Evaluating Portability, Potential Problems and the Post-ATRA Planning Paradigm

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ATRA 2012 (pp. 1-2)

- New "Permanent" Unified Transfer Tax System
  - $5,000,000 Exemption for Gift, Estate and GST Tax
  - Indexed for Inflation
    - $5.12 million for 2012; $5.25 million for 2013;
    - $5.34 million for 2014; **$5.43 million for 2015**
  - 40% Rate on Excess
- Income Tax Rates are Higher
  - Trusts and Estates hit the top bracket at $12,150 for 2014; $12,300 for 2015
  - Not part of ATRA, but 3.8% additional NII tax
- Portability is Now Permanent

The Analysis Has Changed

- Ordinary income tax rates exceed estate tax rates
- High capital gain rates (23.8%) make basis more important
- High estate tax exemptions make estate tax savings illusory for most people
- The definition of "married couple" has changed
- For couples in the $2 to $10 MM range, is the complexity and federal income tax exposure worth trust's non-tax benefits?

Portability (pp. 2-12)

- Allows Surviving Spouse to "Inherit" Unused Gift and Estate Tax Exemption of Deceased Spouse
- Enacted in 2010; Made Permanent by ATRA 2012
- Vocabulary: (p. 2)
  - "Basic Exclusion Amount"
  - "Applicable Exclusion Amount"
  - "Deceased Spousal Unused Exclusion Amount" ("DSUE" Amount)
  - "Executor"
  - "Last deceased spouse"

Example 1: (p. 4)

- H Dies in 2011 with $3 million estate
- $2 million to spouse; $1 million to children
- DSUE Amount available to W = $4,000,000
  - $5,000,000–$1,000,000=$4,000,000
- Wife's 2011 Applicable Exclusion=$9,000,000
  - Basic Exclusion Amount: $5,000,000
  - DSUE Amount: <u>$4,000,000</u>
  - Applicable Exclusion: $9,000,000
- Wife's 2015 Applicable Exclusion=$9,430,000
  - Basic Exclusion Amount: $5,430,000
  - DSUE Amount*: <u>$4,000,000</u>
  - Applicable Exclusion: $9,430,000

*DSUE Amount does not adjust for inflation

Temporary and Proposed Regulations

- Making the Election
  - Timely Filed Estate Tax Return (pp. 3-4)
  - "Complete and Properly Prepared" Return (No Short Form, but . . .) (pp. 4 and 5)
  - "Executor" to Make the Election (or Opt Out of Election) (p. 4)
- Computation of DSUE Amount (pp. 5-6)
  - DSUE Amount is <u>Lesser</u> of:
    - Basic Exclusion Amount; or
    - The Deceased Spouse's *Applicable* Exclusion Amount, less taxable estate (including adjusted taxable gifts)

Example 4: (p. 6)

- H1 dies in 2011 with \$2 million DSUE Amount
- W's Applicable Exclusion = \$7 million
- W makes gift of \$1,500,000
  - W's Applicable Exclusion then \$5,500,000
- W remarries and predeceases H2, leaving all to H2
- DSUE Amount passing to H2=\$5,000,000:
  - W'sBasic Exclusion Amount: **\$5,000,000**
  - *W's Applicable Exclusion*: \$7,000,000
  - Less Taxable Gifts: \$1,500,000
  - Unused Applicable Exclusion Amount: **\$5,500,000**
  - DSUE Amount (lesser of BEA or unused AEA) \$5,000,000

Example 5: (p. 6)

- W makes taxable gifts of \$6 million while married to H1, paying gift tax on \$1 million
- H1 dies leaving \$5 million DSUE Amount
- Under the Statute
  - Basic Exclusion Amount: \$5,000,000
  - Plus DSUE Amount: \$5,000,000
  - Less Taxable Gifts: \$6,000,000
  - Remaining Exclusion: **\$4,000,000 –BUT . . .**
- Under the Regulations
  - Basic Exclusion Amount: \$5,000,000
  - Plus DSUE Amount: \$5,000,000
  - Less Taxable Gifts: \$5,000,000*
  - Remaining Exclusion: **\$5,000,000 –awesome ☺**

***Exclude any amount on which gift taxes were paid**

Temporary and Proposed Regulations (cont.)

- Last Deceased Spouse (p. 6)
  - Remarriage by itself is okay (so long as new spouse survives)
  - Measured at time of gift by surviving spouse
- Using the DSUE Amount (pp. 6-7)
  - Can be used (with caution) immediately after death
  - Early use ensures post-gift appreciation removed from tax, but must be sure that election is made, etc.
- Ordering Rule (p. 8)
  - Gifts by Surviving Spouse use DSUE Amount first
  - Very favorable construction maximizes DSUE benefit

Examples 7-8: (p. 7)

- W dies on June 2, 2011 leaving her entire estate to H
- In July, H makes taxable gift of $7 million
- On March 1, 2012, W's executor timely elects to extend the filing of W's estate tax return until September 2, 2012
- On April 15, 2012, H files a gift tax return claiming W's $5 million DSUE Amount
- If W's executor elects portability on an estate tax return, filed by September 2, 2012, H may use DSUE Amount

Examples 9-10: (p. 8)

- W1 dies in January 2011 leaving her entire estate to H
- H marries W2 in February 2011
- H makes $7 million taxable gift in March 2011
- W2 dies in June 2011
- If W1's executor elects portability, H may use W1's DSUE Amount for gift
  - W1 was his "last deceased spouse" on date of gift
- H cannot use W2's DSUE Amount
  - W2 was not his last deceased spouse on date of gift

Portability Quiz:

- H1 dies with $2 million estate payable to children. H1's executor elects portability so $3 million DSUE Amount passes to W.
- W now has an $8 million AEA; she marries H2
- W dies with an estate of $1 million passing to her children. W's executor elects portability
- What DSUE Amount Does H2 Receive from W?
  - $7 MM (W's $8 MM AEA less her $1 MM TE)?
  - $4 MM (W's $5 MM BEA less her $1 MM TE)?
  - $5 MM (Lesser of (i) W's $5 MM BEA or (ii) W's $8MM AEA less her $1 MM TE

Applicable Exclusion Using DSUE From Multiple Deceased Spouses

- H1 dies leaving $5 million DSUE Amount to W
- W's Applicable Exclusion = $10 million
- W makes taxable gift of $2,000,000
  - W's Applicable Exclusion then $8,000,000
- W marries H2 who dies leaving $2 million DSUE Amount to W and W then dies
- W's Applicable Exclusion=$9,000,000

◦ W's Basic Exclusion Amount still:	$5,000,000
◦ H1's DSUE Amount applied to W's gifts:	$2,000,000
◦ H2's unused DSUE Amount	$2,000,000
◦ W's applicable exclusion amount	$9,000,000

Example 12: (p. 9)

- H1 dies in 2011 with $5 million DSUE Amount
- W's Applicable Exclusion = $10 million
- W makes gift of $5,000,000
  - Applicable Exclusion then $5,000,000
- W marries H2 who dies with $5 million DSUE Amount passing to W
- W makes another gift of $5,000,000
  - Applicable Exclusion then $5,000,000
- W marries H3 and W dies
- W's executor may elect portability, so DSUE Amount to H3=$5,000,000!
  - Prior gifts covered by DSUE Amounts from H1 and H2
  - W's Basic Exclusion Amount still $5,000,000

Portability and State Death Taxes

- 19 States and DC have a state estate and/or inheritance tax
- States with Portability of Excess State Exemption
  - Hawaii
  - Delaware
  - Maryland (after 2019)

Portability and State Death Taxes

- Consider State Death Tax Bypass Trusts
- Example: State with $1 million exemption—H dies with estate of $6 million
- State with state-only QTIP Trust:
  - $1 million passes to Bypass Trust
  - $4 million passes to state-only QTIP Trust
  - $1 million passes to federal and state QTIP Trust
  - Executor makes all state and federal QTIP elections
- State with no state-only QTIP Trust
  - $1 million passes to Bypass Trust
  - $5 million passes to QTIP Trust
  - Executor makes federal QTIP *and portability* elections
- Result in either case: Full transfer tax deferral and preservation of both state and federal exemptions

Non-Resident Issues (p. 9)

- Non-resident Aliens Cannot Leave DSUE Amount
  - No portability election available
- Non-resident Alien Surviving Spouse Cannot Use DSUE Amount (Unless Allowed by Treaty)
- Final DSUE Amount When Using QDOT Trust Not Measured Until QDOT Terminates

Example 13: (p. 10)

- H makes $1 million gift during lifetime
- H dies in 2011 with $2 million estate, passing $1.5 million to QDOT—executor elects QDOT and portability
- H's *preliminary* DSUE Amount is $3,500,000:
  - H's Applicable Exclusion Amount: $5,000,000
  - Less Taxable Gifts: $1,000,000
  - Less Taxable Estate $ 500,000
  - Preliminary DSUE Amount: **$3,500,000**
- W dies when QDOT is $1,800,000
- H's *final* DSUE Amount is $1,700,000:
  - H's Applicable Exclusion Amount: $5,000,000
  - Less Taxable Gifts: $1,000,000
  - Less Taxable Estate $2,300,000*
  - Final DSUE Amount: **$1,700,000**
  - *H's taxable estate of $500,000 augmented by QDOT of $1,800,000

Observations About Portability

- Gifts Using DSUE Amounts from Multiple Deceased Spouses is Permitted
- Consider Authorizing (or Directing) Executor to File Form 706 at Surviving Spouse's Request
- Consider Addressing DSUE Amount in Pre- or Post-Nuptial Agreements (See Exhibit B)
- Must File Timely Estate Tax Return
  - Rev. Proc. 2014-18
  - Possible 9100 relief
- **You MUST Discuss the DSUE Election** with Every Executor of a Married Decedent **and DOCUMENT the Discussion** and Decision about Filing (Exhibit C)

Outright to Spouse + Portability vs. Trust Planning (pp. 12-13)

- Need to Elect by filing IRS Form 706
- No Creditor or Divorce Protection for Surviving Spouse
- Spouse May Dispose of Inherited Assets
- No Estate Tax Shelter for Appreciation
- No Portability of GST Exemption
- Possible Loss on Remarriage
- REMEMBER: You Must Still Consider the Portability Election, Even if Trust Planning Used

A New Estate Planning Paradigm
(pp. 12-19)

- Are Bypass Trusts Out? (p. 12)
  - No basis adjustment at second death
  - High income tax rates on accumulated income
  - Special assets
    - Retirement Plans
    - Residences
    - S-corps and other pass-through entities
  - Disclaimer bypass trusts (p. 13)
    - Adds flexibility to the estate plan
    - At cost of special power of appointment

Why We Still Use Trusts (p. 13-15)

- Control of Assets
- Creditor Protection
- Divorce Protection
- Protection of Government Benefits
- Protection from State Inheritance Taxes
- Income Shifting
- Shifting Wealth to Other Family Members
- No Inflation Adjustment for DSUE Amount
- Risk of Loss of DSUE Amount
- No DSUE Amount for GST Taxes
- Must File Estate Tax Return for Portability

Is All to QTIP the Solution? (pp. 15-18)

- Contrast QTIP Trusts (p. 15)
  - Creditor/Divorce Protection
  - Less Retained Income for Compressed Tax Brackets
  - New Cost Basis at Second Death (if QTIP elected)
  - Preserve GSTT Exemption (by "reverse" QTIP Election)
  - No Estate Tax Savings (but DSUE Amount available)
- QTIP Drawbacks (p. 16)
  - No "Sprinkle" Power
  - Estate Tax Exposure
  - High Income Tax Rates
  - The Rev. Rul. 2001-38 Problem (p. 17)
  - *Clayton* QTIPs (Exhibit D)
  - The QTIP Tax Apportionment Trap (p. 18)

Example 24: (p. 18)

- H dies leaving $10 million estate to QTIP Trust
- H's executor makes QTIP and portability elections
- W's Applicable Exclusion = $10 million
- W makes gift of $10,000,000 to her children
  - Applicable Exclusion then $0
- W dies with $10 million in QTIP trust
- QTIP Trust owes estate tax of $4,000,000
- H's children receive only $6,000,000

The "LEPA" Trust (p. 19)

- Life Estate Power of Appointment Trust
- All Income to Spouse-Like QTIPs
- No Need to File an Estate Tax Return
- Spouse Must Have Unrestricted GPA to Appoint to Self or Estate
  - Inter vivos vs. Testamentary
- Automatic Basis Adjustment at Death
- BUT:
  - Spouse may appoint assets elsewhere
  - Possible creditor exposure—inter vivos vs. test.?
  - No "reverse LEPA" election for GST Tax purpose

Clients' Estate Planning Goals

	Outright to Spouse	All to Bypass Trust	All to QTIP Trust	All to LEPA Trust
Keep it Simple	Y	N	N	N
Creditor/Divorce Protection	N	Y	Y	Y/N
Control Ultimate Disposition	N	Y	Y	N
Management Assistance	N	Y	Y	Y
Sprinkle/Spray to Kids, etc.	N*	Y	N	N
Preserve GST Exemption	N	Y	Y	N
Avoid High Trust Income Taxes	Y	N	Y**	Y**
Avoid Estate Tax on Appreciation	N	Y	N	N
New Cost Basis at 2nd Death	Y	N	Y	Y

*But enhanced gifting possible using DSUE Amount
**Due to less income accumulation, but no ability to shift income

Addressing Basis Issues (p. 19-21)

- K.I.S.S. and Rely on Portability?
  - Is it really simple?
  - Will clients file the return?
  - Risks and downsides to portability
- Creative Options to Create Basis (pp. 19-21)
  - Have Trustee distribute low-basis assets to surviving spouse (p. 20)
  - Draft to grant independent trustee broad distribution authority
  - Draft to give third party power to grant a general power
  - Draft to grant non-fiduciary power to appoint to spouse (p. 21)
  - Decant appreciated assets to estate-tax includable trust
  - Make a late QTIP election

The Optimal Basis Increase Trust ("OBIT") (pp. 22-24)

- Grant to Spouse a Testamentary GPA Over Only Non-IRD Appreciated Assets
  - Result: A "step-up" in basis, but not a step down
- Subject the Power to a Formula to Avoid Estate Tax When the Spouse Dies
- Designing the Formula is Not a Trivial Task
  - "Cascading" power over most appreciated assets"
  - See Exhibit E (in context of Delaware Tax Trap)
  - Complexity of administration
- Restrict the Exercise of the Power
- Testamentary GPA and Creditor Exposure

Springing the "Delaware Tax Trap"

(pp. 24-27)

- Need Only Grant Surviving Spouse a *Special* Power of Appointment ("SPA")
- Spouse *Exercises* SPA over Appreciated Assets to "Spring" the Trap
  - Must Exercise the power by granting a new power of appointment
  - New power must be exercisable "for a period ascertainable without regard to the date of the creation of the first power"
  - Common law: Granting someone a "presently exercisable general power" ("PEG power") does this
  - Sample Language (See Exhibit E)
- Exercise=Estate Tax Inclusion=Basis Step-Up!

The "Delaware Tax Trap" (cont.) (p. 24-27)

- Bypass Trust Language Only Requires Granting Special Power of Appointment
- Check Your "Rule Against Perpetuities" Savings Language
- Costs of Spring the Trap:
  - Assets subject to PEG Power holder's creditors
  - Trust income likely taxed to PEG Power holder
  - Distributions to others may be gift by PEG Power holder
  - Estate tax inclusion for PEG Power holder
    - No GST Tax exemption since estate tax inclusion
    - Assets may get step-up or step-down at PEG Power holder's death
- Moral: Choose your Power Holder Carefully