

## SPOUSAL UNIFIED CREDIT PLANNING & THE PORTABILITY RULE

### DISCLAIMER

*This article is intended for informational purposes, only. It does not constitute legal advice. Nor is it a substitute for legal advice.*

This article is intended to complement the *Federal Transfer Taxes & Unified Credit* article, published as part of this series.

### Review of Unified Credit

Each citizen has a credit under our tax laws that they may use to exempt assets from transfer taxes. (Federal transfer taxation includes the estate tax, the gift tax and the generation skipping transfer tax. See *Federal Transfer Tax & Unified Credit* article.) How much can be exempted from transfer tax using that credit? (This exempt amount is technically known as the **applicable exclusion amount**.) The answer to that question, which for several years has been a moving target, has now been answered “permanently” – we are told – at \$5 million per person.<sup>1</sup> The Taxpayer Relief Act of 2012 fixed the applicable exclusion amount at \$5 million per person permanently indexed as of 2011, so that, as of 2015, that amount is \$5.43 million. If your estate is worth less than \$5.43 million at the time of death, provided the law does not change, it is unlikely that any estate tax will have to be paid.<sup>2</sup>

The unified credit may be used both to exclude gifts from the gift tax and time-of-death transfers from the estate tax. The unified credit is, however, cumulative. If you give away \$1 million in property while you are alive, and exempt that \$1 million transfer from gift tax by using your credit, you will have \$4.43 million of credit remaining. In other words, it is a single, life-time credit.

### Spousal Planning

As stated, each person has a unified credit. This means that each spouse in a marriage has a unified credit and that by using both of those credits a married couple may exempt from transfer taxes a marital estate worth up to \$10.86 million. In some discussions this has been referred to as *doubling* the unified credit. In fact, it is really a question of not wasting or squandering a unified credit. Before we discuss the new Portability Rule which became “permanent” with enactment of the 2012 Tax Payer Relief Act, and which enables most couples to fully utilize both unified credits without prior planning, let’s take a look at a simple example that might help explain the history of spousal unified credit planning.

Assume that Mom and Dad own an estate with a value of \$7 million. They own it jointly with right of survivorship.<sup>3</sup> This means that upon the first death the survivor by

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<sup>1</sup> The proposed presidential budget for 2014, published only three months after the “permanent” fixing of the credit at \$5 million per person, proposed a lower \$3.5 million credit.

<sup>2</sup> Some lawyers will advise their clients to undertake transfer tax planning for estates that are close to a \$3.5 million value, given the extent of political disagreement over the unified credit exclusion amount.

<sup>3</sup> For further discussion of joint tenancy and tenancy in common, see article on *Titling*.

operation of law will own the entire \$7 million estate in his or her own name. (For ease of example, let's assume Mom survives Dad.) In this simple example, Mom now owns a \$7 million estate with only a single \$5.43 unified credit to protect the estate from transfer taxes. This means that there may be \$1.57 million in asset value that will be subject at Mom's death to estate tax at 40%. A significant problem and one that, in the past, could have been prevented with a minimal amount of planning.

How did that planning happen? First, one piece of background. Under transfer tax law, spouses may transfer property to each other, no matter what the value, free of transfer taxes. This is a result of something called the *marital deduction*. The marital deduction is a significant aspect of transfer tax planning in general but one which we are not going to dwell on. The important point for our discussion is that any property which transfers under the marital deduction does not make use of the unified credit. Let's go back to our example, Mom and Dad own a \$7 million between them, but instead of joint ownership, let's assume that they each own their own land worth \$3.5 million. If Dad leaves his land outright to Mom at his death, that land would transfer to Mom under the marital deduction and Dad's unified credit would not be used. We would still have a situation where Mom owns a \$7 million estate in her own name with only a single unified credit to protect it.

OK, back to planning to preserve – or make use of – both unified credits. In the first step, Mom and Dad would deed their assets out of joint tenancy into tenancy in common, meaning that each would now own an undivided half interest. (They could also separate ownership by parcel or by asset; for example, Dad would own some of the land in his name alone and Mom other parcels in her name.) In the next step, Mom and Dad in their Wills (or their Trusts, if they are using trusts as the principal tool for transferring their assets) would include some language to make sure that each of their unified credit's could be used to the extent necessary to protect the marital estate from transfer tax. What does this language do? Although there are a number of variations, the basic idea is not to leave Dad's property (or at least not all of it) outright to Mom. (Remember we are simply assuming that Dad dies before Mom.) So if Dad left his property to the kids, they would receive their inheritance from Dad at the time of his death and that transfer would be protected by his unified credit. But then Mom would have lost the use of Dad's share of the marital property. Most spouses do not want this result. So, how do we not leave the property outright to Mom but still enable her to enjoy the benefit of the property? There are a number of ways to do this. Let's keep it simple. In one of the most traditional ways, Dad would have left the property to the kids at the time of his death but with a life estate for Mom. The property would actually be deeded over to the kids but the deed would have reserved a life estate in Mom. This means, in a nutshell, that Mom, for the duration of her life, would be entitled to possess and control the property: she gets the income from it, she decides who rents it, she pays the real estate taxes, etc.<sup>4</sup> By doing this, the transfer of the property to the kids with a life estate to Mom would not fall under the marital deduction and Dad's unified credit would be used to protect that

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<sup>4</sup> Mom would not be able, however, in all likelihood, to borrow against the property or sell it, certainly not without the consent and cooperation of the kids, who now own the property, after all, subject to mom's life estate.

transfer from tax. The kids own it, subject to Mom's life estate, which ends with her death. That property, at the time of Mom's death, is not part of Mom's taxable estate. Her unified credit can be used to protect the property that she owned in her own name.

A more common structure for preserving each spouse's unified credit would be through the use of what are known as *credit shelter trusts*. In a credit shelter trust (also called a by-pass trust, a family trust or sometimes a disclaimer trust), upon Dad's death, some of his property is transferred into a trust for the benefit of Mom. How much? As much as is needed to protect the entire marital estate from transfer tax at either his or Mom's death. Going back to our example, it might be that all of Dad's \$3.5 million is transferred into the credit shelter trust, or it might be that less than that amount goes into trust. After all, we know that Mom has a \$5.43 million unified credit, and, depending on Mom's age and health at the time of Dad's death, if we are confident that the unified credit amount is politically stable, and that the assets in Mom's ownership will not appreciate in value beyond the protection of Mom's unified credit, we might not decide to transfer all of Dad's property into the trust. For example, \$2 million might go into trust and \$1.5 million go outright to Mom. She would then own an estate in her name worth \$5 million, and have the benefit of the \$2 million that is in trust. At the time of her death, her unified credit would be sufficient to protect the \$5 million that she owned.

This is a basic and simplified description of the workings of credit shelter trusts. It is worth pointing out another variation on such trusts, called a *disclaimer trust*. In this case, Dad in his Will or revocable trust says that he wants everything to go to Mom. But wait, this would mean no use of his unified credit – anything that goes to Mom falls under the marital deduction. But Dad's documents go on to say that everything he owns goes to Mom *unless* she disclaims any part of it, and any part that Mom disclaims goes into a disclaimer trust. The disclaimer trust works like a credit shelter trust in that any property of Dad's that goes into the disclaimer trust makes use of his unified credit. But what the disclaimer trust provision allows is for Mom, at the time of Dad's death, to look at the value of the marital property, the status of the unified credit, and the circumstances of her life, and decide whether or not to disclaim any of Dad's property. Any part she disclaims goes into trust. She has the benefit of that property, but it transfers into trust making use of Dad's credit and will not be part of her taxable estate.

For example, let's say Mom and Dad own a \$4 million estate, \$2 million in each name. If we assume at the time of Dad's death that the unified credit has not changed, that it is \$5 million indexed to inflation. It therefore appears that Mom's single unified credit would be sufficient to protect the full \$4 million estate. Mom might therefore *not* disclaim any part of the \$2 million Dad left to her and take ownership of all property outright in her own name. Dad's unified credit was not used, but only because we are confident that it was not – and will not be – needed. However, if at the time of Dad's death the unified credit had dropped down to \$3.5 million, Mom would want to disclaim some part of the \$2 million (at least \$500,000) to use Dad's unified credit to protect the estate from transfer tax. Mom may want to do the same if the property is appreciating rapidly and her life expectancy is considerable.

### The New Rule – Portability to the Rescue

In 2011 a new rule took effect, a rule which became “permanent” under the 2012 Tax Payer Relief Act. The rule has become known as the Portability Rule. What does it do? In a nutshell, it enables a couple, without any advance planning, to use each spouse’s unified credit to protect the marital estate from gift and estate taxes.

How does it work? At the time of Dad’s death, a 706 Federal Estate Tax return is filed, primarily for the purpose of making the portability election, which election essentially transfers Dad’s unused unified credit over to Mom. So, going back to our example, Mom and dad own a \$7 million estate. They own it jointly with right of survivorship. At Dad’s death, Mom became the owner of the entire \$7 million estate. Her unified credit is \$5.34 million. As part of Dad’s estate, the 706 is prepared and filed and his unused \$5.43 million credit is transferred over to Mom. Mom now has a unified credit equal to \$10.86 million, enough to protect the \$7 million marital estate. A good rule, too long in coming. (Dad’s unused unified credit that has been transferred to Mom is not available to use with respect to generation skipping transfer taxes, but only gift and estate taxes.)

In many respects, the Portability Rule replaces spousal reliance on credit shelter or disclaimer trusts. It means, among other things, that spouses may continue to own property as joint tenants with rights of survivorship, which typically means that nothing needs to happen at the time of the first spouse’s death in order to transfer property. In those few states, like Nebraska, which impose an inheritance tax, it typically means that no inheritance tax determination needs to occur at the time of the first death. The costs of those transfers and determinations are therefore avoided. In addition, Mom has the security (and control) of owning the entire marital estate outright in her own name. Finally, the kids receive a step up in basis in the full marital estate at the time of Mom’s death, which may mean that they acquire a higher basis than they would have if they received half the property at the time of Dad’s death.

However, the use of Portability is not without its costs, namely the preparation and filing of a 706 Federal Estate Tax return, which might not otherwise have to be filed. In general, there is no requirement to file a 706 if the gross estate of the decedent is worth less than the unified credit exemption amount, i.e. the \$5.43 million.

There may be other reasons to consider using credit shelter or disclaimer trusts rather than relying solely on portability. Avoiding the need to file a 706 return is one. Safeguarding against appreciation might be another. For example, if at the time of Dad’s death \$3.5 million of the marital estate went into a trust for Mom’s benefit (or if it went to the kids with a life estate reserved to Mom), that \$3.5 million would not again be subject to tax at the time of Mom’s death as part of her estate. Therefore, any appreciation in the value of that property between the time of Dad’s death and Mom’s death would not be subject to transfer tax. Such appreciation could be significant depending on how long Mom were to survive Dad. In addition, some spouses wish to guard against the possibility that after the first death the survivor would change the estate plan. Obviously, if Mom owned everything outright in her own name, she would be free to dispose of the estate as she decides. If, however, part of that estate is in trust with

certain restrictions imposed upon a sale of the trust property, or if it has already been deeded to the kids, the surviving spouse's ability to change the estate plan may be limited.

The Portability Rule, as stated, requires the timely filing of a 706 return (typically within nine months of death, with possible extensions for up to six months). The election, which is presumed upon the filing of the return unless the filer specifically repudiates the election, is irrevocable. Under the tax rules, the portable credit is referred to as the deceased spouse's unused exclusion amount, or DSUE for short. The person who makes the election can be a personal representative, administrator of the estate or "any person in actual or constructive possession of property of the estate." In all likelihood, it will be the surviving spouse making the election. It also appears that if the 706 return is being filed primarily to make the portability election, and that there are not other reasons for obtaining an appraisal in support of the 706 return, that a best estimate of the value may be given. In other words, it may not be necessary to obtain an appraisal. The transferred credit is available to the surviving spouse both for gift tax purposes as well as estate tax. Finally, a person is entitled to the unused unified credit exemption amount only from that person's last deceased spouse. So, for example, if Mom transfers all of Dad's credit over to herself through the portability election, but she later remarries (which in itself will not affect her right to use Dad's credit amount), and then she survives that second husband, she loses the right to use Dad's unified credit. She is entitled only to the credit of the most recent last deceased spouse. This would be true even if that second spouse died with no remaining unified credit for Mom to acquire through portability.

Portability is a useful rule and will simplify the tax aspects of estate planning for many people. It essentially means that both spouse's unified credits will be available to protect the marital estate even in the absence of advance planning. As stated, there may still be reasons to consider the use of credit shelter trusts, including avoiding the need to file an estate tax return, protecting the inheritance of the kids from possible changes made by the surviving spouse, sheltering appreciation, safeguarding against the possible loss of the first spouse's unified credit through a second marriage by the surviving spouse, and, the asset protections that a trust can offer.

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