

TRUSTS & ESTATES ADVISORY

Portability Is Best Viewed
as a Complement to
Traditional Estate Planning

Portability - Good, But Not Perfect

As discussed in our June 2012 *Trusts & Estates Advisory*, the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (the “Act”), altered the federal estate, gift and generation-skipping transfer (“GST”) tax scheme by increasing the federal gift, estate and GST-tax exemption to \$5,000,000 for 2011 and \$5,120,000 for 2012. In addition, the Act introduced the concept of a “portable” federal gift and estate tax exemption. Under the Act, a decedent’s unused federal estate tax exemption is portable to a surviving spouse, to be used by the surviving spouse during his or her lifetime or at death. Portability will increase the likelihood that a married couple will maximize the use of their federal estate and gift tax exemptions, thereby reducing their potential transfer tax liability.

In our latest *Trusts & Estates Advisory*, we discuss the concept of portability and the pros and cons of portability as it pertains to you, our client. Clearly, portability provides certain benefits for married couples. In today’s tax and estate planning environment, there is great uncertainty as to the future of federal and state estate taxes, gift taxes, and exemptions. Although portability provides a certain level of convenience, its limitations lead us to favor more traditional planning for most clients. Consequently, it makes sense to utilize flexible estate planning documents that maximize the advantages of both portability and trusts to protect your assets for you and your beneficiaries.

Background

Prior to the Act, the federal tax system provided each spouse with a gift or estate tax exemption. Under that framework, if the first spouse to die was only able to use part of his or her estate tax exemption, the unused exemption would be lost. Thus, without proper planning, in many instances the estates of married couples were saddled with taxes on millions of dollars worth of assets that could have been avoided.

In this regard, during the planning process, we often discuss with clients the importance of how assets are held. For example, spouses typically hold title to their residence, bank and brokerage accounts as joint tenants with rights of survivorship. Under the joint tenancy laws, these assets pass automatically to the surviving spouse and not pursuant to a deceased spouse’s estate plan. Similarly, many assets such as life insurance policies, pension plans and IRAs pass by beneficiary designation at death. Consequently, if at a first spouse’s death, a majority of assets passed to the survivor by operation of law or beneficiary designation, it was likely that the deceased spouse would not have a sufficient amount of assets to fully utilize his or her estate tax exemption. As the

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federal estate tax exemption has increased over the past several years, a couple's ability to utilize their federal and estate gift exemption became more difficult.

To alleviate this concern, the Act introduced the concept of a portable estate and gift tax exemption. In order to qualify, at the death of the first spouse, his or her Executor must timely file a federal estate tax return (regardless of whether one is otherwise required). Once this portability election has been registered, the surviving spouse is free to use the deceased spouse's remaining estate or gift tax exemption to shelter lifetime gifts or reduce estate taxes at the surviving spouse's later death. If a surviving spouse makes a taxable gift during his or her lifetime, he or she is deemed to use the deceased spouse's unused federal exemption first.

Consider the following example. Let us assume that: i) John and Mary Smith have combined assets of approximately \$10,000,000; ii) Mary has \$6,000,000 of assets in her name, John has \$3,000,000 of assets in his name, and they have \$1,000,000 in a brokerage account titled in their names as tenants-in-common; and iii) the Smiths have signed estate planning documents designed to utilize their federal estate tax exemptions. The following illustrates what would happen in the event of John's death (assume the federal estate tax exemption is \$5,000,000):

Without Portability	With Portability
<p>At John's death, \$3,500,000 (\$3,000,000 of his assets plus \$500,000 of the tenants-in-common account) would pass to an Estate Tax Sheltered Trust for Mary's benefit which would not be included in her estate. At Mary's later death, she would have a federal taxable estate of approximately \$6,500,000. Mary has a federal estate tax exemption of \$5,000,000 and her estate would pay a 35% tax on the remaining \$1,500,000 of assets, or a tax of approximately \$525,000.</p>	<p>At John's death, \$3,500,000 would pass to an Estate Tax Sheltered Trust for Mary's benefit which would not be included in her estate. In addition, John's Executor would file a federal estate tax return so that his remaining \$1,500,000 federal exemption would be portable to Mary. At Mary's later death, she would have a federal taxable estate of approximately \$6,500,000. However, her federal estate tax exemption would be \$6,500,000 (i.e., her \$5,000,000 plus John's unused \$1,500,000 of exemptions). As a result, Mary's estate would have a federal estate tax liability of \$0.</p>

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As this example illustrates, portability provides a married couple with the opportunity to reduce their potential federal estate tax liability. However, portability has a number of limitations. Some of these are set forth below.

Generation-Skipping Transfer Tax (GST-Tax) Exemption

The federal transfer tax system consists of three separate taxing schemes, the gift tax, the estate tax, and the GST-tax. The GST-tax applies to any transfers that “skip” a generation (typically transfers from a grandparent to a grandchild). The federal gift, estate and GST-tax exemptions are all currently \$5,120,000. However, only the federal gift and estate tax exemptions are portable. The federal GST-tax exemption is not.

Consequently, if a married couple relies on portability, they could be reducing the amount of their assets which could otherwise pass to their grandchildren and more remote descendants transfer tax-free. With a GST-tax rate equal to the highest estate tax rate (currently 35%), the potential exposure is quite significant.

The State Estate Tax Dilemma

The Act is a federal statute, and has no impact on state estate taxes. At this time, no state estate tax exemption is portable. Connecticut, for example, has a \$2,000,000 estate tax exemption. Consequently, if a deceased spouse leaves all of his or her assets outright to the survivor, no estate taxes will be due at the first spouse’s death as a result of the marital deduction available under both federal and state tax law. However, the amount of state estate taxes that would otherwise be due at the survivor’s death will be higher. As a result, it is prudent to create an Estate Tax Sheltered Trust at the first spouse’s death to ensure the use of your state estate tax exemption.

Future Appreciation

Under the example set forth above, at John’s death, an Estate Tax Sheltered Trust was created for Mary’s benefit. As mentioned, any assets remaining in the Estate Tax Sheltered Trust at Mary’s death will not be included in her estate. Consequently, it is not only the assets that initially passed to the Estate Tax Sheltered Trust at Mary’s death, but also any appreciation on the trust’s assets during Mary’s lifetime which would avoid tax. Therefore, it is our recommendation to fully fund an Estate Tax Sheltered Trust at the first spouse’s death to minimize the size of the survivor’s gross estate for federal estate tax purposes.

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Remarriage of Spouse

We must also consider what would occur if the surviving spouse remarries. If John leaves all of his assets to Mary outright, the assets will be disposed of pursuant to her estate plan.

If Mary remarries, it is possible that John's assets could pass to individuals whom John did not wish to benefit. Alternatively, if John's estate plan creates an Estate Tax Sheltered Trust, he can limit the potential beneficiaries at Mary's later death under the terms of his trust.

Mary's remarriage also impacts the portability of John's unused estate tax exemption. Under the Act, a surviving spouse's estate may only use the most recent deceased spouse's unused estate tax exemption. Thus, if Mary marries Bill, and Bill later dies leaving his \$5,000,000 federal estate tax free amount to his children from a previous marriage, at Mary's later death, only Bill's unused exemption of \$0 would be available to her. As a result, John's \$1,500,000 unused estate tax exemption has been wasted.

The Solution: Estate Plan Flexibility

While portability is a useful tool in certain circumstances, it is our strong recommendation that clients not rely on portability to satisfy all of their estate planning goals. First, portability is set to expire on December 31, 2012. Given the constantly changing estate tax landscape, there is no guarantee Congress will extend it, or that future changes won't reduce its availability. Second, the federal generation-skipping transfer tax exemption is not portable. Third, state estate tax exemptions are not portable. Fourth, portability does not shield future appreciation of assets from tax at the second spouse's death. Finally, portability does not provide any flexibility regarding a change in family circumstances such as the remarriage of the surviving spouse.

At the first spouse's death, the funding of an Estate Tax Sheltered Trust can also provide protection against the claims of creditors, including care costs if a spouse becomes disabled. Trusts can also be drafted to protect your children from claims brought by creditors, spouses during divorce and special needs costs for children. Our overriding goal as estate planners is to ensure that your assets pass intact to your designated beneficiaries and, without the protection provided by trusts, assets remain vulnerable. Some of the advantages of portability and creating a trust to hold assets are as follows:

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Advantages of Portability	Advantages of Trusts
<p>Maximize federal estate tax exemptions</p> <ul style="list-style-type: none">• Avoid re-titling of assets• Avoid costs associated with creation and maintenance of trusts• Step-up in basis at the death of each spouse	<ul style="list-style-type: none">• FLEXIBILITY• Maximize both federal and state estate tax exemptions• Preserve the first spouse's GST tax exemption• Appreciation of assets held in estate tax sheltered trust not subject to estate tax• Protect assets for spouse from creditors or in the event of disability• Protect assets for children from prospective creditors or spouses

If you would like to discuss how portability affects your estate plan, or would like to update your estate planning documents, please contact us and we would be happy to assist you.

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