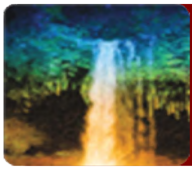

The Problems With Portability - Nine Pitfalls

The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 created a new feature in estate planning: portability. Portability allows a surviving spouse to "port in" the unused estate tax exemption amount of the "last deceased spouse". This 'ported" amount is known as the "Deceased Spousal Unused Exclusion Amount" ("DSUEA"). It has been touted as the death knell of Credit Shelter Trusts (a/k/a Bypass Trusts) and ending the need for A-B trust planning, simplifying the use of both exemptions for married couples. The news of the Credit Shelter Trust's death may be premature. Here are some pitfalls not readily apparent when relying on portability.

Pitfall # 1 – You Have to File to Get It

The estate of the first spouse to die must file an estate tax return and affirmatively elect portability. This means that even estates under the federal estate tax exemption amount ($5 million, indexed annually for inflation), which would not otherwise have to file federal estate tax returns, must bear the expense of filing in order to preserve the DSUEA.

Pitfall # 2 – The Estate Tax Return Must Be Complete

The estate tax return of the decedent must be timely and complete. To be complete, if the decedent had more than one marriage, the return must provide the name, social security number, dates the marriages ended, and how the marriage ended for each former spouse. Have fun with obtaining that information.

Pitfall # 3 – Unlimited Statute of Limitations for DSUEA

Internal Revenue Code §2010(c)(5)(B) states: "Notwithstanding any period of limitation . . . the Secretary may examine a return of the deceased spouse to make determinations with respect to such amounts for purposes of carrying out this subsection." This means that the valuations and calculations used in determining the DSUEA by the executor of the first estate can be challenged by the IRS, even if the second spouse dies decades later, to reduce or even eliminate the DSUEA the survivor expected to be able to use.

(Although some may have read this provision as keeping the statute of limitations open for *all* purposes, the phrase "for purposes of carrying out this subsection" would seem to indicate that the IRS could not go back and impose an additional tax [plus interest for potentially many years] against the first spouse's estate after the normal statute of limitations has run.)

Pitfall # 4 – Unlimited Record Keeping

As a corollary to #3, because the IRS may examine the first decedent's return for such a prolonged amount of time, that return, and all the records, valuations, appraisals and other documents associated with the return, must be kept by the surviving spouse, and then by his or her executor, until the statute of limitations against the IRS challenging that survivor's return will have expired.

Pitfall # 5 – Beware of Intra-Family Squabbles

If there is a not-so-well-blended family, or other reasons for family animosity, will the first decedent's executor be faced with conflicting ethical demands, and perhaps lawsuits from persons with different interests, concerning whether to use estate funds to pay the expense of filing an estate tax return which would only benefit the surviving spouse, especially if that spouse is not a beneficiary of the estate and no return would otherwise have to be filed?

Estate Planning

Pitfall #6 – Portability Amount Not Increased by Inflation

Under the Internal Revenue Code, if a married individual dies and uses no part of his or her $5 million exemption, that exact amount is available as the DSUEA. Even if the survivor dies (let's say) in 2020, and the exemption itself has grown to (again, just as an example) $6,000,000, the DSUEA for that spouse would nevertheless be frozen at $5 million.

Pitfall # 7: - Obtaining Appraisals That Withstand the Test of Time

Since the estate tax return of the first decedent may be examined for an "unlimited" period of time, it is important that the appraisers chosen by the executor to value property be professionals. Professional appraisers will generally be more expensive. For example, a local real estate broker may provide a valuation of a home, but will it stand the test of time?

Pitfall # 8 – Portability Does Not Apply to the GST Tax and State Death Taxes

The uninformed may assume that portability applies to all manner of estate transfers. It does not. Generation Skipping Transfer Tax exemptions may not be "ported" and Hawaii is currently the only state to allow portability for state estate taxes.

Pitfall # 9 –Appreciation and Asset Protection Should be Considered

Appreciation in value of assets is subject to taxation at the later death. Portability does not provide the asset protection and estate freezing features that a properly funded bypass trust can.

Portability was made permanent by the American Taxpayer Relief Act of 2012. Of course, the new definition of permanent after a decade of estate tax uncertainty means "until Congress decides otherwise."

Conclusion

Portability has been touted as a great advance in estate planning for the common person. Many advisors, however, have adopted it with caution. New laws bring new interpretations and case law. This provision has a host of complex provisions, which can be made more difficult by today's "modern" families. With increased federal estate tax exemptions, the focus has shifted to state estate and inheritance tax planning, where generally no portability exists. In addition, credit shelter trusts still play a significant role in freezing estate values, removing growth of assets from taxable estates, providing for children from previous marriages, and providing asset protection from the claims of creditors.

Please consult with your Guardian Financial Representative if you have any questions concerning this document.

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