



Planning Pointers

JUNE 2012

Federal Estate Tax – The Portability Option

In December 2010, Congress provided married couples with a new option, called “portability,” to use in their federal estate tax planning. Congress intended this new option to be less complicated and more easily implemented than the estate tax planning techniques married couples often use. This Planning Pointer provides a general discussion of the benefits and possible downsides of portability, with comparisons to traditional techniques. Which, if any, of these estate tax planning approaches is the best choice will depend on each married couple’s personal and financial situation. Therefore, the information contained in this Planning Pointer should be considered only in conjunction with the advice of an estate planning attorney or tax advisor.

TRADITIONAL TECHNIQUES

The most important building blocks of estate tax planning for married couples have long been the federal marital deduction and applicable exclusion amount (often referred to as an exemption). All assets transferred from a deceased spouse’s estate to a surviving spouse that qualify for the marital deduction pass free of the federal estate tax. Property passing at death that is within the applicable exclusion amount also is not subject to the federal estate tax,

regardless of the relationship of the recipient to the decedent. A primary goal of traditional estate tax planning has been to coordinate the use of these two options so that a couple’s total assets benefit from an applicable exclusion in both estates, thereby reducing or eliminating the overall federal estate tax liability.

The most common method of achieving that goal is to fund a credit shelter trust (sometimes referred to as a by-pass trust) on the first death with assets having a value equal to the applicable exclusion amount. Assets in excess of the exclusion amount then pass to the surviving spouse free of the federal estate tax under the marital deduction, resulting in no federal estate tax liability on the first death. With proper planning the assets held in the credit shelter trust will not be subject to the federal estate tax on the second death as well. The second estate will be able to apply its applicable exclusion amount to the surviving spouse’s assets, thereby making maximum use of each spouse’s applicable exclusion amount.

PORTABILITY

In December 2010, Congress enacted two significant changes to the federal estate tax laws. First, the applicable exclusion amount was increased to \$5,000,000 for

2011 and now \$5,120,000 for 2012. Second, to facilitate full usage of the two applicable exclusion amounts for a husband and wife, Congress adopted the concept of “portability.” Generally, portability means that the estate of the second spouse to die can use his or her applicable exclusion amount *and* the exclusion amount unused in the estate of the first spouse to die.

Portability can be better illustrated by example. Assume the following:

- A husband owned assets of \$3,000,000, his wife owned assets of \$2,000,000, and they jointly owned assets of \$4,000,000.
- The husband died in 2011 survived by his wife.
- The husband left \$1,000,000 of his assets to their children and the balance of his assets to his surviving wife.

Under this scenario, there would have been no federal estate tax at the husband’s death. The husband would have used \$1,000,000 of his applicable exclusion amount, but \$4,000,000 would have been unused and thus wasted. With portability, however, if the surviving wife dies in 2012, her estate of \$8,000,000 would be able to apply the wife’s applicable exclusion amount of \$5,120,000 *plus* the husband’s unused applicable

exclusion amount of \$4,000,000, resulting in a non-taxable estate.

OTHER FACTORS

Although portability offers a simple planning path, it is subject to certain caveats. For example, without further action by Congress, the increased exemption amount and the portability option will expire as of January 1, 2013. (Under President Obama's 2013 budget proposals, however, the applicable exclusion amount would be decreased to \$3,500,000, and portability would become a permanent part of the tax code.) Further, to take advantage of portability while it is still available, an election must be made by the first-to-die's estate. The election can be made only by the timely (i.e., nine months from the date of death) filing of a federal estate tax return, regardless of the size of the estate of the first-to-die. Due to misunderstandings of the law, it is foreseeable that many surviving spouses will fail to properly make the election.

For many married couples, portability can be a useful tool in maximizing

the use of their two applicable exclusion amounts. Reliance on portability, however, has significant drawbacks when compared to traditional use of credit shelter trusts, such as:

- Given the uncertainty about Congressional action concerning tax matters, there is no assurance portability will be extended after 2012.
- Remarriage of a surviving spouse may result in the loss of portability, particularly if the new spouse has significant assets.
- Portability does not apply to the generation-skipping transfer tax exemption.
- Portability will probably not be available with respect to state estate taxation.
- Assets held in a credit shelter trust, even if appreciated in value since the first spouse's death, are not subject to the estate tax in the estate of the second spouse to die. With portability, the full value of assets held by the surviving spouse as a result of the death of the first-

to-die will be subject to estate tax in the second spouse's estate.

- Credit shelter trusts can protect assets from creditors of the surviving spouse and other family members.
- A credit shelter trust can help assure that assets of the first spouse to die will be distributed to, and/or held for the benefit of, his or her designated beneficiaries, such as children and grandchildren.

SUMMARY

Despite the allure of portability's intended simplicity, married couples, in consultation with their professional estate planning and tax advisors, may need to consider their circumstances and goals in evaluating the utility of relying on portability, especially in light of the uncertainty of its continued availability.

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