

“Portability”

For married couples the December 2010 Congressional tax compromise brought in a new tax benefit. If one spouse doesn't use up his or her federal estate tax exemption, the surviving spouse will inherit the unused portion. In layman's terms, the exemption is “portable.” In IRS lingo, it is a Deceased Spousal Unused Exemption Amount (DSUEA).

No longer will trust planning be needed for maximum protection of the family fortune from estate taxes. Bank trust departments and trust companies have promoted “credit shelter trusts” for married couples to consider, showing substantial savings compared to an “all to spouse” estate planning strategy. Those illustrations don't work when the DSUEA is available instead.

However, as nice as portability of unused exemption amounts between spouses sounds, in many cases it may make estate administration somewhat more complicated. To preserve the unused exemption, the executor for the estate of the first spouse to die must file a federal estate tax return, even if no estate tax is due, even if the estate is well under the \$5 million basic exclusion amount. Even if the surviving spouse doesn't appear to be a candidate for paying federal estate taxes, one cannot know how long that the spouse will live and what other assets he or she might come into. Therefore, the number of estates filing federal estate tax returns will have to skyrocket in the coming years.

Three drawbacks have emerged to relying upon portability in an estate plan. First, the DSUEA expires in 2013. A DSUEA that is created because of the death of a spouse in 2011 or 2012 may not be preserved; it will evaporate in 2013, unless new legislation is enacted extending the provision.

Second, if the legislation is extended, the statute of limitations for the estate of the first spouse will remain open until the death of the second spouse, when the DSUEA will be claimed. This could be decades later.

Finally, the DSUEA does not extend to the generation-skipping transfer tax. Relying on this approach “wastes” the exemption of the first spouse to die.

Accordingly, many experts suggest that portability is a good back-up for those who fail to plan, but less than ideal as a first choice. In many cases, especially for smaller estates, the better course will be to rely on a bypass trust to consume the first spouse's exclusion. This allows for finality in that spouse's estate; it offers flexibility in providing for other heirs; and appreciation in bypass trust assets will not be subject to estate tax at the second spouse's death.

Portable exemptions versus credit shelter trusts

This table illustrates the pros and cons of credit shelter trusts versus reliance on the new portability provisions.

| | Portable exemption | Credit shelter trust |
|-----------------------------------|--------------------|--|
| Expiration date under current law | December 31, 2012 | No expiration date |
| Inflation adjustments | Not allowed. | Inflationary growth in trust assets avoids future estate taxation. |

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| Basis step-up at surviving spouse's death | Yes | No |
| Estate planning simplicity | Easily understood, meets most couples' expectations, but will require estate tax filings by nontaxable estates. | Somewhat more complicated, harder for couples to understand, but existing estate plans do not require redrafting. |
| Asset protection upon future remarriage and divorce | No | Yes |
| Preservation of inheritance for children | No | Yes |
| Generation-skipping transfer tax exemption | Lost | Preserved |

Source: IRS Code; M.A.Co.

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