Portability of the Estate Tax Exemption
Is the “Sweetheart Will” Back?

By Muriel Irwin Nichols, JD

A dvisors typically spend many hours educating clients on why they should not do “sweet-heart wills” under which spouses leave everything to each other. Because this is often the desire of many testators, it is the advisor’s job to explain the dire consequences of failing to set up a by-pass or credit-shelter trust at the first death so the decedent’s estate-tax exclusion amount would not be wasted, and the necessity of re-titling assets in the poorer spouse’s name to accomplish that result. With portability, it may seem the client and advisor no longer need to worry about by-pass trusts and re-titling of assets. However, with portability there now are more choices. What was supposed to simplify planning for married couples has resulted in additional complexity.

What is Portability?
Portability allows the first spouse to die to transfer any unused estate-tax exclusion amount to the surviving spouse. Portability was first introduced by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, which was set to expire in two years. At the 11th hour, on January 1, 2013, the U.S. Congress passed the American Tax Relief Act of 2012 that was signed by President Barack Obama on January 2, 2013, which made portability permanent. Portability provides that if the first spouse to die does not use all of his or her full estate and gift tax exclusion (which is $5.25 million in 2013), the surviving spouse may use it either by making lifetime gifts or at his or her subsequent death. The amount has become known as the deceased spouse’s unused exclusion amount (DSUE). The DSUE amount is equal to the deceased spouse’s basic exclusion amount in the year of his or her death, less the amount of such exclusion utilized by the deceased spouse during his or her life and at his or her death. For example, if a wife died in 2013 leaving an estate of $2 million after having made lifetime gifts of $1.5 million, she would have used up a total of $3.5 million of her exclusion amount during her life and at her death. With a total exclusion amount in 2013 of $5.25 million less the $3.5 million used by the deceased, her estate could transfer her remaining $1.75 million of unused exclusion amount to her surviving husband.

Why Not Use a Sweetheart Will and Leave Everything to the Spouse?
With portability, the survivor can use the decedent’s DSUE amount plus his or her own exclusion to make lifetime gifts as well as shelter assets at the second death of up to $10.5 million. This sounds like a great deal, and for many smaller estates, relying on portability could work well.

However, although the federal exclusion is portable, state estate-tax exemptions are not. Sixteen states have estate taxes with exemptions ranging from $675,000 to $5.25 million, with most exemptions frozen at $1 million. Thus, if a credit-shelter trust is not set up for the survivor at the first death, the state exemption will be wasted and an extra tax may be unnecessarily incurred at the second death. In a state with a $1-million state estate-tax exemption, the tax on a survivor’s $4-million estate would be $280,000. If his or her predeceased spouse had set up a by-pass trust for the survivor of $1 million, leaving only $3 million in the survivor’s estate, the tax would be $182,000—a savings of $98,000. There would be additional savings if the trust property appreciated in value.

The generation-skipping tax (GST) exclusion also is not portable. To maximize the GST exclusion (currently $5.25 million in 2013 less any previous GST gifts), it must be used by the first spouse, either by gifts during life or by creating a trust for the survivor and/or descendants to which GST exemption is allocated. If it is not used by the first spouse, the survivor will have only his or her own GST exemption to shelter assets from the GST tax. Trusts to which the GST exemption has been allocated can avoid estate taxes and GST taxes (currently at a 40-percent rate) for many generations.

A trust created at the first death will (hopefully) appreciate during the period between the first and second deaths. That appreciation will be out of the survivor’s estate. The exemption amount is frozen in the year of death and will not increase with inflation. This may not be a concern for very elderly clients.

It may be important to include children or other beneficiaries as current beneficiaries of a by-pass trust even if no outright gifts are made. This is typical in a second marriage where there are children from a previous marriage.

Trusts created at the first death provide creditor and divorce protection. Traditional non-tax reasons for creating trusts for the survivor apply here as well. Although a single marital trust...
can be created, benefits cannot be terminated on remarriage and all net income is required to be paid to the surviving spouse.

The exclusion amount may be reduced in the future. President Obama already has proposed lowering the estate-tax exclusion amount to $3.5 million. Also, there is no assurance that portability will remain in the law when the second spouse dies.

Remarriage may cause loss of the survivor's DSUE amount received from the first spouse if the new spouse also predeceases the survivor. It is only the last spouse's DSUE that can be used at the survivor's death. So if the survivor remarries a person who has made large taxable gifts or who leaves more than the applicable exemption to other family members, the survivor's potential DSUE amount will be reduced. However, if the survivor is wealthy enough, using up the first deceased spouse's DSUE amount by making taxable gifts prior to the new second spouse’s death, such gifts will preserve that benefit. When making lifetime gifts, the survivor is deemed to use the DSUE amount first prior to his/her own basic exclusion amount.

Some interesting possibilities result from these rules: please see table 1.

Harry Married Sally. Harry dies in 2011 when the applicable exclusion amount was $5 million. He leaves his $2-million estate to his children from a previous marriage. His executor elects portability for the remaining $3 million by filing an estate tax return. Sally now has a $3-million DSUE amount plus her own $5.25-million basic exclusion amount.

Why Might One Want to Rely on Portability?

Clients whose estates include large qualified retirement plans or individual retirement accounts (IRAs) often do not want to use the plan proceeds to fund a credit-shelter trust because of high trust income tax rates. Retirement plan and IRA proceeds are ordinary income and the highest income tax rate of 39.6 percent applies to trust income of more than $11,950. Designating a trust as beneficiary also can make it difficult or impossible to "stretch" the payouts for income-tax planning purposes over the lives of younger-generation beneficiaries.

Homes are often a major planning asset. Spouses may not want to leave the home (or an undivided interest in the home) in trust for the survivor. Having a step-up in basis on the whole property at the second death or qualifying for the $500,000 or $250,000 capital-gain exemption when the primary residence is sold also may be important.

Assets in a by-pass trust do not get a step-up in basis at the second death for capital-gains tax purposes. Getting a double step-up may be valuable for survivors where the estate is well under $10.5 million and there is a likelihood of substantial appreciation.

Often a wealthy spouse with substantial assets simply does not want to transfer assets to the poorer spouse, especially now that the exclusion amount is $5.25 million.

Clients with small estates or clients who are quite elderly and are looking to leave their estates outright to their heirs may wish to use portability.

For those procrastinators who never did any planning in the first place or failed to properly re-title assets, failed to revise very old documents did any planning in the first place or failed to properly re-title assets, portability can be very valuable when the advisor is in clean-up mode.

How to Elect Portability

The executor must elect portability affirmatively on a timely filed federal estate tax return that computes the unused exclusion amount. The federal

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**TABLE 1: HARRY MARRIED SALLY**

<table>
<thead>
<tr>
<th>Scenario 1</th>
<th>Scenario 2</th>
<th>Scenario 3</th>
<th>Scenario 4</th>
<th>Scenario 5</th>
<th>Scenario 6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sally dies in 2013 (without remarrying)</td>
<td>Sally remarries Lance who has used all but $1 million of his exclusion amount</td>
<td>Sally remarries Lance who has used all but $1 million of his exclusion amount</td>
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<tr>
<td>Sally dies in 2013</td>
<td>Lance dies in 2012 and his executor makes the portability election</td>
<td>Sally makes $3 million of gifts in 2012 before Lance's death in 2012</td>
<td>Sally dies before Lance in 2013</td>
<td>Sally dies before Lance in 2013</td>
<td>Sally dies before Lance in 2013</td>
</tr>
<tr>
<td>Sally dies in 2013</td>
<td>The gifts are deemed to come first from Harry's DSUE amount</td>
<td>Sally uses her entire $8.25 million of exclusion amount</td>
<td>Sally uses $2 million of her $8.25 million exclusion amount</td>
<td>Sally uses $2 million of her $8.25 million exclusion amount</td>
<td>Sally uses $2 million of her $8.25 million exclusion amount</td>
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<tr>
<td>Sally has $8.25 million of exclusion amount</td>
<td>Sally has $8.25 million of exclusion amount</td>
<td>Sally has $6.25 million of exclusion amount plus made gifts of $3 million</td>
<td>Sally has $1 million of exclusion amount</td>
<td>Sally has $1 million of exclusion amount</td>
<td>Sally has $6.25 million of exclusion amount</td>
</tr>
</tbody>
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*Lance’s own $1 million plus Sally’s basic exclusion amount of up to $5.25 million

Note: Previously taxed property credit is not considered.
Building in Flexibility

Many advisors are looking with increased interest at disclaimer planning. Under such a plan, the survivor may disclaim benefits left to him or her outright in favor of a credit-shelter trust at a time when the estate’s value and the tax regime are known. However, a disclaimer must be made within nine months after the death of the first spouse to die. Use of a single marital trust may permit the executor to make tax elections to qualify portions of the trust for the federal and state marital deductions and divide the trust without the need for the participation of the spouse. This determination can be made up to 15 months after the first death. The additional advantage of waiting for 15 months is that if the surviving spouse dies shortly after the decedent, planning can be done to maximize the tax benefits for both estates.

With the recent decision in United States v. Windsor, legally married same-sex couples in the 16 states and the District of Columbia that recognize same-sex marriage will be eligible for portability as well. All in all, portability, although adding complexity, is a positive development for clients and their advisors.

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References


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