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SPOUSAL PORTABILITY OF ESTATE TAX EXEMPTION: HOW PORTABLE IS IT REALLY?

Last December 17, President Obama signed into law the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the “new tax law”) which made several significant changes affecting estate, gift, and generation-skipping transfer (“GST”) taxes. We described these changes generally in our memorandum of December 20, 2010. In this follow-up memorandum we focus on a feature of the new tax law which, for the first time, allows “portability” of estate and gift tax exemptions between spouses.

Portability refers to the ability of a surviving spouse to use the amount of his or her deceased spouse’s unused estate and gift tax exemption. Under the new tax law, that exemption is \$5 million (during 2011 and 2012) and can be used to shelter gifts during lifetime or bequests at death from the Federal estate tax.

Historically, the estate and gift tax exemption was personal to an individual and could not be passed on to the individual’s spouse. Thus, although a couple technically had available double the amount of one individual’s estate and gift tax exemption – or \$10 million under current law – the only way to utilize the combined amount fully was to make sure, first, that each spouse had sufficient assets titled in his or her name and, second, that those assets did not pass to the surviving spouse such that they would again be includible in the surviving spouse’s estate at his or her later death. Otherwise, part or all of the exemption of first spouse to die would be wasted.

For example, if a couple owned \$10 million in assets titled in the name of only one spouse and the non-owner spouse died first, his or her entire exemption would be wasted. Furthermore, even if each spouse held sufficient assets to absorb the full amount of the exemption, the couple still would have to engage in proactive planning to segregate those assets at the death of the first spouse, so that they could pass outside the survivor’s estate at the survivor’s subsequent death. If the first to die simply left all of his or her assets to the survivor, then his or her exemption would be wasted.

The typical planning strategy used to address the second concern was to create a credit “shelter” or “bypass” trust under the will of the first spouse to die. However, a bypass trust strategy (i) generally required couples to engage legal counsel to assist them in drawing a will that would include a bypass trust, (ii) left surviving spouses without direct access to the assets in the bypass trust (because if a survivor had full access, then the assets would be includible, and subject to tax, in his or her estate), and (iii) meant that the assets in the bypass trust did not receive a step-up in income tax basis at the surviving spouses’ later death (there would be a basis step-up at the first spouse’s death but not another one when the survivor died).

For many couples, the advent of portability under the new tax law appears to solve all of the above challenges. Under the new law, a surviving spouse is able to “inherit” all of the remaining estate and gift tax exemption of his or her deceased spouse. That exemption is tacked on to the surviving spouse’s own exemption and can be applied to taxable gifts made by the survivor, either during lifetime or at death. No special provisions are required in the will of the first to die in order to allow his or her unused exemption to pass to the survivor, and there are no restrictions on the surviving spouse’s access to the assets of the first spouse to die during the survivor’s remaining lifetime. Finally, at the survivor’s later death, all of the assets includible in the survivor’s estate – including any remaining assets of the first spouse – receive a step-up in income tax basis.

It is important to note, however, that portability is not automatic. In order for a surviving spouse to use a deceased spouse’s exemption, an election must be made by the executor of the deceased spouse’s estate on a timely filed estate tax return in respect of the deceased spouse. This is so even though a return otherwise would not have to be filed for the deceased spouse’s gross estate, because his or her gross estate is less than the estate tax exemption. In fact, it would seem that every executor will now have to strongly consider filing an estate tax return for every estate where the estate and gift tax exemption was underutilized so as to preserve the remaining exemption for the surviving spouse.

While taking advantage of portability will be desirable for many couples, there are significant limitations to portability which suggest continued use of bypass trust and similar strategies (including post-mortem disclaimers) to “lock in” the estate tax exemption of the first spouse to die, including:

- Uncertainty About Future Estate Tax Environment – Under current law, portability is only available for two years. If Congress does not extend the new tax law or make it permanent before the end of 2011, then portability will no longer be available. A

surviving spouse who was expecting to take advantage of portability might be in for an unwelcome surprise if the law is changed after the first spouse dies and portability no longer is allowed. Other changes in the law such as a reduction in the estate tax exemption or increases in estate tax rates also may impair the value of the portable exemption.

- State Estate Taxes – So far, portability applies only to the Federal estate tax exemption, not to the state-level exemptions available in states which have their own estate taxes. For example, a decedent from New York is entitled to a state estate tax exemption of \$1 million. Since New York law currently does not provide for portability, the state exemption would be forfeited at the death of the first spouse if portability is relied on exclusively.
- Indexing for Inflation/Appreciation of Assets – Under the new tax law, the Federal estate tax exemption is indexed for inflation beginning in 2012. However, the portable estate tax exemption of the first spouse to die is not similarly indexed. Thus, it will lose value to inflation over the remaining lifetime of the surviving spouse. On the other hand, using a credit bypass trust for the deceased spouse's exemption will effectively allow the first spouse's unused exemption to appreciate outside the survivor's estate.
- GST Taxes – Portability applies only to a spouse's estate and gift tax exemption and not to a spouse's unused GST exemption. Accordingly, to the extent that a couple is planning to utilize any portion of their estate tax exemption to also shelter assets from the GST tax, portability will not be the answer to their planning needs.
- Traditional Benefits of Trusts – Credit bypass strategies using trusts have non-tax benefits that make them worth considering even in an age of portability. A trust provides benefits over leaving assets to a surviving spouse outright, including asset protection for the surviving spouse, an ability to restrict transfers by the surviving spouse, and management oversight.
- Remarriage – Portability applies only to the last deceased spouse of an individual. Thus, if an individual remarries and his or her second spouse also dies, the individual is limited to the second spouse's unused exemption amount, even if that amount is lower than what the first spouse had remaining. By contrast, a credit bypass strategy ensures the use of each spouse's entire unused exemption.

In light of the above described limitations, portability should not take the place of prudent planning to fully utilize one's exemption. However, it does offer welcome relief in certain smaller estates and in cases where there was no advance planning.

We are available to advise our clients in determining what portability means for their particular situation, or to discuss any other estate planning matter.

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