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Steve Leimberg's Estate Planning Email Newsletter - Archive Message #1777

Date: 16-Feb-11
From: Steve Leimberg's Estate Planning Newsletter
Subject: **Dan Evans: Problems with Portability, Part 2**

Do the "portability" provisions of the Tax Relief, Unemployment Insurance Reauthorization, and Jobs Creation Act of 2010 reduce the need for estate planning, or are they just a safety need for those with inadequate planning?

In "Complications from Changes in the Exclusion" (**LISI** Estate Planning Newsletter #1768), **Dan Evans** identified some federal gift tax technical problems caused by the changes in tax rates and exclusions under the Tax Relief, Unemployment Insurance Reauthorization, and Jobs Creation Act of 2010.

In this second of three articles on technical problems in the new tax law, Dan addresses questions about, and problems with, the new "portability" provisions under the new law that allow the surviving spouse to inherit the "deceased spousal unused exclusion amount."

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Here is his commentary:

EXECUTIVE SUMMARY:

The new tax act provides for gift and estate tax exclusion "portability" between spouses, by allowing the surviving spouse to inherit a "deceased spousal unused exclusion amount" that can be applied to shelter both the survivor's gifts and taxable estate. The survivor could therefore have a $10,000,000 gift

and estate tax exclusion, and the full exclusions of both spouses can be used by the survivor.

But before practitioners shred their bypass trust forms, they should know that there are significant limitations and technical issues with the new portability provisions. Some of which are fairly obvious, such as the fact that law creating portability will expire in 2013, the fact that an estate tax return must be filed at the first death in order for the surviving spouse to claim the unused exclusion even if there is little or no taxable estate, and the lack of any inflation adjustment for the unused exclusion.

The two problems discussed in this article are: (a) the possible loss of the extra inherited exclusion if the surviving spouse remarries and then survives the second spouse and the estate tax that might be imposed retroactively on lifetime gifts that used the inherited exclusion, and (b) the reduction in the exclusion for past gifts in excess of the $1,000,000 exclusion for which gift tax was paid. Both of these problems appear to require Congressional action to resolve.

COMMENT:

How the DSUEA Works

Section 303 of the Tax Relief, Unemployment Insurance Reauthorization, and Jobs Creation Act of 2010 (P.L. 111-312)

redefined the "applicable exclusion amount" which is used to calculate the unified credit for gift and estate tax purposes and is found in IRC §2010(c). Instead of being $5,000,000 (with adjustments for inflation), the applicable exclusion amount is now the "basic exclusion amount" (which is the $5,000,000, with adjustments for inflation) plus the "deceased spousal unused exclusion amount" (DSUEA).

The DSUEA of a surviving spouse is defined by a new subsection 2010(c)(4) as the lesser of (a) the basic exclusion or (b) the excess of the deceased spouse's basic exclusion amount over the tentative tax base of the deceased spouse (which is the sum of the taxable estate and the lifetime taxable gifts that are the "adjusted taxable gifts" included in the estate tax calculation). These new provisions only apply to to a deceased spouse who has died after December 31, 2010, and only if an election is made by the executor of the deceased spouse on a timely filed estate tax return.

In thinking about a surviving spouse inheriting a deceased spouse's unused exclusions, an immediate question is whether the DSUEAs can be cumulative. Can a surviving spouse remarry and the second spouse get the benefit of both the surviving spouse's basic exclusion and the DSUEA from the first spouse? The answer is clearly no.

The DSUEA is a "use it or lose it" situation, because any unused DSUEA will be lost at the death of the surviving spouse even if the surviving spouse has remarried. Furthermore, the surviving spouse must use up his or her own exclusion entirely before the

DSUEA is applied, so the estate and gifts of the surviving spouse will be applied first to his or her own exclusion and the DSUEA will be ignored in calculating the surviving spouse's own DSUEA.

To illustrate, assume that a widower has inherited a $2,000,000 DSUEA from his deceased wife, so he has a total applicable exclusion amount of $7,000,000. He makes $3,000,000 in gifts, remarries, and then dies without a taxable estate. What is the DSUEA received by his second wife?

The Joint Committee on Taxation technical explanation (No. JCX-55-10; 12/10/2010), provides an example on page 53 that suggests that the second wife would receive a DSEUA of $4,000,000, meaning that the decedent's lifetime gifts used the DSUEA received from the first wife before using the decedent's own exclusion, leaving $4,000,000 of his $5,000,000 exclusion for his second wife.

Unfortunately, the conclusion of the Joint Committee report is inconsistent with the language of the statute. Under the statute, the DSUEA is the decedent's basic exclusion amount (i.e., the $5,000,000), less the total of the decedent's taxable estate and adjusted taxable gifts. So, in the example above, the DSUEA would be $2,000,000, which is the decedent's $5,000,000 exclusion amount less the $3,000,000 in taxable gifts.

Surviving the Second Spouse

The possible remarriage of a surviving spouse is often a practical concern in estate planning, and it becomes a tax concern under these new portability provisions because remarriage can result in the loss of the DSEUA upon the death of the second spouse.

The DSUEA can be lost upon the death of a second spouse because the DSEUA defined by new IRC subsection 2010(c)(4) refers to the basic exclusion amount (and tentative tax base) of the "last such deceased spouse" of the surviving spouse. So, if a surviving spouse remarries, and the second spouse dies, the surviving spouse loses the DSUEA from the first spouse and receives instead the DSUEA (if any) from the second spouse, which means that the DSUEA could go up or down.

If DSUEA from the second spouse is larger than the DSUEA from the first spouse, no harm is done, and the surviving spouse can make additional lifetime gifts (or shelter additional assets from estate tax) using that new and larger DSUEA.

If the DSUEA from the second spouse is smaller than the DSUEA from the first spouse, there should be no gift tax problems, because of the way the gift tax is calculated. A federal gift tax calculation always starts with figuring the tax on the total of the gifts in the current year and the gifts in previous years, and then subtracting the tax on the gifts in the previous years. It therefore doesn't make any difference whether or not the previous gifts used up any exclusion or resulted in any tax because they are always netted out of the calculation of the tax on the gifts in the current year.

The gift tax unified credit defined by IRC §2505(a) is the current maximum credit amount less the credit allowed against gifts in previous years. If the surviving spouse has made taxable gifts using a DSUEA that is later lost (or reduced) following remarriage and the death of the second spouse, then the credit allowable for the current year might become zero, but it would seem to be an extremely unlikely statutory interpretation that would allow the "credit" to become negative and result in a tax, even though §2505(a) does not explicitly prevent a reduction in the credit below zero.

The possible estate tax after a reduction of the DSUEA is a different issue, because the estate tax is calculated differently from the gift tax. If the DSUEA from the second spouse is smaller than the DSUEA from the first spouse, the estate tax calculation on the death of the surviving spouse is problematical.

For example, assume that a wealthy woman inherits a $5,000,000 DSUEA from her penniless husband. She uses her own basic exclusion amount, together with the DSEAU, to make $10,000,000 in gifts to her children and grandchildren. She then makes the mistake of marrying a wealthy widower who has h children from a prior marriage and who promptly dies, leaving his substantial estate (more than $5,000,000) to his children by his first marriage. The widow's applicable exclusion has then dropped from $10,000,000 to $5,000,000.

Upon her death, the wealthy woman's estate is worth only $1,000,000, but the tentative tax base is $11,000,000, so the

tentative tax is $3,830,800. $1,730,800 will be covered by the unified credit, and the marginal tax on a taxable estate of $1,000,000 should be $350,000, which means that $1,750,000 to be covered by the gift tax payable, as determined under §2001(b)(2). (This calculation ignores any increases to the widow's own exclusion due to inflation.)

In determining the reduction for the gift tax payable on the lifetime gifts, the critical issue is determining what exclusion to apply in calculating the gift tax "payable" under IRC §2001(b)(2) and (g) on the lifetime gifts. If the gift tax payable is calculated based on the exclusions that exist at death (i.e. the decedent's own basic exclusion of $5,000,000), then the gift tax payable is $1,750,000 and the net estate tax liability is $350,000, as hoped for. However, if the gift tax payable is calculated based on the exclusions that existed when the gifts were made (i.e., the $10,000,000 in exclusions), which is the meaning that seems to be implicit to §2001(g), then the gift tax payable on those gifts remains $0 and the estate tax is $2,100,000 on an estate of $1,000,000.

There is nothing in the language of IRC §2001(g) that addresses this problem, so the answer will have to come from Congressional technical corrections (or perhaps Treasury regulations).

This is similar to the "clawback" problem discussed in the previous article (**LISI** Estate Planning Newsletter #1768), which is a problem that might arise if Congress allows current law to expire in 2013. What is different about this problem is that it

exists now, under current law, and will continue to exist even if Congress makes current law permanent.

What is also different is that this "problem" is that it appears to be at least somewhat intentional. The definition of the DSUEA in IRC §2010(c)(4) specifically states that it is not just the deceased spouse's exclusion less the spouse's tentative tax base, but that it can't be more than "the basic exclusion amount," which appears to refer to the current basic exclusion amount and not the basic exclusion amount in effect at the death of the deceased spouse.

The only possible purpose of that limitation would be to reduce any unused DSUEA if (and when) Congress should reduce the basic exclusion. So, if as part of a tax reform bill in 2012, Congress reduces the basic exclusion from $5,000,000 to $4,000,000, all outstanding and unused DSUEAs will be reduced by $1,000,000 as well.

So the drafters of IRC §2010(c)(4) most likely intended that a DSUEA could go down during the surviving spouse's lifetime. The only uncertainty is whether they intended to impose an additional estate tax at death when the lifetime gifts turn out to exceed the basic exclusion and DSUEA at death.

Until the law is clarified, the remarriage of a wealthy person with a DSUEA carries certain risks. One risk is that the remarried surviving spouse might lose the benefit of the DSUEA upon the death of the second spouse, and the way to minimize that risk

would be to use up all available exclusions by lifetime gifts, either before or after the second marriage. However, the possibility of additional estate tax being imposed upon the death of the twice-married surviving spouse would still remain.

The Gift Tax Paid Problem

As noted above, the DSUEA is a relatively simple calculation, taking the decedent's basic exclusion amount and subtracting the tentative tax base, which is the sum of the taxable estate and the adjusted taxable gifts. The "adjusted taxable gifts" are the taxable gifts made after 1976 that are not drawn back into the gross estate by reason of IRC §2036 or other similar provisions. The simplicity is admirable, but results in a loss of exclusion when the decedent has made gifts in excess of the $1,000,000 exclusion amount.

For example, assume that the decedent had made $2,000,000 in gifts before 2011, using up the $1,000,000 exclusion that existed before 2011 and paying gift tax on the amount in excess of that exclusion, and then dies in 2011 with a net estate (after payment of all debts and deductions other than the marital deduction) of $4,000,000.

If the $4,000,000 goes into a bypass trust for the surviving spouse, there will be no federal estate tax. The tentative tax base will be $6,000,000, and so the tentative tax will be $2,080,000, but there will be a reduction of $350,000 under IRC §2001(b)(2) for the gift tax payable on the $1,000,000 of gifts in

excess of the exclusion, so the gross estate tax will be $1,730,800, which is reduced to zero by the unified credit.

If the $4,000,000 goes to the surviving spouse, then the DSEUA is only $3,000,000, because the $5,000,000 exclusion is reduced by the tentative tax base of $2,000,000 even though $1,000,000 of those gifts did not use any exclusion. That means that $1,000,000 of the decedent's $5,000,000 exclusion has been lost.

The statute seems unambiguous, so only Congress can fix this problem. Until Congress does fix the problem (and assuming that Congress thinks that it's a problem), estate planning for married clients who have paid gift tax should continue to rely on bypass trusts, rather than DSUEA portability.

Conclusion

The "deceased spousal unused exclusion amount" was undoubtedly enacted with good intentions, but it seems to be both temporary and fragile, suggesting that the abbreviation "DSUEA" should be pronounced "tissue" (or perhaps "diss you"). It will be helpful for those who are unable or unwilling to arrange assets between a husband and wife and plan their estates in classic ways, and so allow the estate tax exclusion of the first to die can be salvaged and utilized by the survivor notwithstanding inadequate estate planning. But the problems that can arise due to remarriage should make it an undesirable option in intentional estate planning, and the definition of the DSUEA may make it unacceptable to those who have paid gift tax on gifts made

before 2011.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Dan Evans

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