
Estate Planning Insights

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Karen S. Gerstner & Associates, P.C.

Attorneys at Law

5615 Kirby Drive, Suite 306

Houston, Texas 77005-2448

(713) 520-5205

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ABOUT TO EXPIRE: Special Extension of Time to File Form 706 to Elect Portability

What is Portability? Portability was first available for the estates of decedents who died in 2011. Pursuant to the American Taxpayer Relief Act of 2012 ("ATRA"), which was passed in January 2013, portability was made "permanent."

Portability is an election that can be made in a Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return ("Form 706"), filed for the estate of the first spouse to die. By making the portability election, the deceased spouse's *unused estate tax exclusion amount* is transported to the surviving spouse. Through the portability election, the surviving spouse can end up with two (2) estate tax exclusion amounts: his/her own and his/her deceased spouse's transported amount.

What is the Estate Tax Exclusion Amount? In general, the estate tax exclusion amount is the amount that a decedent can transfer at death without his estate having to pay any US estate taxes. Pursuant to ATRA, the "permanent" estate tax exclusion amount is \$5,000,000, adjusted for inflation, with inflation adjustments starting from a base year of 2011. Thus, for persons who die in 2014, the estate tax exclusion amount is \$5,340,000. Next year, the amount is projected to be \$5,430,000.

Reduction for Taxable Gifts. The estate tax exclusion amount available to a particular decedent's estate at death is reduced by that decedent's use of his lifetime gift tax exemption amount during life. As we have discussed, people who make "taxable gifts" during life must file a Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return ("Form 709"), to report those gifts. *Taxable gifts* use up some of the gift-giver's lifetime gift tax exemption amount, and, at the same time, use up some of his estate tax exclusion amount. Generally,

a *taxable gift* means a gift to a particular recipient having a value that exceeds the gift tax annual exclusion amount, which is currently \$14,000 (although there are other taxable gifts that must be reported as well). As we have discussed before, the term, *taxable gift*, means a gift that is *reportable* in a Form 709 and does not necessarily mean that any gift taxes have to be paid with respect to that gift.

When is the Estate Tax Exclusion Amount "Unused"? If a decedent leaves his entire estate to charity at death, then his entire remaining estate tax exclusion amount will be "unused" because of the estate tax charitable deduction. There is an unlimited charitable deduction for all amounts passing to qualified charitable organizations at death. Thus, no part of a decedent's estate tax exclusion amount has to be used for amounts passing to charity at death.

In a similar way, no part of a decedent's estate tax exclusion amount must be used to avoid estate taxes on amounts being left at death to a spouse who is a US citizen due to the unlimited marital deduction. Different rules apply when the spouse is not a US citizen. We will not discuss those rules in this newsletter and *in the remainder of this newsletter we will assume that all spouses are US citizens.*

How the Estate Tax Works. If a husband dies and leaves everything he owns to his wife, no estate taxes will be payable on his death because of the marital deduction. It does not matter what method of transfer the husband is using to transport his interest in the assets to his wife (e.g., by Will, due to a trust provision, by beneficiary designation, via a right of survivorship)—anything passing from the husband to the wife at death that is not a "terminable interest" will qualify for the estate tax marital deduction. Consider, however, that the wife will become the

100% owner of *all* of the assets upon the husband's death in that case. If no planning is done and the total value of the wife's assets when she dies exceeds the \$5,000,000 estate tax exclusion amount (as adjusted for inflation), the wife's estate WILL owe estate taxes on her death. That is because married couples do *not automatically* get two exemptions from the estate tax. They must *do something* to obtain two exemptions from the estate tax.

Two Methods for Obtaining Two Exemptions. In general, there are two methods for obtaining two exemptions from the estate tax: (i) make the portability election on the first spouse's death or (ii) fund a Bypass Trust on the first spouse's death. In certain cases, both methods can be used. Let's use a simple example with numbers to see how this works.

Suppose a married couple has a combined estate with a value of \$7,000,000 and it's all community property. If the husband dies first and his half of the combined estate – \$3,500,000 – passes directly (outright) to the wife, no estate taxes will be due *on the husband's death* because of the marital deduction. However, if the portability election is not made when the husband dies, *on the wife's death*, her estate will owe estate taxes on the amount above the \$5,000,000 estate tax exclusion amount (as adjusted for inflation). Ignoring inflation adjustments and deductions, and simply using the 40% "starting" estate tax rate, the wife's estate would owe approximately \$800,000 in estate taxes on her death ($\$7,000,000 - \$5,000,000 = \$2,000,000 \times 40\%$).

If, instead, on the husband's death, a Form 706 had been filed to make the portability election, the husband's entire unused estate tax exclusion amount, called the "DSUE Amount," would have been transported to the wife, giving her two exemptions. The husband's DSUE Amount in our example would be \$5,000,000, adjusted for inflation to the amount applicable in the husband's year of death (we're assuming no lifetime taxable gifts in our examples). Note that the husband's DSUE Amount is larger than his actual estate! Upon the wife's death in the second case, although she has a \$7,000,000 estate (just as in the prior example), no estate taxes would be payable because she has a total estate tax exclusion amount of \$10,000,000 (as adjusted).

The other method for obtaining two exemptions from the estate tax requires that a Bypass Trust be

established and funded on the first spouse's death. Considering the same couple, for this method to work, (i) the husband's Will or Trust Agreement must leave his estate (or exclusion amount) to a Bypass Trust for the wife; (ii) the husband and wife must avoid titling their joint accounts as "Joint Tenants with Right of Survivorship" (because the survivorship feature in the title will prevent the husband's interest in those accounts from "making it into" the Bypass Trust—his interest will pass directly to the wife on his death, outside his Will/Trust); (iii) the husband must avoid naming the wife as the "Pay on Death" ("POD") or "Transfer on Death" ("TOD") beneficiary of any accounts titled solely in his name (because, again, the POD/TOD arrangement will cause the husband's interest in those accounts to pass directly to the wife and not into the Bypass Trust); and (iv) all beneficiary designation forms for all "beneficiary designation assets" in the husband's name (life insurance, employee benefit plans, IRAs and annuities) must be completed in a manner that will at least preserve the option of the husband's interest in those assets being able to "make it into" the Bypass Trust.

If, in our example, the husband's \$3,500,000 estate passes into a Bypass Trust on his death, when the wife later dies, no estate taxes will be payable on the Bypass Trust assets—those assets will *bypass* the wife's estate and be distributed to the remainder beneficiaries (usually, the couple's children), free of estate taxes. Only the wife's personally owned estate—worth \$3,500,000 in our example—will be subject to estate taxes upon her death, and the wife's own \$5,000,000 estate tax exclusion amount is sufficient to cover that. Obviously, it takes a lot more work to establish and fund a Bypass Trust on the first spouse's death. It also takes more work during life to preserve the Bypass Trust estate plan in the Will or Trust Agreement because the way accounts and other assets are titled and the way beneficiary designation forms are completed can completely override the couple's Bypass Trust estate plan in their Will or Trust Agreement.

Which Method is Better? Both have pros and cons.

Advantages of a Bypass Trust over Portability:

1. The trust assets are protected from creditors' claims (most clients worry about "tort" creditors).
2. The trust assets are protected from being diverted

to a new spouse (or, ultimately, the children of a new spouse) of the surviving spouse.

3. The trust structure allows for management of the trust assets by a qualified Trustee.

4. The trust provides a "ready-made" asset management device in the event the surviving spouse loses his mental capacity.

5. The trust serves as a "tax shelter" to the extent of any increase in the value of the trust assets during the surviving spouse's life. This increase could be the result of (i) capital appreciation (i.e., growth in the value of the assets held in the trust) and/or (ii) the accumulation of net after-tax income, meaning income earned by the trust assets that is retained in the trust. In other words, there is no estate tax on the assets in the Bypass Trust when the surviving spouse dies no matter how large in value the assets have grown by then.

6. A Bypass Trust can provide more income tax options, depending on the design of the trust (because the surviving spouse is often not the only trust beneficiary who can receive trust income).

7. Use of a Bypass Trust may avoid the need to file a Form 706 for the first spouse's estate to elect portability.

8. The trust preserves (doesn't waste) the deceased spouse's estate tax exclusion amount, no matter what later happens (when there is no Bypass Trust, the DSUE Amount can be "lost"—see later discussion).

9. GST exemption can be allocated to the Bypass Trust (this is important if lifetime trusts are created for children on the death of the surviving spouse because it promotes long-term estate tax avoidance).

Disadvantages of a Bypass Trust:

1. It takes extra work to fund a Bypass Trust on the death of the first spouse (versus having the assets go directly to the surviving spouse). This results in expense and complexity.

2. There is no second "step-up" in income tax basis for the assets held in the Bypass Trust at the time of the surviving spouse's death.

3. A Bypass Trust must file a Form 1041, US Fiduciary Income Tax Return, each year. A CPA should prepare the Trust's annual income tax return (it's too complicated for most lay persons to prepare). Thus, there is accounting expense each year.

4. If Trust income is not distributed out of the Trust to one or more permissible beneficiaries, income taxes will be paid at a very high rate.

Advantages of Portability over a Bypass Trust:

1. Simplicity: There is no trust to fund on the death of the first spouse. Also, there is no trust to administer during the surviving spouse's lifetime and no additional income tax return to file each year.

2. There is a second "step-up" in income tax basis for all assets owned by the surviving spouse on her death.

Disadvantages of Portability:

1. The cost of preparing and filing even a "simplified" Form 706 can be significant.

2. If the surviving spouse remarries and her new spouse predeceases her, the DSUE Amount from the prior spouse can be "lost." Only the most recently deceased spouse's DSUE Amount can be used upon a spouse's death. In other words, if the surviving spouse's new spouse dies with less unused estate tax exclusion amount than the prior spouse (or, none), the surviving spouse may still end up with less than two exemptions on her death and, therefore, "unnecessary" estate taxes may still be paid when she dies. Thus, remarriage of the surviving spouse can result in loss of all or part of the DSUE Amount. In a case like that, the cost of preparing and filing the Form 706 to elect portability was a total waste. To avoid losing the DSUE Amount, a surviving spouse who is about to remarry should consider making *taxable gifts* using the DSUE Amount.

3. None of the protections and other advantages shown for the Bypass Trust apply (i.e., there is no creditor protection, no "remarriage protection," no increased income tax options, no estate tax exclusion for the growth in the value of the assets after the first spouse's death, etc.).

4. There is no portability of the GST exemption. Therefore, if no trust is created on the first spouse's death, the couple only gets one GST exemption.

There are situations where a Marital Trust, rather than a Bypass Trust, is funded on the first spouse's death to obtain *some* of the benefits of both the Bypass Trust and portability. We will not discuss that in this newsletter.

Special Extension of Time to Elect Portability. In Revenue Procedure 2014-18, 2014-7 IRB, the IRS announced that the estates of decedents who died after December 31, 2010 and before January 1, 2014,

KAREN S. GERSTNER & ASSOCIATES, P. C.
A Professional Corporation
Attorneys at Law
5615 Kirby Drive, Suite 306
Houston, Texas 77005-2448

PRSRT STD
U.S. POSTAGE
PAID
PERMIT NO. 600
HOUSTON, TX

Telephone: (713) 520-5205
Fax: (713) 520-5235

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Karen S. Gerstner & Associates, P.C.

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having a total value below the Form 706 filing requirement would have until December 31, 2014, to file a Form 706 to make the portability election. Normally, a Form 706 is due nine (9) months after the decedent's death, although an automatic six (6) month extension of time to file the Form 706 can be obtained if Form 4768 (the extension request) is timely filed. Obviously, it is technically too late for the estate of a decedent who died before January 2014 to file a Form 706 to make the portability election. However, in view of Revenue Procedure 2014-18, there is still time to do that (through December 31, 2014). Thus, if you know a surviving spouse who might benefit from filing a Form 706 to make the portability election for the estate of his/her spouse who died in 2011, 2012 or 2013, let him/her know about this special opportunity as soon as possible!

A Little Help. We are still short-handed and would love to find an attorney with at least three years' legal experience to help us. We have not had very much success with attorneys right out of law school, however, so we would prefer someone with a few years' experience. We mentioned our need for help in a prior newsletter and one of the firm's

clients (whose name shall remain confidential) came forward and offered to help out on a part-time basis. She had prior experience as a paralegal with one of Houston's large law firms, so we are very grateful to have her. But we are still short-handed. So, if you know anyone who is really bright, does careful work and has some prior experience in this field, please send them our way!

Holiday Schedule. The firm will be closed November 27 and 28 for Thanksgiving, December 24 and 25 for Christmas, and January 1 for New Year's Day. We thank all of you for your business and referrals and we wish you Happy Holidays!

Contact us:

If you have any questions about the material in this publication, or if we can be of assistance to you or someone you know regarding estate planning or probate matters, feel free to contact us by phone, fax or traditional mail at the address and phone number shown above. You can also reach us by email addressed to:

Karen S. Gerstner* karen@gerstnerlaw.com

Biljana Salamunovic biljana@gerstnerlaw.com
Laura Gerstner laura@gerstnerlaw.com

*Board Certified, Estate Planning & Probate Law, Texas Board of Legal Specialization