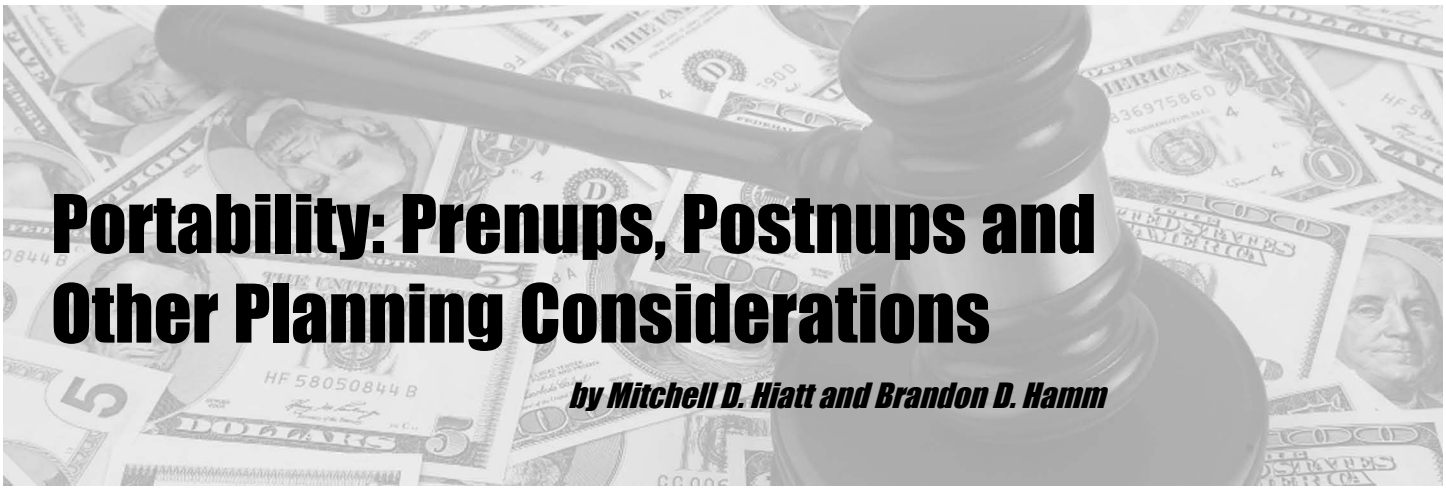

Portability: Prenups, Postnups and Other Planning Considerations

by Mitchell D. Hiatt and Brandon D. Hamm

This article addresses the relatively new federal estate tax concept commonly referred to as "portability." While some might argue that portability should be reserved to the world of estate planning attorneys, the authors of this article believe portability has a broader application. The purpose of this article is to highlight various portability-related considerations, some of which apply not only to attorneys who practice in the estate planning arena, but also to those attorneys, including family law and matrimonial law attorneys, who negotiate and draft marital agreements.

A Primer on Portability

Under federal estate tax laws, each individual has the ability to transfer a certain amount of assets at death to non-spouse, non-charitable beneficiaries free of federal estate tax.[1] This tax-free amount is known as the "applicable exclusion amount" (the "Exclusion Amount"). Because the federal estate and gift tax regimes are "unified," an individual may also use the Exclusion Amount to make lifetime gifts to non-spouse, non-charitable beneficiaries free of federal gift tax. Lifetime usage of the Exclusion Amount results in a dollar-for-dollar reduction of the Exclusion Amount available to transfer assets free of federal estate tax at death.

The use of the Exclusion Amount was, historically speaking, a "use it or lose it" proposition. That is, if an individual died without utilizing all of his or her Exclusion Amount to pass assets tax free to non-spouse, non-charitable beneficiaries, the unused portion of the decedent's Exclusion Amount was forfeited. With the adoption of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the "2010 Act") on December 17, 2010, Congress did away with the "use it or lose it" nature of the Exclusion Amount by introducing the concept now known as "portability," which allows the unused portion of a married decedent's Exclusion Amount to be allocated to and later utilized by the surviving spouse to shelter additional assets from the estate tax at the surviving spouse's subsequent death. However, there was a great deal of uncertainty regarding the long-term viability of portability

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due to a "sunset" provision in the 2010 Act, which called for the expiration of the 2010 Act on December 31, 2012. This uncertainty was resolved with the adoption of the American Taxpayer Relief Act of 2012 on January 2, 2013, which made portability a permanent feature of the laws.

With the introduction of portability, the tax code was revised to define the Exclusion Amount as the sum of the "basic exclusion amount" and the "deceased spousal unused exclusion amount."[2] The "basic exclusion amount" refers to a specified dollar figure, much like that of the pre-portability laws. In 2013, the "basic exclusion amount" is $5,250,000.[3] The "deceased spousal unused exclusion amount" refers to the amount of a deceased spouse's basic exclusion amount that was not used to shelter assets from federal gift or estate tax and was "ported" to the surviving spouse for his or her subsequent use.[4] In other words, through the concept of portability, a surviving spouse may now take into account his or her last deceased spouse's unused basic exclusion amount ("Unused Exclusion") in determining the value of the surviving spouse's Exclusion Amount.

Executors of estates that have a value less than the decedent's basic exclusion amount are not required to file a federal estate tax return. However, in order to "port" a deceased spouse's Unused Exclusion, the executor of the deceased spouse's estate must file an estate tax return within the time prescribed by law (including extensions), even though an estate tax return may not otherwise be required.[5] If an estate tax return is filed to port a deceased spouse's Unused Exclusion to the surviving spouse, the surviving spouse may then utilize the Unused Exclusion to transfer additional assets to non-spouse, non-charitable beneficiaries free of federal gift and estate tax. Simply put, utilization of a deceased spouse's Unused Exclusion allows a surviving spouse to transfer more assets free of estate and gift tax than the surviving spouse would have been able to without the availability of the Unused Exclusion.

Prenups

In the right circumstances, utilization of a deceased spouse's Unused Exclusion can represent significant tax savings to the surviving spouse and/or the beneficiaries of the surviving spouse's estate. In this regard, an individual's anticipated Unused Exclusion can appropriately be viewed as an asset, which can be left to a surviving spouse for his or her subsequent use. This perspective can be valuable for attorneys who represent clients in negotiating marital agreements where one party is likely to face estate tax issues.

For example, assume a man and a woman are engaged to be married. Both are in their early-sixties and have adult children from prior marriages. The man has a modest estate and will almost certainly be able to pass his entire estate to his children without incurring any federal estate tax. In contrast, the woman has a significant estate, well beyond her basic exclusion amount, and will likely incur a significant estate tax by passing

assets to her children at her death. Although the man and woman are very much in love, their children have strained relationships with their parent's new partner. The couple would like to enter into a prenuptial agreement and generally agree that each of them should be able to dispose of their own assets to their own children at death.

If you represent the woman with regard to the prenuptial agreement, it would be advantageous to her and her children to be able to utilize the man's Unused Exclusion in the event of his death during the marriage. However, because the man's estate will likely have a value less than the basic exclusion amount, the executor of his estate will not be required to file an estate tax return. In fact, if the executor files a return to port his Unused Exclusion to the woman, it would have the effect of reducing the inheritance available to his children because of the expense associated with preparing and filing the return. It would also potentially expose the executor to a claim for breach of fiduciary duty. Even if the woman were willing to pay for the preparation of the estate tax return, the man's children may be opposed to the executor doing so simply out of spite.

To ensure the availability of the man's Unused Exclusion for the woman and to avoid complications between the woman's and the man's respective children, it would be advisable to include a provision in the prenuptial agreement requiring the man's executor to port his Unused Exclusion to the woman in the event of his death during the marriage. In exchange, the woman may be willing to make certain concessions to provide for the man in the event of divorce or the woman's death during the marriage.

On the other hand, if you represent the man, his anticipated Unused Exclusion will represent significant tax savings to the woman and her children. In that regard, it would be advantageous to view the man's anticipated Unused Exclusion as an asset, to be used as a bargaining chip in negotiating for more favorable terms for him in the prenuptial agreement.

Below is a sample provision to consider including in a prenuptial agreement in such circumstances:

> The parties agree that, in the event of the death of either party during the marriage, the executor of the deceased spouse's estate shall, to the extent permitted under applicable law at the time of the deceased spouse's death, and at the request of and the sole expense of the surviving spouse, take such steps as may be necessary to affirmatively elect to allocate to the surviving spouse the "deceased spousal unused exclusion amount" (as such term is defined in Section 2010(c) of the Code) of the deceased spouse, including, but not limited to, the timely filing of a Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return, or such other method as may be prescribed under the Code or associated Treasury Regulations.

Postnups and Portability Provisions In Wills

Given the sensitive nature of the topic, prenuptial agreements are often not even discussed by couples before marriage. Even when a prenuptial agreement is discussed, it is common that a prenuptial agreement is not implemented before marriage. There is also the possibility that a couple entered into a prenuptial agreement prior to marriage (perhaps even after portability was introduced), but the agreement does not address portability. What options are available in these circumstances when one or both of the spouses later desire to secure the use of the anticipated Unused Exclusion of the other?

One solution is for the spouses to simply enter into a postnuptial agreement. The approach to be taken in negotiating the postnuptial agreement is almost identical to that described above for a prenuptial agreement, as are the portability-related provisions that would be included in the postnuptial agreement.

Another option is to include portability-related provisions in a will. In other words, a spouse can always specifically direct his/her executor to port their Unused Exclusion to his/her surviving spouse in his/her will. Below is a sample provision to consider including in a will in such a situation:

> Following my death, if my Spouse survives me and makes a request of my executor within three (3) months of my death, I direct my executor to affirmatively elect to allocate my "deceased spousal unused exclusion amount" (as such term is defined in Section 2010(c) of the Code), if any, to my Spouse with a timely filed Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return (or by such other method as shall be prescribed under the Code or associated Treasury Regulations), to the extent such an election is permitted under applicable law at the time of my death. All expenses associated with such allocation, including reasonable attorneys' fees, shall be at the sole expense of my Spouse.

There are a number of reasons such a provision should eliminate any concern by either spouse that their own children (or other beneficiaries) would impede the steps required to port the Unused Exclusion to the surviving spouse. First, the provision requires the surviving spouse, who would benefit from the ported Unused Exclusion, to pay for the preparation of the return, thereby eliminating any potential reduction in the inheritance of the children of the deceased spouse. Second, the provision is a clear expression of intent that the executor would presumably be obligated to follow in carrying out its fiduciary duties. Finally, if the Unused Exclusion is viewed as an asset as suggested above, the surviving spouse could argue that they are a beneficiary of the deceased spouse's estate, strengthening their argument that the executor must take the appropriate actions to port the deceased spouse's Unused Exclusion.

The Last Deceased Spouse Rule

An additional aspect of portability to consider is that a surviving spouse can only utilize the Unused Exclusion of his/her "last deceased spouse."[6] In other words, an individual cannot collect or "stack" the Unused Exclusions from multiple deceased spouses.

To illustrate this limitation, consider a situation in which Husband was previously married to First Wife, who passed away in 2011, survived by Husband and their children. The executor of First Wife's estate validly ported First Wife's Unused Exclusion to Husband. Husband has a significant estate and, without the ported Unused Exclusion from First Wife, would be facing an estate tax issue. Now, Husband is to be married to Second Wife, but wants to ensure the bulk of his estate passes to his children at his death. If, following their marriage, Second Wife predeceases Husband, the Unused Exclusion ported to Husband from First Wife will be forfeited because Second Wife will then be Husband's "last deceased spouse." Thus, if Second Wife will have Unused Exclusion to port to Husband in the event of Second Wife's death during the marriage, Husband and Second Wife should consider entering into a prenuptial agreement requiring the executor of Second Wife's estate to port Second Wife's Unused Exclusion to Husband.

Another planning option in this situation is for Husband to make significant gifts to his children prior to or after the marriage, but in any event, before the death of Second Wife. Husband's gifts will consume the Unused Exclusion ported to Husband from First Wife prior to consuming Husband's own basic exclusion amount, even if those gifts are made while married to Second Wife.[7] If this option may be pursued, then any prenuptial agreement should permit Husband to make such gifts without Second Wife's consent.

"9100 Relief" For Late Elections

As mentioned above, in order to port a deceased spouse's Unused Exclusion to a surviving spouse, the executor of the deceased spouse's estate must file an estate tax return within the time prescribed by law (including extensions).[8] In most cases, failing to timely file an estate tax return will result in the forfeiture of the opportunity. However, some practitioners have suggested that the IRS may be willing to grant "9100 relief" (*i.e.*, administrative relief available under Treas. Reg. §§ 301.9100-1 through -3 for failure to make a tax election by the due date for such election) for estates that failed to timely file an estate tax return electing in favor of portability. In that regard, James Hogan, from the Branch 4 Office of the Associate Chief Counsel (Passthroughs & Special Industries), recently stated that the IRS "will consider requests for 9100 relief on the portability of the individual exemption for estates under the credit amount."[9] Thus, attorneys should consider whether it is worthwhile to seek 9100 relief in certain circumstances (*i.e.*, where a client's spouse died after December 31, 2010, and the executor failed to timely file an estate tax return to port the deceased spouse's Unused Exclusion to the client).

Conclusion

Portability provides a tremendous amount of additional estate planning flexibility and is a positive development in federal estate tax laws. However, it has a broader application than just in the estate planning arena. Any attorney that represents clients in marital agreement preparation should have a working knowledge of portability in order to fully represent their clients' interests.

Endnotes

1. Transfers made to spouses and charities typically pass estate tax free due to the application of the marital deduction and charitable deduction, respectively.
2. I.R.C. § 2010(c)(2).
3. I.R.C. § 2010(c)(3); Rev. Proc. 13-15, 2013-15 I.R.B. 2013-5.
4. See I.R.C. § 2010(c)(4).
5. I.R.C. § 2010(c)(5)(A).
6. I.R.C. § 2010(c)(4).
7. Temp. Treas. Reg. § 25.2505-2T(b) (2012).
8. I.R.C. § 2010(c)(5)(A).
9. News, Commentary, and Analysis, Doc. 2013-11615, 2013 TNT 93-9 (May 13, 2013).

If you are aware of anyone within the Nebraska legal community (lawyers, law office personnel, judges, courthouse employees or law students) who suffers a sudden, catastrophic loss due to an unexpected event, illness or injury, the NSBA's SOLACE Program can likely assist that person in some meaningful way.

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