Estate Planning in the Age of Portability

By David E. Sloan

For many years, estate planners have been comfortable using a traditional estate-planning approach for a typical estate involving a married couple. The standard estate plan in this case was based on a two-pronged approach involving the following steps:

1. The creation of a separate revocable trust for each spouse, with each trust becoming irrevocable upon the death of the spouse who created the trust.
2. The allocation of assets between the two spouses so that the first spouse to die would have sufficient assets for sheltering from the federal estate tax in his or her irrevocable trust.

In a world of rising estate tax exemptions, the tax savings from this type of planning for a larger estate could be as much as $2 million or more at the death of the surviving spouse.

Suddenly, with the advent of permanent portability on January 1, 2013, this traditional estate planning approach may no longer be the best strategy for many people.

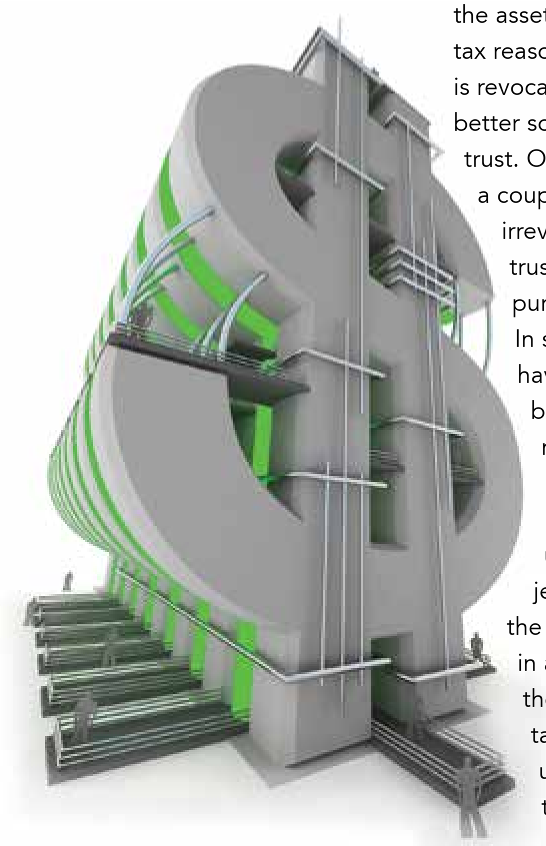
Basically, estate tax portability means that regardless of how assets are allocated between husband and wife, any unused exemption of the first spouse to die can be "ported" to the surviving spouse. For example, if a husband dies in 2013 and leaves everything to his wife, who survives him, his exemption of $5.25 million can be added to his wife's exemption of $5.25 million, leaving the wife with an exemption of $10.5 million, which is a much larger exemption than most couples will ever need in order to shelter their assets from the estate tax.

One basic requirement for making the exemption of the first to die portable is that an estate tax return must be filed on a timely basis with the IRS. Ironically, at a time when very few taxpayers will be *required* to file estate tax returns because of the current high estate-tax exemption, many taxpayers will still choose to file a return in order to take advantage of portability.

For married couples who would prefer to give the surviving spouse complete control of

▸ AGE OF PORTABILITY
| continued on page 14

AGE OF PORTABILITY | continued from page 9



the assets in the absence of compelling estate tax reasons to do otherwise, a joint trust that is revocable by the surviving spouse may be a better solution than the traditional credit shelter trust. Of course, there may still be reasons for a couple to use separate trusts that become irrevocable at death rather than a joint trust — for example, for asset protection purposes or in second marriage situations. In such cases, the traditional estate plan of having separate irrevocable trusts may still be the preferred method of estate planning. An additional advantage of the traditional approach is that assets retained in a credit shelter trust can have unlimited growth in value without subjecting the increase to the estate tax at the surviving spouse's death, while growth in assets left in a revocable joint trust for the survivor could be subject to estate tax. In other words, if the exemption is used by the first to die, appreciation in the sheltered assets will be free from

IN THE AGE OF PORTABILITY, GOOD ESTATE PLANNING REQUIRES BOTH SOUND LEGAL ADVICE AND REASONABLE PROJECTIONS ABOUT THE FUTURE. YOUR ESTATE PLANNING ATTORNEY CAN HELP YOU WORK THROUGH THESE ISSUES AND MAKE THE RIGHT DECISIONS FOR YOUR SPECIFIC SITUATION.

estate tax, whereas if the exemption is ported to the surviving spouse instead, that same appreciation may be subject to tax. With a combined exemption of $10.5 million in 2013 (indexed for inflation), sheltering appreciation will be of little concern to the majority of estates.

However, there is one major drawback to the traditional plan that should be carefully considered. If assets are sheltered in the trust of the first spouse to die, those assets will not qualify for an income tax step-up in basis at the death of the surviving spouse. As a result, any appreciation in the value of those assets that occurs after the first death of a spouse will potentially be subject to the capital gains tax at some time in the future. This will be true regardless of the size of the estate. By way of a simple illustration, if $2 million was sheltered in the trust of the first to die and those assets grew to $3 million by the time the surviving spouse passed away, the cost of sheltering could be $250,000 when the assets are eventually sold (assuming a 25-percent capital-gains tax rate). At the same time, there may be no offsetting benefit from avoiding unnecessary estate taxes if the currently high estate tax exemption remains in effect. What this means is that there are many existing estate plans based on the traditional approach that are no longer needed to avoid estate taxes but actually stand in the way of lower income taxes.[1] On the other hand, if assets are instead left to the surviving spouse in reliance upon portability and those assets depreciate in value, a *step-down* in basis will occur at the survivor's death with a corresponding loss of income tax benefits.

The foregoing discussion illustrates the importance of reviewing every estate plan in light of the new law. Although portability was presented to Congress as tax simplification, in reality it has made things more complicated for clients and more challenging for estate planners. Projections about future changes in asset values, income tax rates, and estate tax exemptions and rates have become more important than ever. In the age of portability, good estate planning requires both sound legal advice and reasonable projections about the future. Your estate planning attorney can help you work through these issues and make the right decisions for your specific situation.

David E. Sloan is Chair of Van Cott's Tax, Estate & Benefit Planning Group. Mr. Sloan represents individuals, estates, and trusts in a variety of areas, including estate planning, probate, estate and trust administration, charitable giving, state and local taxation, retirement plan distributions, tax-free exchanges, matters before the IRS, and other general tax and business planning matters.

[1] A possible alternative for obtaining the asset protection and second marriage benefits of the traditional irrevocable trust while simultaneously obtaining the benefit of a step-up in basis and certain other tax advantages is a qualified terminable interest property trust, sometimes referred to as a "qtip trust."