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Estate Tax Portability

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On December 17, 2010, President Obama signed the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (TRA 2010). TRA 2010 temporarily changed the federal estate tax system for the years 2011 and 2012. As part of TRA 2010, a new estate tax concept, portability, was born. Portability allows a decedent's unused estate tax exemption to be transferred to and used by his or her surviving spouse, either to shelter lifetime gifts from gift taxes or transfers at the surviving spouse's subsequent death. Portability for married couples, heterosexual or same-sex, was made permanent for 2013 and future years by the American Taxpayer Relief Act, signed by President Obama on January 2, 2013. In 2014, the federal exemption amount is $5,340,000.

Portability makes it easier for spouses to minimize the impact of estate taxes. Historically, spouses who wanted to utilize both of their exemption amounts had to plan in advance by creating an estate plan that incorporated what is commonly known as a credit shelter trust (a/k/a a bypass trust or a family trust). A credit shelter trust is created on the first spouse's death and is funded with an amount up to the deceased spouse's then available estate tax exemption, thus using the first spouse's exemption to the greatest extent possible. This credit shelter trust is not subject to estate taxes at the surviving spouse's death. If, however, a married couple did not create such a plan and all assets were transferred outright to the surviving spouse at the first death (at which time no exemption would be used due to the unlimited marital deduction), the deceased spouse's exemption would be wasted and the survivor would be left to shelter their entire joint estate using only his or her sole exemption.

Portability gives a married couple a second chance at minimizing estate taxes. But in order to do so, there are actions that need to be taken after the death of the first spouse. The only way to "port" the exemption to the surviving spouse is by making an affirmative election on a timely filed federal estate tax return (Form 706). This must be done even though filing an estate tax return would not otherwise be required.

Although the new law has its obvious advantages, the decision to port a deceased spouse's unused estate tax exemption should be made after careful consideration of the law's complications and limitations. Below are some reasons that should be carefully considered before making a decision as to whether to rely on portability or whether to establish a credit shelter trust or use other estate planning techniques:

- **Volatility of the Estate Tax Law**. Even though the law is currently "permanent," Congress could decide to change the law at any time; the application of portability could change or cease to exist. To have a fully funded credit shelter trust at the first spouse's death protects against this uncertainty.
- **Indexing for Inflation/Appreciation of Assets**. Under current law, the federal estate tax exemption is indexed for inflation beginning in 2012. However, any ported estate tax exemption of the first spouse is not similarly indexed. This means that the ported exemption will not grow with inflation, as the surviving spouse's exemption grows. Also, if the deceased spouse's assets appreciate in value, the appreciation will also be included in the surviving spouse's estate if portability is relied upon, but along with a step-up in cost basis, saving the beneficiaries capital gains tax on that appreciation. In contrast, any appreciation occurring in a credit shelter trust will not be subject to estate taxes at the surviving spouse's death, but also carries with it the lower cost basis from the deceased spouse's date of death, which can leave the beneficiary with a significant capital gains tax.
- **Creditor Protection**. Assets that are transferred to a surviving spouse outright will not be protected against a spouse's potential creditors. A credit shelter trust can protect assets from creditors.
- **Generation-Skipping Transfer Taxes**. Portability applies only to a deceased spouse's estate and gift tax exemption and not to unused generation-skipping transfer tax exemption. Thus, for a couple who wishes to plan for many generations or for a very wealthy family where the children may also face estate tax issues, a funded credit shelter trust may be a much better option.
- **Remarriage**. Portability applies only to the last deceased spouse of an individual. If a surviving spouse remarries, the ported exemption of the first deceased spouse will be lost if the second spouse dies before the surviving spouse. Also, relying on portability leaves all control with the surviving spouse, which may not always be the best result. For example, in a second marriage situation, a funded credit shelter trust may be a better choice as disposition of those trust assets can be irrevocably designated upon the first death so that children from a previous marriage ultimately receive the balance of the credit shelter trust.

If you have any questions, please contact your Reinhart attorney or any member of the Reinhart Trusts and Estates or Tax Practices Areas.