclusion amount that is allowed to the surviving spouse is called the "deceased spousal unused exclusion amount."
  (3) And the total amount of unused deceased spousal exclusion amount allowed to a surviving spouse is referred to as the "aggregate deceased spousal unused exclusion amount." The "applicable exclusion amount" now would equal the sum of (a) the basic exclusion amount; and (b) in the case of a surviving spouse, the aggregate deceased spousal unused exclusion amount.
- None of the bills include portability of the generation-skipping transfer (GST) tax exemption of the first spouse to die.

Only bill S. 722 provides for the gift tax exclusion amount to be increased by any estate tax exemption that is ported to a surviving spouse.

Because all three bills include the concept of portability, even if the exact terms implementing portability may need to be resolved in a conference committee, portability has a distinct possibility of passage.

Is It a Good Idea?

Portability seems a positive step forward for those who don't plan (let's call them "non-planners") and/or for those who don't plan in a complex manner because their estates are near or only very slightly over the exemption level (let's call them "the smaller estates"). Both would benefit from two estate tax exemptions instead of just one. Under the current law and without portability, non-planners and small estates generally benefit from only one estate tax exemption.

For example, assume clients have "leave it all to my spouse" wills or hold all of their assets in joint accounts or beneficiary-designated accounts passing to the surviving spouse. Currently, the estate tax exemption of the first spouse to die will be totally wasted. If portability becomes law, the couple would benefit from the ability to use both exemptions. Thus, if the combined estates of a husband and wife are under the exemption amount at the first death, but grow in value over time and exceed the exemption amount by the surviving spouse's death, having two exemptions will clearly be a benefit.

Moreover, from an income tax perspective, there may be a benefit to portability for clients with estates worth up to the total of both exemptions. If the estate of the first spouse to die gets a stepped-up basis on the first death, the survivor may be able to better pick and choose which assets to spend, so as to minimize income taxes during her lifetime. Whereas there's an estate tax disincentive to picking and choosing assets in a credit shelter trust, even though those assets may have a stepped-up basis.

Then, when all the assets are included in the survivor's estate (and assuming the combined estate is less than the two exemptions so that no estate tax is due), there will be a second step-up in basis. For some clients, that will be quite beneficial and a positive tax change from the current system in which the assets placed in the credit shelter trust on the first death won't benefit from a stepped-up basis on the second death.

For many couples with smaller estates, this type of outright planning might be sufficient. It certainly has the appeal of simplicity. Without the tax aspects to concern them any longer, many clients would likely prefer easier-to-understand planning.

Wealthy clients who avoid planning because they are relying on portability may waste several potentially large-scale benefits that credit shelter trust planning now offers.

There also are others who might benefit if portability is passed. For example, many clients do not feel comfortable splitting their assets during their lifetimes, and are not excited by the current primary alternative: creating and funding an inter vivos qualified terminable interest property trust, which may be expensive and cumbersome. For those clients, portability would assure both exemptions are utilized.

Also, there are many clients (especially those with asset protection concerns) who have a large part of their wealth tied up in a home (which may have unique planning aspects, like the Florida homestead exemption) and in retirement accounts (qualified plans, IRAs and annuities). Those clients should benefit from portability by avoiding the complex problems of trying to fund a credit shelter trust on the first death with these assets. In addition, particularly if one spouse has most of the wealth in his own name (likely the case in such an example), having portability avoids some very troubling issues of how to fund the credit shelter trust of the first to die if that is the spouse without the assets.

But there are some whom portability might harm.

For example, portability poses problems for clients with substantial estates, that is to say, those who really need to properly plan—people with estates in excess of the exemption level. Depending on how portability works, as the current bills envision it, relying on portability would be poor planning for most clients of means. Wealthy clients who avoid planning because they are relying on portability may waste several potentially large-scale benefits that credit shelter trust planning now offers:

(1) the ability to use both spouses' full GST tax exemptions,

(2) the ability to have all of the appreciation on the assets used to fund the credit shelter trust of the first to die pass estate tax free on the second death, and

(3) the loss of creditor protection and marital claim protection (protection from a future divorce or elective share claims by a second or later spouse).

Plus, portability might put planners at odds with their clients in new and challenging ways.

- The first and probably largest hole in the portability proposals to date is the lack of portability of the GST tax exemption. While it would be helpful for portability to include the gift tax exemption of the first to die, that issue seems less significant than the lack of GST tax portability. Obviously, without it, the GST tax exemption of the first to die is wasted in estates relying on portability and not using credit shelter trust planning. While it appears far too many estates already fail to take advantage of the GST tax exemption (as many estate plans still seem to pass outright to the descendants), one can surmise that the failure to maximize GST tax planning may be exacerbated under a regime of portability.

- The portability proposals do not increase the value of the ported estate tax exemption. If the first spouse dies and the entire $3.5 million exemption is ported to the survivor, the survivor's estate adds only $3.5 million of exemption, regardless of how long the survivor lives. If the two deaths occur relatively close in time, this issue would likely be immaterial. But the lack of any inflation adjustment will impact estates increasingly over time.

If one spouse dies and funds a credit shelter trust that increases in value at 8 percent per year, we expect the trust assets to double in nine years. If the survivor lives for an additional 15 to 20 years, then without any inflation adjustment for the ported exemption, the non-charitable beneficiaries could be harmed significantly (tax-wise) as a result of the failure to use credit shelter trust planning. Thus, we can imagine a scenario in which portability actually increases revenue for the government.

• Another problem of relying on the simplicity of an "all to the spouse plan"—taking advantage of estate tax portability and not using credit shelter and marital trust planning—would be the exposure of the total estate to the surviving spouse's creditors and/or new spouses. While credit shelter trust planning might involve some additional work, it offers a degree of protection from creditors and new spouses that should not be overlooked. The lack of creditor protection in an outright plan can impact both larger and smaller estates. In some respects, it might be even more significant in smaller estates with fewer funds available to satisfy a creditor claim or two.

• Another adverse aspect of portability is the potential it has to create divisiveness between planners and clients. Planners still will urge clients to use complex plans with credit shelter trusts for valid estate, GST tax and creditor protection purposes. But clients may hear that portability simplifies matters and might fear planners are making things needlessly complex solely to generate fees. It could lead clients who need good advice to seek cheap advice or cookie-cutter solutions. And it will further perceptions of the commoditization of our business.

If that happens, the planner may appear to have contrary interests to the client, even though the planner is trying to counsel the client on certain important protections and tax-saving opportunities. Ultimately, any dumbing-down of our practices or commoditization of estate planning (real or perceived) could harm clients. Moreover, to the extent that clients avoid efficacious estate planning as a result of reliance on portability, they will have missed valuable opportunities to benefit their families.

Next Steps

The estate tax reform debate is heating up again; the time to act is now if you have any thoughts or concerns regarding the proposed changes, including the potential addition of portability. Genuine reform, if it is to happen, might well occur before the end of this year. Few believe the government will allow the federal estate tax to disappear, even if only for a year, starting on Jan. 1, 2010.

But it is possible this reform debate will drag on. Congress could buy another year by simply extending the current estate tax exemption and rates for 2010. If that happens, we face the very real potential of a return to the $1 million exemption and 55 percent top brackets on Jan. 1, 2011. And if in fact the estate tax exemption declines and/or the rates increase, the pressure for an offsetting "middle class" benefit like portability might become even more powerful. Thus, the likelihood of its passage may in part depend upon the momentum that the current reform proposals (or perhaps even new bills) generate. TE

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