PERMANENT PORTABILITY UNDER THE AMERICAN TAXPAYER RELIEF ACT OF 2012: PROMISED LAND OR PITFALLS?

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Hooray! Life just got easy!

We’ve reached the promised land of permanent portability milk and honey!!
Or have we instead just gotten a carton of sour milk?
Some Definitions To Get Us Started

- **S1**: First spouse to die.
- **S2**: Surviving and second spouse to die.
- **Portability (simplified)**: The ability of S2 to utilize S1’s unused (leftover) gift and estate tax exemption.
- **Basic Exclusion Amount**: $5.25 million for 2013, adjusted up for future inflation.
More Definitions

- **Deceased Spousal Unused Exclusion Amount ("DSUE amount"):** S1’s gift and estate tax exclusion available for S2 to apply during life or at death against those taxes. (The is the essential feature of Portability).

- **Applicable Exclusion Amount ("AEA"):** the sum of the Basic Exclusion Amount and the DSUE amount.
Portability: Brief Background

- Portability was enacted effective for S1’s who died after December 31, 2010.
- It was set to expire on December 31, 2012, but it didn’t.
- Portability was made “permanent” by ATRA of 2012 (really enacted in 2013).
Why is Portability important?

- Portability is now a fundamental factor that we must understand, consider, and address in every married couple’s estate planning (N/A to single persons)

- When there is a possibility, even if remote, of federal estate tax imposition on either spouse’s estate.
Our New Dilemma (Oversimplified)

Traditional Approach vs. Portability
Traditional Marital Estate Planning (Pre-Portability)

- **S1 dies and leaves assets behind:**
  - First in a By-Pass Trust to the extent of S1’s unused gift and estate tax exemption (for benefit of surviving spouse and descendants) and
  - Remainder in a Marital Trust (usually a “QTIP Trust” for benefit of surviving spouse during life, then to descendants outright or in further trust).
Rationale for Use of By-Pass Trust

- By-Pass Trust:
  - Uses up as much of S1’s estate tax exemption as possible,
  - So assets in the trust are exempt from estate tax at S1’s and S2’s deaths
  - (i.e., those assets “by-pass” S2’s estate and pass estate tax free).
Rationale for Use of Marital Trust

- Marital Trust:
  - Utilizes unlimited marital deduction
  - To avoid estate tax at S1’s death, and
  - Defers federal estate tax exposure until S2’s death.
Rationale for Use of Marital Trust (Continued)

- Upon S2’s death, assets from S1 may have been used up (consumed) leaving little to no estate tax liability for the Marital Trust.

- At a minimum, assets from S1 can grow federal estate tax free until S2 dies (and then may be covered by S2’s exemption).
What does Portability add?

- Instead of the complicated traditional structure, S1 at death could pass his assets to S2 estate tax free because of the unlimited marital deduction.

- At S2’s death, both S1’s DSUE amount and S2’s estate tax exemption could be used to avoid estate tax (exemptions currently total $10.5 million).
Ok, so it’s easy now, right?
Everyone is happy?
Reasons to Continue Using Traditional Plan (vs. Portability)

- No estate tax exposure on By-Pass Trust assets at S2’s death:
  - Assets S1 leaves behind likely will appreciate in value.
  - But, DSUE amount is not indexed for inflation to cover that appreciation.
  - By-Pass Trust insures no estate tax at S2’s death on assets in that trust.
Reasons to Continue Using Traditional Plan (vs. Portability)

- **Asset Protection:**
  - Assets in trusts can be protected from S2’s and other beneficiaries’ creditors (but would not if they passed outright).
  - (Don’t forget potential for S2 to remarry and have assets exposed to new spouse’s rights, e.g., elective share and equitable distribution).
Reasons to Continue Using Traditional Plan (vs. Portability)

- Asset Management:
  - By-Pass Trust and Marital Trust assets can be managed by independent, professional trustees (and money managers).
Reasons to Continue Using Traditional Plan (vs. Portability)

- **S1 Can Control Ultimate Asset Disposition from By-Pass and Marital Trusts:**
  - And the trusts’ beneficiaries (S2 and descendants) can be protected from undue influence from:
    - Greedy family members,
    - Late-in-life caretakers,
    - New spouses,
    - Etc.
Reasons to Continue Using Traditional Plan (vs. Portability)

- S1’s GST Exemption Can Be Fully Utilized:
  - GST exemption is not portable between spouses.
  - By-Pass Trust enables use of S1’s GST exemption to exempt from estate tax assets passing to grandchildren and later generations.
Reasons to Continue Using Traditional Plan (vs. Portability)

- Privacy for S1 versus S2 and others:
  - To “port” the DSUE amount to S2, S1’s estate has to file a federal estate tax return, even if otherwise not required because estate value below AEA. S2 is entitled to know about it.
  - With traditional approach, if S1’s estate is below the AEA, no return is due (other than to elect Portability for any unused credit) and S1’s privacy can be preserved.
Reasons to Use Portability Instead

- At S2’s death, because assets from S1 are exposed to estate tax there is a tax free basis step up (appreciation presumed) to fair market value:
  - Even though those assets are protected from estate tax by S1’s DSUE amount.
  - Most folks cite this as the “BIG” difference in favor of Portability.
Reasons to Use Portability Instead

- Can avoid estate tax on S1’s assets passing to S2 outside of S1’s will or revocable trust:
  - (And thus not through the By-Pass or Marital Trusts)
  - E.g., life insurance death benefits and JTWROS or tenants by the entireties properties
Reasons to Use Portability Instead

Avoid estate tax on income in respect of decedent assets (IRC § 691):

– E.g., retirement benefits like IRAs, deferred annuities, etc.

– Those assets aren’t good choices to fund By-Pass Trust because of inherent income tax exposure, but typically can pass to S2 without immediate income tax imposition.
What about gift tax planning with Portability?

- Treasury Temp Regs 6 20.2505-2T(b):
  
  — When S2 makes a gift, DSUE amount of “last deceased spouse” at time of gift is applied first, before S2’s exemption.
Gift Tax Planning with Portability

- How to remember the rule of whose AEA goes first? Similar to inventory methods FIFO and LIFO:
  - "FIGLAG"
  8 "First in the Ground" (S1): "FIG"
  8 Then, "Last Above Ground" (S2): "LAG"
Gift Tax Planning with Portability

Without that Temp Reg, if S2 remarried, the DSUE amount from S1 could evaporate if S2’s new spouse (S3) died before S2.
Gift Tax Planning with Portability

- **Temp Regs Effect:**
  - Even if S2 had multiple spouses and
  - S2 made taxable gifts relying on S1’s DSUE amount (before S3 dies),
  - S2 will get benefit of S1’s DSUE amount because S1 was “last deceased spouse” **at time of S2’s gifting.**
And, the estate tax effect:

- S2’s AEA upon S2’s death will include both:
  - DSUE amount of “last deceased spouse” and
  - S2’s own remaining estate tax exemption.
Key Conceptual Differences: Traditional vs. Portability

- With traditional (By-Pass/Marital Trusts) plan, S1’s estate tax exemption had to be fully utilized during life or upon death (through the By-Pass Trust).

- With Portability (and reunification of gift and estate tax exemptions), both S1’s and S2’s exemptions can be used anytime up through S2’s death. Nice!!
Can we have the best of both Traditional and Portability?

- When S1 dies, assets that otherwise would have gone to a By-Pass Trust instead can be put into a Marital Trust,

- Personal Representative makes:
  - QTIP election,
  - Reverse QTIP election (as to GST exemption) and,
  - Portability election.
Results

- **QTIP Marital Trust can provide:**
  - Asset Protection
  - Asset Management

- **Reverse QTIP election provides:**
  - Virtual porting of GST exemption

- **S1 can control asset disposition at S2’s death**
A Sweetener

- Give S2 power to disclaim assets into a by-pass trust:
  - Avoids QTIP mandatory annual income distributions to S2 during S2’s lifetime, and
  - Avoids QTIP lifetime principal distributions only to S2 during S2’s lifetime.
  - Thus, could allow income and principal to descendants during S2’s lifetime (including potential lowering of income taxes).
Our Challenge Now

- Applying the myriad variables of a particular married couples’ estate planning situation to yield a credible comparison of the pros and cons of traditional planning versus Portability.
Among the Factors to Consider

- Size and make up of spouses’ net worth.
- Projected longevity/mortality of each spouse: *E.g.*, how much longer do we expect them to live?
- What asset appreciation and income production rates over that period?
- What rate of consumption of income and wealth over that period?
- What federal (and state?) income tax rates (OI, LTCG, etc.) do we expect to apply to income earned in the traditional plan trusts versus outright?
Among the Factors to Consider

- What increases do we project in the AEA over the relevant time period?
- What gifts will the couple make during life?
- How permanent is the $5.0 million exemption floor?
- Any state death tax exposure?
But Consider . . .

- Given our volatile political and economic environments, is Portability really permanent?

- Will transfer tax laws become less favorable toward married couples if the USSC holds that the right to marry is not limited to one man and one woman as husband and wife?
To live happily ever after in the new "Promised Land" of Portability

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Final Thought

Outside of a dog, a book is a man’s best friend. Inside of a dog, it’s too dark to read . . . Groucho Marx