Fox Rothschild LLP
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TAX & ESTATES DEPARTMENT

ALERT

Portability Allows Married Couples To Share Estate and Gift Tax Exemptions

In December 2010, we issued an alert informing you of the passage of the Tax Relief Unemployment Insurance Reauthorization and Job Creation Act of 2010, which had a wide impact on estate planning strategies. Fox Rothschild attorneys are issuing specific alerts on a number of issues relating to the Act. This is the second in the series.

A basic concept in federal estate and gift tax planning is the unified credit—now referred to as the applicable exclusion amount—that represents the amount a taxpayer can leave to heirs free of federal estate and gift tax. The amount of this exclusion has increased over the years from $600,000 in the 1980s to $5 million in 2011 and 2012. Married couples can leave twice this amount since each spouse has a separate exclusion.

For years, an important part of estate planning has been making sure the assets of a married couple were properly titled so their estates would get the benefit of using both of their exemptions. The idea was to ensure no matter which spouse died first, sufficient assets would exist in the first estate to fully utilize the exemption. This often led to retitling assets from joint names to individual names, which may have been contrary to how the clients wanted to own their assets. As estate planners, we would advise they had to do it for "tax purposes." It was an example of the tax tail wagging the asset dog.

In recent years, many in favor of tax simplification suggested it would make sense to allow a married couple to share their two exemptions, regardless of which spouse dies first and how the assets are titled. If the first spouse to die does not have sufficient assets to fully utilize his or her exemption, then the unused part would be available for the surviving spouse to use in the second estate. This sharing of the exemption amount became known as portability.

The Tax Relief Act of 2010 enacted portability into the law for tax years 2011 and 2012 by amending Section 2010(c) of the Internal Revenue Code. It created an election for estates of decedents dying during those two years to make the deceased spouse's unused exclusion amount (DESUEA) available to the surviving spouse, both for gift and estate tax purposes. The election is made on the federal estate tax return in the first estate that will require estates to file returns even if the size of the assets is well below the exclusion amount. The result may be more estate tax returns being filed even though one would otherwise expect the new $5 million exclusion amount would result in fewer estates filing returns.

While the concept of portability is appealing since it could make estate planning for married couples less complicated, its use in practice will be anything but simple. Many factors will be involved in deciding whether to take advantage of portability:

- Portability is currently in the law for only 2011 and 2012. Not knowing whether portability will go away in 2013, it would be very risky to not retitle assets and not plan for using the first spouse's exemption. Even if we are fairly certain the first spouse will die during the two-year period, it is the second spouse's estate that will get the benefit of portability.

• The statute of limitations for the first spouse's estate tax return is extended for purposes of calculating the DESUEA. It may be better to utilize the first spouse's exemption and start the statute of limitations running than to leave the statute open until the surviving spouse dies. This is especially true if there are difficult to value assets and you do not want to give the IRS a second chance to challenge the values.

• Portability only applies to the last deceased spouse's unused exemption. If the surviving spouse remarries and survives the second spouse, the first deceased spouse's DESUEA will be lost. This is a much worse result than if a trust had been established on the first spouse's death to preserve the exemption for the benefit of the children or other heirs.

• There are also tax basis issues to consider. In traditional unified credit planning, a trust would be created on the first death to capture the exclusion of the first spouse. While the assets will receive a step up in basis on the first death, the assets do not get a second step up on the second death. With portability, if all of the assets are left to the surviving spouse, all of the assets will get a step up at both the first and second deaths. In other words, portability can reduce capital gains taxes the heirs will pay when they sell inherited assets.

• Portability applies for estate and gift tax purposes, which allows the surviving spouse to make gifts to utilize the DESUEA. If it becomes clear at the end of 2012 Congress is not going to extend portability, there may be a strong incentive for surviving spouses to make gifts before the DESUEA goes away in 2013. While we are waiting for regulations to explain how this will work, it appears any gifts made by the surviving spouse would first use up the DESUEA before using up the surviving spouse's own exclusion amount. There is also uncertainty regarding how such gifts would be treated for estate tax purposes if the exemption amount is lower at the time of the second spouse's death.

• Portability does not apply to the generation skipping transfer tax (GSTT). Therefore, the GSTT exemption of the first spouse would be lost if all of the assets are left to the surviving spouse, who is planning on using the DESUEA to exempt those assets from estate tax in the second estate.

• There are many reasons to use trusts aside from potential tax savings. These include asset protection, preservation of assets for remainder beneficiaries, professional management of assets and protection of assets in the event of divorce. In second marriage situations, clients often want to ensure assets will go to children from the first marriage after the death of the second spouse. In first marriage situations, many clients are concerned their spouse could remarry and leave their assets to the new spouse rather than their children. Trusts can help in all of these situations, regardless of any tax considerations.

So much for tax simplification! Until we know whether portability will become a permanent part of the estate and gift tax laws, we will need to provide for flexibility in planning to accommodate clients' needs under various alternative circumstances, which will ultimately make planning more complex. For now, portability may be of greater use as a post-mortem tool in applicable situations. It can also be a means of fixing a problem after someone dies, such as where a client leaves the entire estate to the surviving spouse outright and there is no way to preserve the client's exemption amount without portability. While portability is an exciting new tool for estate, gift and post-mortem tax planning, it must be handled with care.

Please Call Us With Your Questions

We encourage you to contact your relationship lawyer at Fox Rothschild or a member of the firm's Tax and Estates Department in the state in which you maintain your permanent residence to discuss the potential impact of the Tax Relief Act of 2010 on your current estate plan and evaluate whether appropriate changes should be made.

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