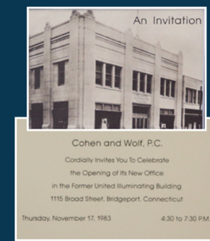
Publications



Portability of the Unused Spousal Exemption Amount - Sometimes You CAN Take It With You

02.16.2011

The Tax Relief Act of 2010, enacted on December 17, 2010, raised and re-unified the federal Estate, Gift and Generation-Skipping Transfer tax exemption amounts to $5,000,000. This means that as of January 1, 2011, you can give away during life, or upon death, up to $5,000,000 free of any estate, gift, or generation skipping tax. Transfers of any amount between spouses during life or at death pass free of estate or gift tax (the unlimited marital deduction).

Previously, spouses could only capture only each other's unused exemption amount by the creation of a trust upon the first death (commonly referred to as a "credit shelter trust"). Under the old law, any unused exemption which was not captured in such a trust was forever unavailable to the survivor. For example, under the old rule, a couple with a combined estate of $10,000,000 who did not engage in trust planning (simply leaving the estate to each other and then to their children) would incur no tax at the first death (due to the unlimited marital deduction); but at the death of the surviving spouse, the $10,000,000 estate in our example would incur a federal estate tax in the amount of $1,750,000. By stark contrast, zero tax would be due for this same couple if a credit shelter trust was funded at the first death (the trust would capture the $5,000,000 exemption of the deceased spouse, and the survivor could pass the remaining $5,000,0000 free of tax).

The new law permits "portability" of the exemption amount, and creates a mechanism designed to enable married persons to avoid estate tax by using each other's unused exemption amount without a credit shelter trust.

In theory, portability works simply: When a spouse dies, the executor of his or her estate may elect to make use of the unused portion of the exemption amount for the benefit of the surviving spouse. This election must be made on a timely filed federal estate tax return (which would have to be filed, even if one was not required). The new exemption amount to which the surviving spouse is entitled is the sum of the survivor's basic exemption amount (which is $5,000,000 until 2012) plus the amount of the spouse's unused exemption amount (also referred to as the "DSUEA", which stands for "Deceased Spouse's Unused Exemption Amount"). The application of this formula is more complex for persons who have been married to more than one predeceased spouse, but the general rule is that only the most recent deceased spouse's unused exemption may be used by the surviving spouse.

Though a portable exemption between spouses has curb appeal, there are substantial pitfalls which render it unsuitable as a 'one-size fits-all' substitute for a credit shelter trust. Families with assets in excess of $5,000,000 are likely to have concerns other than the federal estate tax which are best addressed by a trust. Importantly, there is no portability for the state estate tax exemption (the Connecticut estate tax exemption amount is $3.5 million) or for the generation skipping tax exemption, so a trust is still the only tool to minimize these taxes. Another important benefit of a trust over the portability election is that the funding of a credit shelter trust freezes appreciation of assets, which then continue to grow in value outside of the survivor's estate. An added advantage is that a trust offers a built-in mechanism for management of the assets in the event of disability of the survivor. Additionally, a trust offers creditor protection as well as control of distributions for families with children from previous marriages.

However, portability may have an advantage over a credit shelter trust for estates comprised heavily of low cost basis assets. This is because under the portability election, assets pass to the surviving spouse with a step-up in the cost basis to the value on the on the date of the spouse's death. In estates with substantial low basis assets, an analysis should be done, taking state estate tax into consideration, to see whether the income tax savings from a step-up in basis support a decision to elect portability.

As a final caveat, the Tax Relief Act is only effective for persons dying in 2011 and 2012. At the end of 2012, portability may no longer be available. Traditional credit shelter trust planning offers the comfort of long term stability while the future of portability remains uncertain, at least for now.

PRACTICE AREAS

Tax

Trusts & Estates