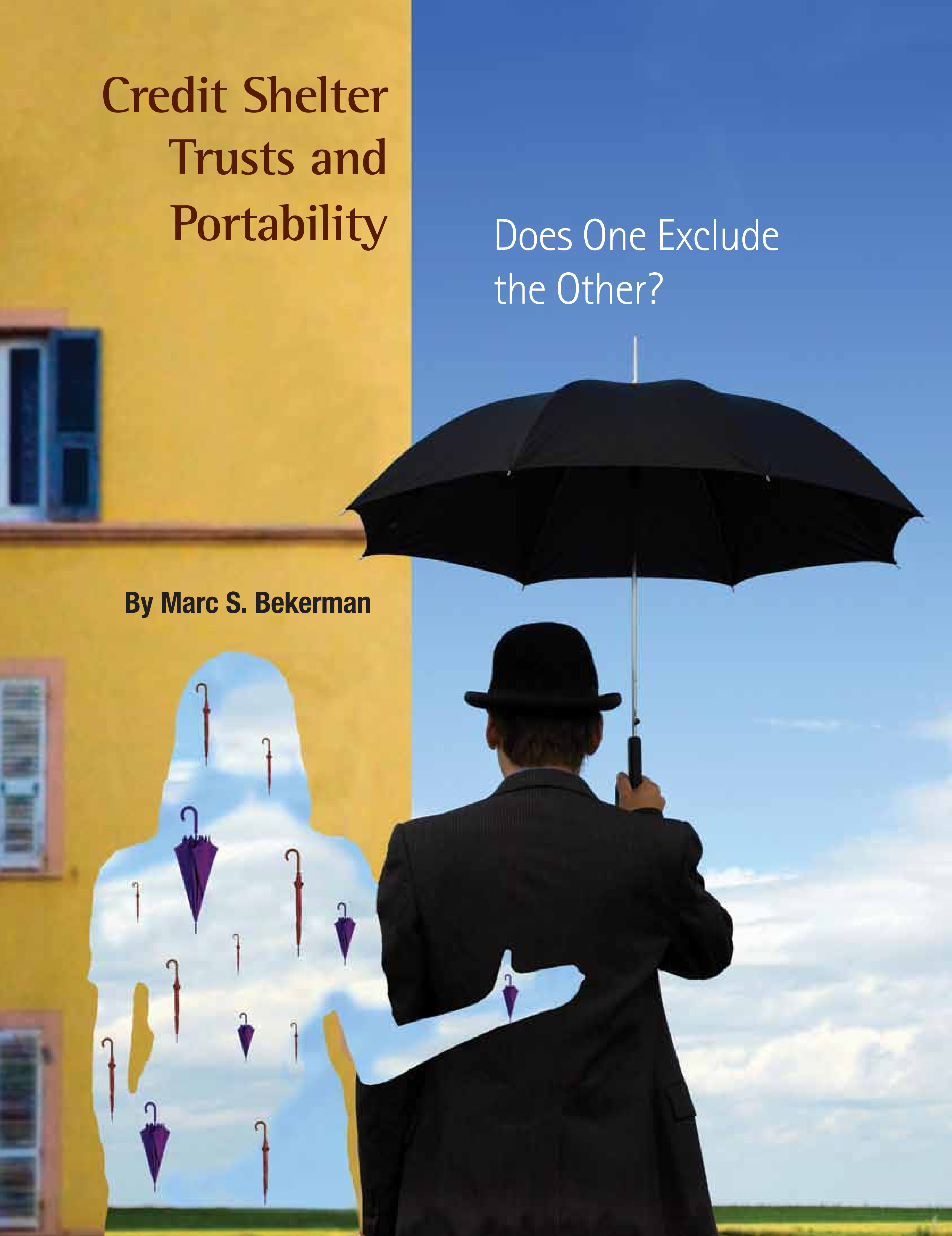
Credit Shelter Trusts and Portability

Does One Exclude the Other?

By Marc S. Bekerman



In the September/October 2009 issue of *Probate & Property*, the author published an article titled *What Portability Means to Trust and Estate Professionals*, contemplating the possibility that the estate of a surviving spouse might be permitted to use the unused estate tax applicable exemption amount from the estate of his or her predeceased spouse. This concept has been referred to as portability of the applicable exemption amount, and the article identified several issues that might arise should portability be permitted. This article is a follow-up to that prior article because portability has indeed been enacted as part of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 ("2010 Tax Act"), Pub. L. No. 111-312, 124 Stat. 3296.

Background

Interaction of Marital Deduction and Use of Applicable Exemption Amount

An estate must take a deduction on its estate tax return for any bequest to the surviving spouse that qualifies for the marital deduction. Mandatory use of the marital deduction directly reduces the use of the applicable exemption amount because the applicable exemption amount is applied only after calculating any estate tax due. As a result, if the entire estate passes to a qualifying spouse in a qualifying manner, the estate tax owed will be zero before application of the applicable exemption amount. Avoiding the complete loss of the applicable exemption amount is the goal of much tax-based estate planning and one benefit provided by portability.

Effect of Portability on Estate Plans

As described above, it has been necessary to have property pass free of the marital deduction on the death of the first spouse in order to use that spouse's applicable exemption amount. These bequests can be either to beneficiaries not qualifying for the marital or charitable deduction (that is, to a beneficiary neither a spouse nor a qualifying charity) or to a qualifying beneficiary in a nonqualifying form (that is, to a trust for the benefit of a spouse or charity not qualifying under the Internal Revenue Code for the applicable deduction).

Frequently, an estate plan creates a credit shelter trust or bypass trust under the will of the first spouse to die to ensure that at least some of his or her applicable exemption amount was used. These trusts are usually funded either by (1) using a formula that requires funding by the executor of an amount calculated after the death of the first spouse or (2) giving most of the estate to the surviving spouse, thereby allowing the surviving spouse to determine the amount of funding by disclaiming an appropriate portion to be determined within nine months of the first spouse's death. Usually the disclaimed property passes into a trust under the terms of the decedent's will, often called a disclaimer trust that acts as the credit shelter trust. (Although both funding approaches have advantages and disadvantages depending on the facts and circumstances, an analysis of the respective approaches is outside the scope of this article.) Because both funding approaches have their weaknesses, however, some practitioners have informally commented that portability will obviate the need for credit shelter trusts. The author disagrees with this position and, as will be discussed below, believes that credit shelter trusts will continue to be useful vehicles for estate planning under portability.

The Statutory Provisions

Section 303 of the 2010 Tax Act defines the term "applicable exclusion amount" to equal the sum of the basic exclusion amount and, in the case of a surviving spouse, the deceased spousal unused exclusion amount.

The Basic Exclusion Amount

The basic exclusion amount is the traditional "applicable exemption amount." Under the 2010 Tax Act, the basic exclusion amount has been increased to $5 million and will be indexed for inflation in increments of $10,000.

The Deceased Spousal Unused Exclusion Amount (DSUEA)

The DSUEA is the concept on which portability as enacted by the 2010 Tax Act is based. In cases in which the decedent was a surviving spouse, the decedent's estate will have both the decedent's own basic exclusion amount, discussed above, plus the unused portion of the predeceased spouse's basic exclusion amount. The unused portion of the predeceased spouse's basic exclusion amount is defined as the basic exclusion amount of the last such deceased spouse of such surviving spouse, less the amount on which the tentative tax is determined under IRC § 2001(b)(1) on the estate of such deceased spouse. As will be discussed below, however, several conditions must be met before the estate of the surviving spouse will be eligible to take advantage of this provision.

Qualifying for DSUEA

Several issues relate to the availability of the DSUEA in the estate of the surviving spouse.

Both Spouses Must Die After December 31, 2010

The statute only applies to the estate of a decedent dying after December 31, 2010. The statute, however, contemplates that the predeceased spouse also must have died after December 31, 2010. In other words, the estate of a decedent dying in January 2011 whose spouse died in 2009 cannot use any portion of the predeceased spouse's unused applicable exemption amount.

Surviving Spouse Is Limited to the Unused Exclusion Amount of His or Her Deceased Spouse

One of the issues identified by the author in his prior article was how to address the ordering of the use of the applicable exemption amounts in the estate of the surviving spouse. This is

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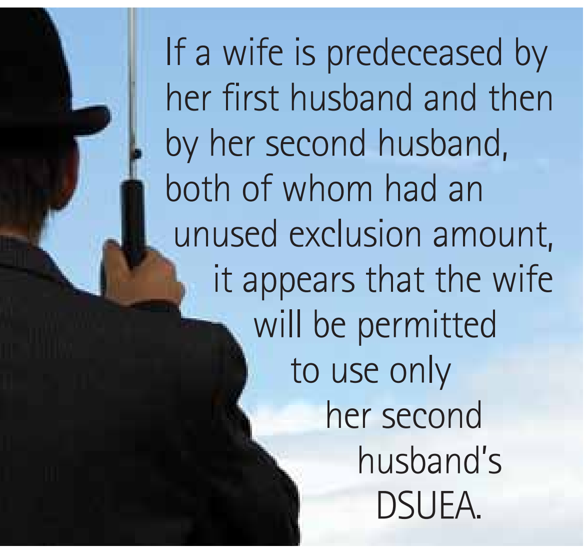
an important concept when the surviving spouse has remarried and is illustrated by the following example:

> **Example 1—**A wife dies in 2011, leaving an estate of $10 million, all of which is titled in her own name. Under the terms of the wife's last will, the entire estate is payable to her surviving spouse. The husband subsequently remarries to wife 2 and revises his last will to divide his estate equally between wife 2 and his children. Assume the husband dies later in 2011 with a gross estate of $16 million. Wife 2 dies in 2012. The husband's estate will have an applicable exclusion amount consisting of the basic exclusion amount of $5 million, plus the DSUEA of $5 million (the wife's basic exclusion amount of $5 million less $0, the tax base of wife's estate), for a total applicable exclusion amount of $10 million. If the $8 million passing to wife 2 will qualify for the marital deduction, then the entire $8 million passing to the children will be free of estate tax by use of the husband's applicable exclusion amount.



From the perspective of wife 2, however, it is important to recall that the DSUEA is the lesser of (1) the basic exclusion amount and (2) the excess of the deceased spouse's basic exclusion amount less the tentative tax base of the estate of the deceased spouse.

There are two possible ways to compute the DSUEA available to wife 2:

1. It could be claimed that there will be no DSUEA available to wife 2 as such amount will be the lesser of $5 million (the husband's basic exclusion amount) and $0 (the husband's basic exclusion amount of $5 million less the $8 million on which the tentative tax was determined). This approach results in the husband's basic exclusion amount being used first, and then the DSUEA available to his estate. Given that his unused DSUEA cannot be used by his surviving spouse, no DSUEA is available to wife 2 under this method.
2. Alternatively, wife 2 may have $2 million of DSUEA available because such amount will be the lesser of $5 million (the husband's basic exclusion amount) and $2 million (the husband's basic exclusion amount of $5 million, plus the DSUEA available to the husband's estate of $5 million, less the $8 million on which the tentative tax was determined). This approach results in the husband's DSUEA amount being used first, and then his basic exclusion amount. Given that the husband does not use his entire basic exclusion amount under the facts in Example 1, wife 2 may be able to use the unused $2 million as her DSUEA.

The Joint Committee on Taxation's explanation of the 2010 Tax Act adopts the second approach, which is clearly favorable to the taxpayer. It remains to be seen whether the Internal Revenue Service will agree, given that the 2010 Tax Act itself is silent, and the author expects this may need to be addressed by regulations to be promulgated by the IRS.

DRAFTING NOTE: Depending on the testator's intent for a surviving spouse not the parent of the testator's children, it may be appropriate to bifurcate the bequest to the surviving spouse into a "credit shelter" portion and a "marital" portion to ensure the use of the testator's entire applicable exclusion amount. In Example 1, the $8 million bequest to the children will only use a portion of the husband's entire applicable exclusion amount of $10 million. It may be consistent with the husband's wishes that the $8 million bequest to wife 2 be split, with $2 million put into a credit shelter trust of which wife 2 is the primary beneficiary and the children are the ultimate remaindermen to ensure full use of his applicable exclusion amount for the benefit of his children. (The marital portion of the bequest to the surviving spouse can be either an outright bequest or a bequest to a QTIP trust.)

Similarly, the author's prior article noted the possibility of cascading applicable exemption amounts that could occur if unused exemption amounts could be passed to future surviving spouses. This would be illustrated by Example 1 if wife 2 were able to use the $2 million of husband's unused exclusion amount in her estate (wife's $5 million plus husband's $5 million less the $8 million that passed to the children). If wife 2 were to marry husband 2, leaving her entire estate to him, it might have been possible to have the estate of husband 2 have a $12 million applicable exclusion amount (wife 2's $5 million basic exclusion amount, plus wife 2's DSUEA of $2 million shown above, plus husband 2's $5 million basic exclusion amount). It is clear that the provisions of the 2010 Tax Act prevent such cascading of exemption amounts.

The Estate of the Surviving Spouse Is Limited to the DSUEA of His or Her Most Recent Deceased Spouse

If a wife is predeceased by her first husband and then by her second husband, both of whom had an unused exclusion amount, it appears that the wife will be permitted to use only her second husband's DSUEA. This could be a concern when the first husband had left his entire estate to the wife, thereby not using any of his applicable exclusion amount, while the second husband used a significant portion of his applicable exclusion amount (for example, to shelter from estate or gift tax gifts to his children from a different relationship).

An Estate Tax Return Must Be Filed for the Estate of the First Spouse to Die

A vital consideration in administering the estate of the first spouse to die is whether the estate is required to file an estate tax return. Under the 2010 Tax Act, the estate of the surviving spouse cannot use any amount of the predeceased spouse's unused exclusion amount unless the estate of the predeceased spouse filed an estate tax return showing the amount of the unused exclusion amount and making an irrevocable election on the return designating the unused exemption amount as such. As discussed in the author's prior article, this approach to portability simplifies the determination of the amount of the DSUEA available to the estate of the surviving spouse but may make the administration of the estate of the predeceased spouse more expensive through the preparation and filing of an estate tax return that might not otherwise be required.

Further, the 2010 Tax Act requires that this election can be made only if the return is filed within the time prescribed by law, including extensions. As such, it may be impossible for the estate of the surviving spouse to cure a defect created during the administration of the estate of the predeceased spouse.

Finally, the author previously expressed concern that the increased number of estate tax returns filed, combined with dispositions to surviving spouses to discourage audits, could hinder the IRS by implying that the IRS would be bound in future proceedings by the expiration of the statute of limitations on the estate tax return for the estate of the predeceased spouse. The 2010 Tax Act alleviates this concern in part by specifically providing that, notwithstanding any applicable statute of limitations, the IRS will be permitted to examine the estate tax return of the estate of the predeceased spouse to make determinations about the available DSUEA.

Miscellaneous Issues

There are several other issues of concern relating to the DSUEA.

The Value of the Estate of the First Spouse to Die Is Not a Factor in the DSUEA

Based on the provisions of the 2010 Tax Act, it appears that the estate of the first spouse to die need not have sufficient assets to fully use the entire basic exclusion amount. In other words, if a spouse dies in 2011 with a gross estate of $3 million, all of which passes to the surviving spouse, the surviving spouse will still have a DSUEA of $5 million available.

Effect on Inter Vivos Gifts

The 2010 Tax Act reunified the estate and gift taxes. Accordingly, several provisions of the 2010 Tax Act combine to equate the lifetime gift tax exemption to the applicable exclusion amount that would apply as if the donor died as of the end of the calendar year in which the gift was made. Because the 2010 Tax Act defined the applicable exclusion amount as the sum of the basic exclusion amount and the DSUEA, it appears that a surviving spouse will be able to use an appropriate DSUEA in making inter vivos gifts. A full review of the effect of portability on inter vivos gifts is beyond the scope of this article. It is unclear, however, whether the surviving spouse must use his or her basic exclusion before using the DSUEA, which could become an issue if the surviving spouse remarries after using a DSUEA from his or her prior spouse.

No Effect on GST Tax

The portability provisions of the 2010 Tax Act do not apply to the generation-skipping transfer (GST) tax. As such, any unused GST tax exemption in the estate of the first spouse to die cannot be used to increase the surviving spouse's GST tax exemption.

How Portability Works

The following examples can provide a framework for discussion and analysis:

> **Example 2—**A wife dies in 2011 with an estate of $16 million, in which all assets are held with her husband as joint tenants with right of survivorship. Absent portability, the husband would have had to disclaim some portion of the joint property so that such property is payable to the wife's estate (as opposed to payable to the husband by operation of law) in order to use any of the wife's applicable exclusion amount of $5 million.
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> Further, if the wife's estate is payable in its entirety to the husband, the husband will have to execute a second disclaimer to permit property to pass to other beneficiaries of the estate. This scenario is often referred to as a double disclaimer and is not an uncommon situation on the death of the first spouse when most assets are payable to the surviving spouse by operation of law.

With portability and absent any disclaimers, the husband can now accept the $16 million and have an applicable exclusion amount of at least $10 million at his death, if the wife was his last spouse.

> **Example 3—**A wife dies in 2011 leaving an estate of $6 million, all of which is titled in her own name. Under the terms of the wife's last will, the entire estate is payable to her surviving spouse. The husband dies in 2012 with an estate of $9 million (assume that the applicable exclusion amount is still $5 million).

On the death of the first spouse, no applicable exclusion amount is used because the entire estate qualifies for the marital deduction. On the death of the surviving spouse, the husband's estate will have his $5 million basic exclusion amount available along with the $5 million DSUEA. As a result, the entire $9 million could pass free of estate tax to the beneficiaries of the husband's estate.

> **Example 4—**Same facts as Example 3, except that the wife's last will divides her estate equally between her surviving spouse and her children.

On the wife's death, $3 million of her applicable exclusion amount is used and the balance of the entire estate qualifies for the marital deduction, thereby leaving a $2 million unused applicable exclusion amount. On the husband's death, his estate will have his $5 million basic exclusion amount available along with the unused $2 million DSUEA. As a result, $7 million could pass free of estate tax to the beneficiaries of the husband's estate. (Presumably his estate is smaller than in Example 3 because a significant portion of his inheritance was diverted to the children on the death of the first spouse.)

Portability as a Savings Provision

Example 2 shows how portability of the applicable exclusion amount can provide a convenient crutch for either a couple's failure to plan or failure to follow through on a plan. On the wife's death, the entire estate will pass to the husband by operation of law and qualify for the marital deduction. As discussed above, the only way to use any of the wife's applicable exclusion amount would be through the use of disclaimers. Disclaimers, however, can raise complicated issues, depending on the type of assets owned by the husband and the wife, the type of assets sought to be disclaimed by the husband, the husband's capacity at the time of the wife's death, the husband's willingness to take the necessary steps in a prompt manner after the wife's death, and the husband's willingness to seek assistance in the administration of the wife's estate. In contrast, portability of the applicable exclusion amount allows the wife's entire unused applicable exclusion amount to be available on the husband's death as the DSUEA. As a result, portability can eliminate the need for any disclaimers in the wife's estate.

Concerns Regarding Portability

Many advocates of portability planning in lieu of traditional credit shelter planning believe that portability planning will reduce the costs of estate planning because fewer trusts would need to be created and a couple may not need tax-based estate planning until after the death of the first spouse to die. As will now be discussed, however, the author believes that portability should not necessarily lead to a reduction in estate planning.

Portability May Impair Planning, Which Clients Should Do Despite Portability

Many practitioners, including the author, are concerned that the portability provisions combined with the increase in the basic exclusion amount to $5 million will discourage most clients from engaging in estate planning.

> **Example 5—**A husband and wife have a total combined estate of $7 million. They wish to have the entire estate pass to the surviving spouse on the death of the first spouse with all property going to their children on the death of the surviving spouse. Based on their research, they have determined that they do not need to engage in more complicated estate planning because of the increase in the basic exclusion amount and the portability provisions of the 2010 Tax Act.

Clearly, several reasons should encourage the husband and wife in Example 5 to consult with their professional advisors and engage in appropriate estate planning. For example, certain techniques such as significant tax-free inter vivos gifts may not be available after the death of the first spouse. In addition, there are still valid nontax reasons to consider using trusts in the estate of the first spouse to die. Finally, the use of current planning techniques such as credit shelter trusts may still be in the family's best interest for tax purposes.

Leaving the Entire Estate to the First Spouse to Die Can Increase the Overall Estate Tax Payable

If the entire estate of the first spouse to die qualifies for the marital deduction, all of these assets could be included for estate tax purposes in the estate of the surviving spouse, whether the transfer is by outright bequest or in trust. Although all growth and income from the marital bequest will be included in the estate of the surviving spouse to the extent that they have not spent down any distributions, the DSUEA will not increase. In fact, the DSUEA is not even indexed for inflation. Under an analysis similar to the time value of money, the longer the surviving spouse lives, the more the value of the DSUEA will decrease. This result can be avoided through the use of planning similar to current credit shelter planning, whether funded by formula or disclaimer, which will allow the use of some portion of the basic exclusion amount of the first spouse to die at the time of his or her death, thereby maximizing its value and not seeing the value diminish over time. For example, a $5 million credit shelter trust may increase in value to $50 million before the death of the surviving spouse. The entire $50 million would not even be included in the surviving spouse's gross estate at the time of the subsequent death. Further, the entire $50 million may be exempt from the generation-skipping transfer tax.

Credit Shelter Trusts May Better Provide for the Decedent's Issue than the Surviving Spouse

There are two ways in which a credit shelter trust established under the estate plan of the first spouse to die may be a better vehicle for providing for the deceased spouse's descendants. First, the surviving spouse may be unwilling or uncomfortable making significant gifts from his or her own assets, especially if the surviving spouse is not a parent of the deceased spouse's children. The same spouse, however, may be willing to make such distributions from a credit shelter trust. Further, appointment of trustees (whether or not the surviving spouse is such a trustee) may allow others chosen by the deceased spouse to make these decisions.

In addition, there may be tax savings in establishing a credit shelter trust for distributions to descendants. If the surviving spouse does not wish to trigger gift tax liability, the spouse will be limited to annual exclusion gifts and his or her available applicable exclusion amount. The trustee of a properly structured credit shelter trust, however, could make distributions to beneficiaries with no gift tax implications to the surviving spouse whether or not the surviving spouse is making gifts from his or her personal assets.

Outright Bequests to the Surviving Spouse May Not Adequately Ensure That Issue of the First Spouse to Die Ultimately Receive Their Wealth

Historically, it was less common for a surviving spouse to remarry. One characteristic of the modern American family, however, is the increased likelihood of remarriage. Leaving an entire estate outright to a surviving spouse can place at risk the future inheritance of the decedent's issue. If the surviving spouse remarries, he or she may choose to leave all or some portion of the estate to the new spouse. Further, if the surviving spouse fails to secure a premarital agreement, the entire estate may be subject to a subsequent divorce court division if the second marriage ends in divorce or to either community property law division or a right of election if the marriage terminates on a spouse's death. Finally, trusts are often used for asset protection purposes. The property inherited outright from the predeceased spouse will be subject to the claims of the surviving spouse's creditors. But the assets held in a "spendthrift" credit shelter trust are generally exempt from the beneficiary's creditors.

Often the intent of the first spouse to die is to benefit his or her surviving spouse as a primary goal and to benefit descendants or other beneficiaries as a secondary goal. The first spouse to die frequently seeks to provide for his or her children after assuring the continued comfort and support of the surviving spouse. The most effective method for this planning may be through the use of a traditional credit shelter trust whether or not portability of the applicable exclusion amount is available.

Issues to Be Considered in Portability

Interaction with State Estate Taxes

One interesting issue with potential complications is the interaction between portability and state estate taxes. If a state assessing its own estate tax does not automatically conform with the Internal Revenue Code, estates may face the dilemma of whether to use portability that would not be recognized on the state level. This issue is similar to the decoupling concerns that have faced many estate planners and will continue to be considerations under the 2010 Tax Act.

Sunset Provision

It should be noted that the portability provisions of the 2010 Tax Act are scheduled to sunset for decedents dying after December 31, 2012 (similar to the other changes to the estate and gift tax provisions made by the 2010 Tax Act). As such, any planning for the use of portability must be done with an understanding that the future of portability for decedents dying in 2013 is uncertain. This is another important reason to continue planning with credit shelter trusts.

Ability of Secretary to Prescribe Regulations

The 2010 Tax Act specifically permits the Secretary of the Treasury to promulgate regulations for these provisions. As such, some of the questions left by the wording of the statute might, in turn, be answered by the IRS through the issuance of regulations. But, because the act is currently due to sunset for decedents dying after December 31, 2012, and would only be available for estates in which both spouses died between January 1, 2011, and December 31, 2012, the author questions whether the drafting of regulations in this area will be much of a priority for the IRS.

Effect on Estate Planning Practice

The author is concerned that portability will wrongly reduce estate planning practice, both in perception and in actuality. Although clients can be educated about the need for estate planning even with portability, the bigger question is whether estate planning professionals will have the opportunity to provide such an education to their clients. Further, even with proper education, there is a question about the value the client will give to estate planning and the corresponding compensation to the estate planner. As such, the author believes that some estate planners will voluntarily leave the area either because of the perception that their practices will diminish or because of the inability of their practices to justify the continued involvement in the field.

Conclusion

Be careful what you wish for. Many people have long thought that portability would be a welcome addition to the transfer tax system. Although portability under the 2010 Tax Act has several potential advantages to taxpayers, these same provisions create a minefield of traps for the unwary client and estate planning professional. ■