Avoiding malpractice under the new estate tax portability rules

By Robert J. Kolasa

The recent increase in the federal estate tax exclusion to the stratospheric heights of $5.34 million,[1] with a $4 million exclusion under the Illinois rules,[2] has dramatically shrunk the number of taxpayers subject to death taxes. Clients with property lower that these limits may justifiably decide not to plan for estate taxes in their respective wills and revocable living trusts. The heightened exclusions have reduced the estate tax responsibilities of many estate planning attorneys, as they have fewer clients with sufficient assets to run afoul of estate taxes in the first place.

Nevertheless, concluding that the client's assets are "too small" for estate tax planning may trigger malpractice concerns for practitioners because of the difficulties in predicting asset growth. A taxpayer worth $3 million may not need estate tax planning if asset values remain static, while the opposite conclusion prevails if such property doubles or triples in value. As explained below, estate tax portability exacerbates the importance of projecting appreciation in the surviving spouse's assets because of its "use it or lose it" feature requiring an election on a timely filed estate tax return shortly after the death of the first spouse. Not electing portability may trigger millions of dollars in additional estate tax liability, even for a seemingly small estate which later incurs explosive asset growth.

This article examines the estate tax portability rules and the sensitive filing deadlines which are needed to invoke its benefit. Of particular note is a special IRS relief provision expiring at the end of this year permitting a "late" portability election for certain decedents, including same-sex couples who were not eligible for portability under prior law. The failure to make a timely estate tax portability election now constitutes a dangerous malpractice trap for estate planners counseling surviving spouses.

The Need for Estate Tax Portability

Estate tax portability was created under the federal rules as a relief provision for married taxpayers not having the planning prowess to establish a credit shelter trust at the death of the first to die. Under prior law, fundamental estate tax planning for a married couple revolved around funding the credit shelter trust of the first to die with assets equal to the federal estate tax exclusion amount. Full funding would prevent "wasting" the exclusion of the first deceased spouse, which could result in higher estate taxes.

Traditional estate tax planning was turned on its head by estate tax portability, which permits the surviving spouse to capture the estate tax exclusion of the first deceased spouse without a credit shelter trust. For example, previously it would be an estate planning mistake for a married couple worth $10 million to hold their assets in joint tenancy because with all assets going to the surviving spouse, the first to die's federal estate exclusion would disappear without a credit shelter trust. Under the portability rules, such "wasted" exclusion (i.e., known as the "Deceased Spousal Unused Exclusion Amount" or "DSUE") can now be claimed by the surviving spouse for lifetime or testamentary use.

A drawback of estate tax portability is that it currently relates only to the federal estate tax exclusion and does not preserve "wasted" exclusions under the Illinois estate tax or federal generation skipping transfer tax ("GST"). For Illinois married couples whose combined assets are expected to exceed the $4 million Illinois estate tax exclusion amount, this means that in most cases proper planning still involves establishing a credit shelter trust soaking up all or a portion of the Illinois exclusion.[3] If the credit shelter trust is funded with less than the $5.34 million federal exclusion, the portability election should be considered for the portion of the federal exclusion not utilized.

Estate Tax Portability Rules

Under Code Section 2010(c)(4), DSUE is defined as the lesser of (i) the basic exclusion amount in the year of the decedent's death; or (ii) the excess of the applicable exclusion amount of the "last deceased spouse" less his or her taxable estate and adjusted taxable gifts. Since DSUE can be claimed only from a taxpayer's "last deceased spouse," the rules become somewhat hairy when a spouse remarries and either the surviving spouse dies before the new spouse, or the new spouse dies before the surviving spouse.

Understanding the DSUE computation can be accomplished by studying the following examples from the Joint Committee on Taxation:[4]

Example 1: Husband 1 dies in 2011 when the basic exclusion amount is $5 million, having made prior adjusted taxable gifts of $3 million with no taxable estate (thus the DSUE amount is $2 million, which is the difference between the $5 million exclusion and $3 million taxable gifts). An estate tax portability election is timely made on Husband 1's estate tax return. Accordingly, Wife's applicable exclusion amount is $7 million (her $5 million basic exclusion amount plus the $2 million DSUE), which she may use for lifetime gifts or for transfers at death.

Example 2 (new spouse dies before surviving spouse): Assume the same facts as in Example 1, except that Wife subsequently marries Husband 2. Husband 2 also predeceases Wife, having made prior adjusted taxable gifts of $4 million and having no taxable estate (Husband 2's DSUE amount is $1 million, which is the difference between the $5 million exclusion and $4 million taxable gifts). Only Husband 2's DSUE of $1 million can benefit Wife. The higher $2 million DSUE of Husband 1 is ignored since he no longer is the "last deceased spouse."

Example 3 (new spouse outlives surviving spouse): Assume the same facts as in Examples 1 and 2, except that Wife predeceases Husband 2 and has a taxable estate of $3 million. Wife's applicable exclusion amount is $7 million (her $5 million basic exclusion amount and $2 DSUE from Husband 1). An estate tax portability election is timely made on Wife's estate tax return. Accordingly, Husband 2's applicable exclusion amount is increased to $9 million (his $5 million exclusion, plus Wife's $4 million DSUE, which is the difference between her $7 million applicable exclusion amount and $3 million taxable estate).

Example #3 stirred tremendous attention and commentary from the estate planning community for its bizarre results and because the original statutory language was technically flawed requiring technical cor-

rections.[5] Husbands 1 and 2 are unrelated individuals not in "privity" who may not have even known each other. Nevertheless, Husband 2 benefits from Husband 1's unused $2 million estate exclusion because of its incorporation in Wife's DSUE computation. It pays to marry and survive a spouse with a high DSUE earned from a prior marriage, although the DSUE can never be higher than the basic exclusion amount.

Careful attention should be given whenever the surviving spouse possessing DSUE remarries. Example #2 illustrates the tragic downstroking of Wife's DSUE because Husband 2 (the "new" last deceased spouse) had a lower amount of unused exclusion than Husband 1. A planning technique to preserve the DSUE for remarrying surviving spouses is to make taxable gifts while such spouse and the new spouse are alive. This prevents dissipation of DSUE by the untimely death of the new spouse.[6]

The dark side of portability is that a new spouse's unused federal estate exclusion (which transmutes to DSUE upon death) becomes a relevant pre-marriage financial question. Is it proper lawyering to advise a client *not* to remarry if the "new" spouse has a lower DSUE than the "old" spouse? Should the poor spouse bargain in a prenuptial agreement to be compensated for this valuable asset? Will there be trafficking in DSUEs, generating internet dating ads such as "Love Starved Millionaire Needs Terminally Ill Bride to generate $5 Million DSUE?" For wealthy clients, Cupid's arrows may unavoidably become intertwined with estate tax and DSUE planning concerns.

Making the Portability Election

For a valid portability election, the executor generally needs to file a "complete and properly prepared"[7] estate tax return (Form 706) within nine months after the decedent's death, plus an additional 6 months if an extension is filed. A timely filed return will be deemed to have elected portability unless it is affirmatively stated on the return that the estate is not electing portability.[8] Even if the DSUE appearing on the deceased spouse's estate tax return is not challenged, the IRS can always revisit this computation upon the surviving spouse's death due to a special rule which extends the statute of limitations for this purpose.[9]

The IRS regulations provide that the court appointed executor or administrator of a decedent's estate has priority to make the portability election. If there is no appointed executor, any person in actual or constructive possession of the decedent's property (the "non-appointed executor") may file the estate tax return and elect portability. A portability election made by a non-appointed executor generally cannot be superceded by a contrary election made by another non-appointed executor.[10]

In most cases, it would seem that the surviving spouse will be in possession of enough assets of the deceased spouse to file the estate tax return and elect portability. However, in second marriage scenarios there may be differences of opinion between the surviving spouse and other family members whether the portability election is advisable. Since the court appointed executor has priority to make the portability election, the identity of the executor in the decedent's Will (or priority of family members to act as administrator) becomes critical. If there is no court appointed executor and the property is held by the surviving spouse and children, will there be a "race" to determine which group files the estate tax return first to fit under the priority set in the IRS regulations? The inquiry of who holds the key to make the portability election should generate interesting conflicts among dueling parties.

IRS Relief for Late Portability Elections

The IRS recently issued Rev. Proc. 2014-18, which provides generous relief provision for taxpayers who missed the 9 month (15 months with extension) filing deadline.[11] This procedure generally allows the executor until the end of this year to file Form 706 and elect portability if (i) the decedent died after December 31, 2010 and on or before December 31, 2013; and (ii) no estate tax return was required to be filed because the decedent's gross estate and adjusted taxable gifts are less than the Form 706 threshold filing requirement ($5 million for 2011; $5.12 million for 2012; and $5.25 million for 2013).

Rev. Proc. 2014-18 makes clear that this procedure was grounded in the recent Supreme Court decision in *United States v. Windsor*, 570 U.S. 12 (2013), which caused the IRS to recognize same-sex marriages for tax purposes. Since the case was decided more than two years after estate tax portability became effective in 2011, the executors of many decedents of same-sex marriages missed the election because it was contrary to IRS policy at the time the portability election deadline expired. The procedure generously allows missed portability elections to be made for *all* 2011-2013 decedents having assets below the return filing threshold and is not limited to same-sex marriages.

Accordingly, qualifying estates which may have inadvertently missed the portability filing deadline get a second bite at the apple if the portability election is made by December 31, 2014. The procedure also permits a refund of estate or gift taxes previously paid which is eliminated by the newly discovered DSUE. Best practices would be to review client files for *all* married clients dying after 2010 to determine whether the benefits of portability are worthwhile.

Malpractice Concerns and Prevention

At first glance, it is hard to imagine why the estate portability election is not automatically made for all taxpayers for whom an election is possible. By avoiding the election, the surviving spouse may forfeit DSUE potentially worth millions of dollars. Yet the preparation of an estate tax return can be a complicated and costly task which the surviving spouse may not want to fund, especially if the portability benefits are speculative. This rings true where the estate of the surviving spouse is not projected to generate federal estate taxes. But what such if projections are wrong and the assets balloon to a point where estate taxes (which are avoidable under a portability regimen) are due at the survivor's death?

For second marriages, where family members of the deceased spouse will not inherit from the surviving spouse, the decision of electing portability involves more than the cost of return preparation. Making the election imposes burdens relating to the open DSUE statute of limitations, which may trigger a friendly IRS audit of the deceased spouse's estate tax return decades after his or her death. The deceased spouse's executor arguably would be required to retain the return and all supporting documents relating to asset valuations until after the death of the surviving spouse. Also, what if the executor refuses to make the portability election? Is this omission a breach of fiduciary duty to the surviving spouse? If the spouse is not the executor can he or she petition the probate court for relief? The executor walks a litigation tightrope in balancing interests between the family of the deceased spouse

and the surviving spouse.

Planning can go a long way toward addressing possible family conflicts and mitigating malpractice concerns of the estate planner. The following strategies are suggested:

1. The planner should maintain a docket checklist of whether an estate will elect estate tax portability, with a decision to be made well before the end of the estate tax filing deadline.

2. If a decision is made not to elect estate tax portability, some documentation should be created acknowledging this decision. This could entail a written acknowledgment signed by the executor, surviving spouse and possibly beneficiaries. At a bare minimum, the attorney should correspond to the executor and surviving spouse that portability is not being elected.

3. If a decision is made to elect estate tax portability, deliberate whether documentation should be created cautioning clients about the pitfalls of portability (which include limitations relating to state estate taxes, the GST tax and post death appreciation). Additionally, the executor should be advised that he or she must maintain adequate records (generally the estate tax return and supporting appraisals) in case the DSUE amount is audited by the IRS in the future.

4. Consider addressing estate tax portability in the document preparation stage. Wills and trusts can be drafted which specifically dictate whether the executor will elect portability. It may make sense to provide that the surviving spouse who benefits from the portability election will pay all or a portion of the cost of the estate tax return electing portability. Premarital agreements can specifically address the portability election, including the requirement of parties to disclose prior lifetime gifts which affect the DSUE computation.

5. When representing a client in a second marriage, realize that estate tax portability is an economic asset that the parties may bargain for. In addition to paying for the cost of filing the estate tax return, the poorer spouse may ask that a QTIP trust (or outright gift) be established for his or her benefit as an inducement for the portability election. Also, the executor making the election should think about tendering the estate tax return and asset valuations to the surviving spouse, so this information is not somehow lost if an IRS audit subsequently occurs.

6. If a client has DSUE from a prior marriage and remarries, such DSUE evaporates if the new spouse dies before the DSUE is utilized. In such cases, ponder whether documentation should be created advising the client to consider making lifetime gifts before the new spouse dies in order to preserve such DSUE. ■

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1. The federal estate tax exclusion ("basic exclusion amount") was initially set at $5 million in 2011 but is adjusted annually for inflation under Section 2010(c)(3) of the Internal Revenue Code ("Code").

2. 35 ILCS 405/2(b).

3. It is debatable whether the credit shelter trust should be funded with up to the Illinois or federal exclusion amounts. If funded at the federal $5.34 million limit, there is no estate tax portability but an Illinois QTIP election for the $1.34 million "gap amount" difference between the federal and Illinois exclusions. Post death appreciation is excluded from the surviving spouse's estate, but the downside is that the gap amount assets do not get a stepped-up basis at the survivor's death. If funded at the Illinois $4 million limit, the $1.34 million gap amount is subject to the portability election and the gap amount assets get a stepped-up basis at the survivor's death, but the downside is that post death appreciation may be included in the survivor's estate.

4. Joint Committee on Taxation, Technical Explanation of the Revenue Provisions Contained in the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (JCX-55-10), December 10, 2010, at pages 52-53.

5. In Treas. Reg. Section 20.2010-2T(c)(1), the IRS construed Code Section 2010(c)(4)(B) in a manner consistent with Example #3. Technical corrections to the statute were later made under Section 101(c)(2) of Pub. L. No. 112-240.

6. Taxable gifts also have the advantage of lowering Illinois estate taxes; See Robert J. Kolasa, "Making Gifts Can Reduce Illinois Estate Taxes," 100 Ill. B. J. 646 (December 2012). Also, the text hints at the fabled "black widow" scenario of a rich spouse killing a poor spouse to reap the rewards of a $5 million DSUE, gifting such DSUE and then repeating the remarrying, killing and gifting cycles many times over to ensure the transfer of great wealth. Query whether human malice can be quite so tax efficient?

7. Treas. Reg. Section 20.2010-2T(a)(7)(ii) relaxes this requirement by providing that in certain cases the estate need not report the value of property that qualifies for the marital or charitable deduction, although an estimate of the value of the gross estate must be made. Since hard values must normally be provided to determine the stepped up basis of inherited assets, one wonders how much this procedure will be utilized.

8. Treas. Reg. Section 20.2010-2T(a)(2).

9. Code Section 2010(c)(5)(B).

10. Treas. Reg. Section 20.2010-2T(a)(6).

11. Rev. Proc. 2014-18 provides a simplified method for certain taxpayers to obtain an extension of time to elect portability. If a taxpayer does not qualify under the procedure (or it has expired), relief on an individual basis may be requested under Treas. Reg. Section 301.9100-3. See PLR 201421002.