NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON

PORTABILITY OF THE ESTATE TAX EXCLUSION

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New York State Bar Association Tax Section

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Introduction

This report[1] of the Tax Section of the New York State Bar Association provides comments on the "portability" of a first-to-die spouse's unused estate tax exclusion to the surviving spouse, both under current law and pending legislation.

In December of 2010, Congress amended section 2010(c)[2] to allow the surviving spouse of a decedent who dies after December 31, 2010 to utilize any unused estate tax exclusion of the decedent. This right, commonly referred to as "portability", was enacted as part of the Tax Relief, Unemployment, Reauthorization, and Job Creation Act of 2010,[3] and will sunset on December 31, 2012 unless extended or made permanent by future legislation.

Bills have already been introduced to extend the portability rules and the Obama Administration's Fiscal Year 2013 budget includes a proposal to make the portability rules permanent.[4] The current statute authorizes the Secretary to prescribe such regulations as may be necessary or appropriate to carry out Section 2010(c).[5] On September 29, 2011, the Internal

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1 The principal author of this report is Laura Twomey. Significant contributions were made by Alan S. Halperin. Helpful comments were received from Andrew H. Braiterman, Stephen B. Land, Andrew W. Needham, Deborah L. Paul, Michael L. Schler and Diana L. Wollman. This report reflects solely the views of the Tax Section of the NYSBA and not those of the NYSBA Executive Committee of the House of Delegates.

2 Unless indicated otherwise, all "Section" references are to the Internal Revenue Code of 1986, as amended.

3 P.L. No. 111-312, §§ 101(a), 303(c), (304), 124 Stat. 3296 (2010).

4 General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals, Department of the Treasury, released February 13, 2012 ("As reflected in the Administration's adjusted baseline projection, the portability of unused estate and gift tax exclusion between spouses would be made permanent").

5 IRC § 2010(c)(6).

Revenue Service invited comments on several issues under consideration for future proposed regulations on portability.[6] Many organizations have provided comments, and requested that future regulations clarify a number of issues raised by the current statute.

Because the statute itself may be extended, we would like to take this opportunity to suggest certain modifications to the current statutory language of Section 2010(c). We believe that these modifications would better reflect the policy objectives Congress sought to achieve when it first amended Section 2010(c) in 2010. In doing so, however, we express no view on whether Congress should extend the statute beyond the current year.

The Policy Considerations in Favor of Portability of the Estate Tax Exclusion

Historically, the Unified Credit against Estate Tax set forth in Section 2010 has provided each individual with an exclusion from estate tax of the Applicable Exclusion Amount (as defined below). If an individual passed away without taking advantage of all or a portion of the Applicable Exclusion Amount, either because she had insufficient assets to fully absorb the exclusion or because she left all of her assets to her spouse and/or a charity and thereby was not subject to estate tax, the benefit of her unused exclusion was not available to the surviving spouse.

With estate planning, sophisticated couples with sufficient assets are able to take advantage of the entire exclusion without relying on the portability statute. A common method for doing so is to bequeath assets equal to the exclusion amount to a "by-pass" trust (also referred to as a "credit shelter" trust) for the surviving spouse and children, rather than leaving the entire estate to the surviving spouse. The technique requires that each spouse have sufficient assets titled in his or her own name to fund the by-pass trust.

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[6] Notice 2011-82, Unified Credit Against Estate Tax—Unused Exclusion Amount—Portability Election Required, released on September 29, 2011.

Other couples do not like to divide up the ownership of their assets into "mine" and "yours;" they view themselves as a single unit from a financial perspective and are treated as such for many tax purposes. For example, the unlimited marital estate and gift tax deduction, the ability to split gifts, and the right to file a joint income tax return all reflect the basic principle that a married couple is a single economic unit.[7] But if a couple fails to create the by-pass trust and optimize the separate legal ownership of its assets with the assistance of an estate planner, the couple may not benefit from the unused exclusion of the first-to-die spouse.

The purpose of the portability amendment to the statute was to eliminate the need for this type of estate planning. As stated in the JCX-23-08, *Taxation of Wealth Transfers within a Family: A Discussion of Selected Areas for Possible Reform*, allowing portability of a deceased spouse's unused exclusion to the surviving spouse was intended to "contribute to simplicity and facilitate compliance with the law, because it largely would eliminate the need for couples to employ the credit shelter trust strategy or to monitor and adjust the titling of assets."[8] It is also consistent with the basic tax principle that a married couple is as single economic unit.

<u>The Current Statute</u>

Section 2010 currently provides that the amount that will be excluded from estate tax upon an individual's death (the "Applicable Exclusion Amount") is equal to "*the sum of*

(A) the basic exclusion amount, and

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[7] Testimony of Shirley L. Kovar, fellow of the American College Trusts and Estates Counsel, Hearing Before the Senate Finance Committee, April 3, 2008. Ms. Kovar points out in her testimony that "The Finance Committee stated in 1981 when the marital deduction was made unlimited that '[t]he committee believes that a husband and wife should be treated as one economic unit for purposes of estate and gift taxes, as they generally are for income tax purposes.'" S. Rep. No. 97-144, 97th Cong., 1st Sess. 127 (1981).

[8] JCX-23-08, April 2, 2008, p. 10. Because the statute sunsets at the end of 2012, however, we do not believe it is likely to "largely…eliminate" the need for this type of estate planning. Only a couple who knows that both will die before the statute expires can be assured of claiming the benefit of the additional exclusion without estate planning.

(B) in the case of a surviving spouse, the deceased spousal unused exclusion amount."[9]

The basic exclusion amount ("Basic Exclusion Amount") is equal to $5 million, subject to an annual inflation adjustment.[10] The deceased spousal unused exclusion amount ("DSUEA") is equal to "*the lesser of*

(A) the basic exclusion amount, or

(B) the excess of

(i) the basic exclusion amount of the *last* such deceased spouse of such surviving spouse, over

(ii) the amount with respect to which the tentative tax is determined under section 2001(b)(1) on the estate of such deceased spouse."[11]

In other words, the Applicable Exclusion Amount is equal to the sum of the individual's Basic Exclusion Amount (*i.e.*, $5 million, as adjusted for inflation) and the DSUEA (*i.e.,* the amount of exclusion inherited from the last deceased spouse).

We believe that the definition of DSUEA raises several issues that Congress should resolve before extending portability by future legislation.

Issues Raised by JCT Examples

The Staff of the Joint Committee on Taxation provided the following three examples to illustrate the application of the portability rules of Section 2010(c):[12]

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[9] IRC § 2010(c)(2) (emphasis added).

[10] IRC § 2010(c)(3). The Basic Exclusion Amount increased to $5.12 million in 2012 due to the inflation adjustment.

[11] IRC § 2010(c)(4) (emphasis added). The amount described in (ii) is the taxable estate of the deceased spouse plus adjusted taxable gifts.

[12] Staff of the Joint Comm. of Tax'n, Technical Explanation of the Revenue Provisions Contained in the "Tax Relief Unemployment Insurance Reauthorization, and Job Creation Act of 2010" Scheduled for Consideration by the United States Senate at 52-53 (JCX-55-10) (Dec. 10, 2010) (the "2010 JCT Explanation"). All three examples involve very wealthy couples: Husband 1 and Wife have $6 million between them, and Husband 2 has $4 million. Although this may give the impression that portability is of

> **Example 1**.−Assume that Husband 1 dies in 2011, having made taxable transfers of $3 million and having no taxable estate. An election is made on Husband 1's estate tax return to permit Wife to use Husband 1's deceased spousal unused exclusion amount. As of Husband 1's death, Wife has made no taxable gifts. Thereafter, Wife's applicable exclusion amount is $7 million (her $5 million basic exclusion amount plus $2 million deceased spousal unused exclusion amount from Husband 1), which she may use for lifetime gifts or for transfers at death.
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> **Example 2**.−Assume the same facts as in Example 1, except that Wife subsequently marries Husband 2. Husband 2 also predeceases Wife, having made $4 million in taxable transfers and having no taxable estate. An election is made on Husband 2's estate tax return to permit Wife to use Husband 2's deceased spousal unused exclusion amount. Although the combined amount of unused exclusion of Husband 1 and Husband 2 is $3 million ($2 million for Husband 1 and $1 million for Husband 2), only Husband 2's $1 million unused exclusion is available for use by Wife, because the deceased spousal unused exclusion amount 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, Husband 2's $1 million unused exclusion). Thereafter, Wife's applicable exclusion amount is $6 million (her $5 million basic exclusion amount plus $1 million deceased spousal unused exclusion amount from Husband 2), which she may use for lifetime gifts or for transfers at death.
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> **Example 3**.−Assume the same facts as in Examples 1 and 2, except that Wife predeceases Husband 2. Following Husband 1's death, Wife's applicable exclusion amount is $7 million (her $5 million basic exclusion amount plus $2 million deceased spousal unused exclusion amount from Husband 1). Wife made no taxable transfers and has a taxable estate of $3 million. An election is made on Wife's estate tax return to permit Husband 2 to use Wife's deceased spousal unused exclusion amount, which is $4 million (Wife's $7 million *applicable exclusion amount* less her $3 million taxable estate). Under the provision, Husband 2's applicable exclusion amount is increased by $4 million, *i.e.*, the amount of deceased spousal unused exclusion amount of Wife. (emphasis added).

Examples 1 and 2 correctly apply the statute to the stated facts. They also illustrate the simplicity by which a surviving spouse may take advantage of the DSUEA with little or no estate planning.[13]

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little or no relevance to the vast majority of taxpayers, portability will become relevant to many more taxpayers if the Basic Exclusion Amount is ever reduced back to its historic levels.

13 To claim this benefit, however, the executor of the predeceased spouse must elect portability on his or her estate tax return even if an estate tax return was not otherwise required to be filed. IRC § 2010(c)(5)(A).

As others have pointed out, however, Example 3 does not correctly apply the statute. Section 2010(c) provides that a surviving spouse's Applicable Exclusion Amount is equal to his Basic Exclusion Amount plus any DSUEA available to him. The DSUEA that may be inherited by the surviving spouse is the lesser of (A) the Basic Exclusion Amount (in Example 3, $5 million) or (B) the excess of (i) the Basic Exclusion Amount of the last deceased spouse of the surviving spouse (in Example 3, $5 million) over (ii) the taxable estate of such deceased spouse plus adjusted taxable gifts (in Example 3, $3 million). In Example 3, "the lesser of" (i) and (ii) is $2 million. When added to the surviving spouse's Basic Exclusion Amount, the Applicable Exclusion Amount of the surviving spouse should be $7 million (*i.e.*, the Basic Exclusion Amount of $5 million plus the $2 million of inherited DSUEA). This is consistent with the statute because Wife died with an estate of $3 million at a time when the Basic Exclusion Amount was $5 million. In Example 3, however, the surviving spouse inherits $4 million rather than $2 million in DSUEA.

The reason for the $2 million discrepancy is that Example 3 subtracts the deceased spouse's taxable estate from her Applicable Exclusion Amount rather than from her Basic Exclusion Amount. While the Applicable Exclusion Amount is the proper amount for purposes of determining the taxable estate of the predeceased spouse (she is permitted under the statute to use DSUEA inherited from her last deceased spouse), it is *not* the correct amount available to the *next* surviving spouse. Under the statute, the amount available to the next surviving spouse is calculated with respect to the Basic Exclusion Amount as of the deceased spouse's death.[14]

The Joint Committee on Taxation acknowledged this error with an errata statement, adding a footnote to Example 3 that a technical correction to the statute may be necessary to

[14] IRC § 2010(c)(4)(B)(i) (the Basic Exclusion Amount of the "last such deceased spouse").

replace the reference to "basic exclusion amount" of the last deceased spouse of the surviving spouse in limitation (B)(ii) above with a reference to the "applicable exclusion amount" of such last deceased spouse. The effect of this technical correction would be to eliminate the discrepancy between Example 3 and Section 2010(c)(4). The Joint Committee described these corrections as necessary "so that the statute reflects intent."

As Example 3 illustrates, however, this "correction" allows the estate of Husband 2 to inherit the unused exclusion of Husband 1. We do not believe this is consistent with the purposes of the portability statute. Nor does it promote the broader goal of the federal wealth transfer tax to minimize unfair disadvantages to married couples who do not engage in sophisticated estate planning. Although the Joint Committee has previously expressed policy concerns as to whether an individual should be able to inherit the unused exclusion from a deceased spouse's former spouse, Example 3 allows it: it permits Husband 2 to increase his Applicable Exclusion Amount by adding DSUEA inherited by Wife from Husband 1, which the current statute expressly prohibits.

Permitting Husband 2 to inherit Husband 1's exclusion also unfairly disadvantages the government. Compare the outcome in Example 2 to the outcome in Example 3: in Example 2, Wife was not permitted to use the $2 million exclusion she inherited from Husband 1 because she remarried and her second husband died before she did. Upon her second husband's death, she could only use the $1 million exclusion she inherited from him because he was her *last* deceased spouse. In Example 3, however, Husband 2 is permitted to use Husbands 1's exclusion merely because his spouse died before he did. To cut off Wife's ability to use Husband 1's exemption in one situation, but allow Wife to effectively bequeath Husband 1's exemption to Husband 2 in another based on the order of their deaths serves no discernible policy objective.

Example 3 was first published in 2008 by the Joint Committee on Taxation in JCX-23-08 to explain HR 5638 and HR 5970, both of which had passed the House in 2006. In 2008, Example 3 correctly applied the proposed statutory language at that time. The reason is that *neither* of the 2006 bills contained a last deceased spouse limitation. They merely capped the amount of unused exclusion an individual could inherit from *all* predeceased spouses at $5 million. Nevertheless, Example 3 reappeared without modification in the 2010 JCT Explanation of the 2010 statute. Rather than explaining the current statute, Example 3 in fact explains statutory language from a previous bill that Congress never enacted. It therefore failed to apply the last deceased spouse limitation, allowing Husband 2 to inherit an exclusion amount that his spouse would no longer have possessed if he had predeceased her.

Rather than revising the statute to reflect Example 3, therefore, we believe Example 3 should be revised to reflect the statute as currently drafted. Specifically, we recommend that the final two sentences of Example 3 be revised to provide as follows:

> "An election is made on Wife's estate tax return to permit Husband 2 to use Wife's deceased spousal unused exclusion amount, which is $2 million (Wife's $5 million basic exclusion amount less her $3 million taxable estate). Under the provision, Husband 2's Applicable Exclusion Amount is increased by $2 million, *i.e.*, the amount of deceased spousal unused exclusion amount of Wife."

Issues Raised By the Last Deceased Spouse Rule

Additional issues arise when Wife remarries after having made lifetime gifts in reliance on the DSUEA inherited from Husband 1.

For example, assume Wife's Applicable Exclusion Amount is $10 million (*i.e.* her basic $5 million exclusion plus Husband 1's unused $5 million exclusion). Wife makes a gift of $10 million in 2011 and pays no gift tax because of her inherited DSUEA. Years later, Wife remarries and Husband 2 predeceases her, leaving her with no inherited exclusion. At the time of Wife's subsequent death, wife's Applicable Exclusion Amount is now calculated with

reference to Husband 2 rather than Husband 1 because Husband 2 is the *last* deceased spouse. Since Husband 2 left no exclusion, the Applicable Exclusion Amount of Wife is limited to the Basic Exclusion Amount in effect for the year of her death. In calculating Wife's estate, therefore, it appears that the $10 million of gifts made in reliance on Husband 1's DSUEA must be added back even though the Applicable Exclusion Amount applied in calculating Wife's estate tax would be limited to the Basic Exclusion Amount (*i.e.* her $5 million, plus inflation adjustments). The end result is that Husband 1's $5 million of DSUEA (less the amount of any inflation adjustments to Wife's basic exclusion amount) is "clawed back" into her estate and subject to estate tax upon her death.

We do not believe that Congress intended this result. First, consider the converse situation: Many individuals made gifts prior to 2010 when the gift tax exclusion was $1 million and paid gift tax on the "excess" gifts. Although the gift tax exclusion later increased to $5 million, these individuals did not become entitled to a refund. If an individual is not entitled to a refund of gift tax after a retroactive *increase* in the exclusion amount, he should not be subject to estate tax after a retroactive *decrease* in the exclusion amount. Second, the purpose of the portability rule is to simplify the use of the exemption, not to create a trap for the unwary. If Congress chooses to make the statute permanent, therefore, we recommend that it clarify that gifts made during life in reliance upon DSUEA available to Wife at that time will not become subject to future estate tax if Husband 2 predeceases Wife.[15]

Assume the same facts except that Wife's gift of $10 million utilizing the DSUEA inherited from Husband 1 occurs in 2012, months before Husband 2's death. At the time Wife

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[15] See also, "Portability – Part One," American Bar Association Estate and Gift Tax Committee in coordination with other committees of the Income and Transfer Tax Planning Group of the Section of Real Property Trust & Estate Law," Examples 8-15, pp. 18-26.

makes the gift, she expects to pay no gift tax. However, since Section 2505(a) states that for gift tax purposes the unified credit shall be the Applicable Credit Amount in effect at the end of the calendar year, Wife's Applicable Exclusion Amount would be calculated with reference to Husband 2, not Husband 1, even though she relied on Husband 1's DSUEA at the time of the gift. The result is that Wife owes transfer taxes on the $10 million gift. We believe that this too is an unintended result and recommend that Section 2505(a) be amended for this purpose to provide that the date of gift, rather than the end of year rule applies for purposes of determining the gift tax consequences of a gift made by an individual who has inherited exclusion on the date of the gift.[16]

Clarification Regarding Gifts on which Gift Tax was Paid

As stated above, Example 1 provides a clear and accurate description of how to calculate the DSUEA that Wife inherits upon the death of Husband 1. In that example, Husband 1 died in 2011, having made $3 million of gifts and having no taxable estate, leaving Wife a DSUEA of $2 million. This example assumes that Husband 1's gifts were made in 2011 and therefore were not subject to gift tax, reducing his $5 million Basic Exclusion by the $3 million of gifts.

But what if Husband 1 had made his $3 million of gifts in 2008 at a time when the gift tax exclusion was only $1 million and therefore paid gift taxes on $2 million? Presumably in this instance Husband 1 should be viewed as having used $1 million of exclusion, leaving $4 million of available exclusion for his Wife. As drafted, however, the current statute does not support this result.

[16] In all examples in this report, we have assumed that the portability rules are in effect in all years and that the executor of the estate of each predeceased spouse validity elected to allow the decedent's surviving spouse to use the deceased spouse's unused exclusion amount.

Section 2010(c)(4) states that the DSUEA is the lesser of (A) the Basic Exclusion Amount or (B) the excess of (i) the Basic Exclusion Amount of the surviving spouse's last deceased spouse, over (ii) "the amount with respect to which the tentative tax is determined under section 2001(b)(1) on the estate of such deceased spouse." The requirement in Section 2010(c)(4)(B)(ii) that the last deceased spouse's Basic Exclusion Amount be reduced by "the amount with respect to which the tentative tax is determined under section 2001(b)(1) on the estate of such deceased spouse" ignores the fact that the last deceased spouse paid gift tax on transfers that exceeded the Applicable Exclusion Amount in effect at the time of the gift, yet died with unused exclusion as a result of a subsequent statutory increase in the Applicable Exclusion Amount.

One of the policy objectives of portability is to leave the surviving spouse in the same position she could have achieved with estate planning. Had Husband bequeathed his remaining exclusion amount to a by-pass trust for Wife and children at death, for example, the trust would have been funded with $4 million. Nevertheless, the amount of DSUEA available to Wife in this example is reduced by Husband's entire $3 million adjusted taxable gift, including the portion on which gift tax was paid because no Applicable Exclusion Amount was available. If portability is made permanent or extended, we believe that Section 2010(c) should be revised to clarify that taxable gifts made by a last deceased spouse on which gift tax was actually paid are excluded from the amount specified in Section 2010(c)(4)(B)(ii).

<u>Summary</u>

Unless extended, portability of the estate tax exclusion will sunset on December 31, 2012. In this report, we have recommended several changes to the existing statute that we believe better serve the basic policy objectives of the current portability rules, all based on the

assumption that it is extended beyond 2012. Specifically, we recommended that (i) any revised statute retain rather than modify the current definition of DSUEA, (ii) Example 3 from the 2010 JCT Explanation be revised to conform to the unmodified definition of DSUEA, and (iii) any revised statute clarify that taxable gifts on which gift tax was paid by the last deceased spouse are excluded from the Section 2010(c)(4)(B)(ii) amount. We have also recommended that any revised statute clarify certain issues a surviving spouse would face concerning the amount and use of the DSUEA if he or she were to remarry after a valid portability election is in effect.