Advisory

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If you have any questions about this Advisory, please contact:

LEONARD LEADER, CHAIR
203.363.7602
lleader@wiggin.com

ROBERT BENJAMIN
212.551.2602
rbenjamin@wiggin.com

MICHAEL CLEAR
203.363.7675
mclear@wiggin.com

KAREN CLUTE
203.498.4349
kclute@wiggin.com

DANIEL DANIELS
203.363.7665
ddaniels@wiggin.com

HELEN HEINTZ
203.363.7607
hheintz@wiggin.com

DAVID KESNER
203.498.4406
dkesner@wiggin.com

CHARLES KINGSLEY
203.498.4307
ckingsley@wiggin.com

ARSINEH KAZAZIAN
212.551.2632
akazazian@wiggin.com

LISA PAGE
203.363.7635
lpage@wiggin.com

BETH SCHARPF
212.551.2634
bscharpf@wiggin.com

MATTHEW SMITH
203.363.7639
msmith@wiggin.com

Portability: A Useful Estate Planning Tool

INTRODUCTION

The concept of "portability" in estate planning is the most substantial change to the estate planning landscape for married couples in recent memory. Introduced as a temporary feature by the 2010 Tax Relief Act, portability became permanent under the Taxpayer Relief Act of 2012. The IRS did not issue the final regulations governing portability until the summer of 2015, so the intricacies of using portability going forward are only now becoming clearer.

Portability is a tax election available to married couples that permits a surviving spouse to take advantage of his or her deceased spouse's unused exemption from federal estate and gift taxes. In general terms, each person has a lifetime exemption from federal estate and gift taxes, which, prior to the advent of portability, you had to "use or lose"; that is, if a decedent did not make taxable transfers in life or at death of the full value of his or her lifetime exemption from federal estate and gift taxes, the unused exemption simply evaporated at his or her death. Now, by making the portability election, that unused exemption – the "deceased spousal unused exemption" amount or the "DSUE" amount – can be "ported," or transferred, over to the surviving spouse, who may then use it to shelter his or her own gifts or estate from transfer taxes.

PORTABILITY APPLIED

Prior to the enactment of portability, a decedent's unused lifetime exemption from federal estate and gift taxes (the "lifetime exemption," for simplicity) went to waste, as illustrated by the following simplified example:

> **Scenario 1:** T and T's spouse each owned assets valued at $5,000,000 ($10,000,000 in total). At T's death in 2011, he left all of his assets outright to his spouse,[1] using none of his lifetime exemption. (In 2011, the lifetime exemption was $5,000,000.) At the later death of T's spouse, she has an estate valued at $10,000,000 (her $5,000,000 plus the $5,000,000 inherited from her spouse), and only her own lifetime exemption to shield her estate from federal estate taxes. In 2016, the lifetime exemption is $5,450,000, so if T's spouse dies in 2016, $4,550,000 of her estate would be subject to federal estate taxes. (The current tax rate is 40%.) Their heirs would receive substantially less than the full $10,000,000 T and T's spouse began with.

If, in lieu of leaving his estate outright to his spouse, T had funded a trust for his spouse designed to take advantage of his lifetime exemption (often referred to as an "Estate Tax Sheltered Trust" or a "Credit Shelter Trust"), the overall tax result would be more favorable:

> **Scenario 2:** T and T's spouse each owned assets valued at $5,000,000 ($10,000,000 in total). T died in a year (2011) in which the lifetime exemption was $5,000,000. At T's death, he left his $5,000,000 in an Estate Tax Sheltered Trust for his spouse,

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which would pass tax-free to their heirs at her death, fully sheltered by T's lifetime exemption. At T's spouse's later death in 2016, she has an estate valued at $5,000,000, which is fully sheltered from tax by her own lifetime exemption ($5,450,000 in 2016). Neither estate incurs any federal estate tax, maximizing the amount received by their heirs.

This second scenario illustrates the dominant estate planning strategy in recent history. Portability achieves a similar result to that illustrated by Scenario 2, but through different means:

Scenario 3: T and T's spouse each owned assets valued at $5,000,000 ($10,000,000 in total). T died in a year (2011) in which the lifetime exemption was $5,000,000 and portability was available. At T's death, he left his $5,000,000 outright to his spouse, and the executor of his estate made the portability election. At T's spouse's later death in 2016, she has an estate valued at $10,000,000. T's spouse has her own $5,450,000 lifetime exemption, plus T's $5,000,000 DSUE amount, for a total of $10,450,000 in exemption from federal estate and gift taxes, more than enough to shield her entire $10,000,000 estate from federal estate tax. Neither estate incurs any federal estate tax, maximizing the amount received by their heirs.

PROS AND CONS OF ELECTING PORTABILITY

For the estate of a married decedent, the executor or administrator of that estate must make the portability election on a timely-filed federal estate tax return. Before making that election, the executor, advisors and surviving spouse should determine whether and to what extent to rely on portability, considering factors such as the terms of the decedent's estate plan, the size of the decedent's estate and the surviving spouse's prospective estate, and the kind of assets owned by each. In making this determination, the executor should take into account the pros and cons of relying on portability, which include the following:

- **Con:** Portability is available only for federal estate and gift taxes. The exemptions from federal generation-skipping transfer taxes and state estate taxes are not portable, and will be lost if portability is the only estate planning technique used in the estate of the first spouse to die.

- **Pro:** Assets included in the estate of a decedent receive a step-up in cost basis. (A step-up in cost basis reduces capital gains tax on a future sale of the asset.) The new cost basis is equal to the fair market value of the asset at the time of the decedent's death. Assets left to a surviving spouse in an Estate Tax Sheltered Trust receive only one step-up in basis, on the death of the first spouse to die. Assets sheltered from estate taxes by portability, on the other hand, are included in both estates, and therefore receive a second step-up in basis at the second death as well. (This potentially reduces any capital gains tax further.) A surviving spouse should consider factors such as his or her life expectancy and the nature of the assets in the estate of the first spouse to die when weighing the value of a second step-up in basis.

- **Con:** A surviving spouse may only take advantage of the DSUE amount of his or her last deceased spouse. Thus, if a surviving spouse remarries and survives the second spouse, the DSUE amount of the first deceased spouse is no longer available. Relying on portability may not be an appropriate planning technique where a surviving spouse is likely to contemplate remarriage. (Timely, strategic gifting of assets, however, can allow a surviving spouse to take advantage of the DSUE amount of a prior deceased spouse without risk that the DSUE amount will be lost on the death of a subsequent spouse.)

- **Pro:** A surviving spouse has greater planning latitude over assets left to him or her outright than over assets received in an Estate Tax Sheltered Trust. Working with advisors, a surviving spouse may determine that there is more effective estate planning that can be done using inherited assets and a deceased spouse's DSUE amount, such as gifting to a grantor trust that may be subject to more favorable income tax treatment than an Estate Tax Sheltered Trust.

- **Con:** In leaving assets outright to a surviving spouse, the decedent spouse forgoes all control over how these assets are used. A surviving spouse would be free to channel these assets to a new spouse or otherwise away from descendants or other intended beneficiaries.

- **Con:** The DSUE amount is fixed at the death of the first spouse to die and will not appreciate. Assets in an Estate Tax Sheltered Trust, on the other hand, will

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appreciate outside of the estate of the surviving spouse, incurring no estate taxes at second death.

CONCLUSION

Now that portability is a permanent feature of the federal estate and gift tax laws, it adds an important and useful tool to the estate planning toolbox. It should nevertheless be embraced with some caution; although portability offers appealing estate planning opportunities and viable alternatives to traditional approaches, relying on portability to the exclusion of other estate planning techniques can come at some cost.

For a couple considering their own estate planning, it can be difficult to predict whether a surviving spouse would choose to make a portability election, given the number of inevitable unknowns at the estate planning phase – including future earnings, ultimate longevity, family circumstances, and the like. Nevertheless, the availability of portability should be taken into account in the estate planning process. A couple, in consultation with their advisors, should decide what role portability will play in the couple's estate plan, and ultimately select the best approach to achieving their objectives.

We would welcome the opportunity to revisit your estate planning objectives, and discuss whether your current estate plan is the best approach to achieving these goals, given the recent changes in estate and gift tax laws. Please contact your Wiggin and Dana attorney with any questions you may have. We look forward to speaking with you.

[1] *Assets left outright to a surviving spouse pass tax-free under the unlimited marital deduction, and in turn become a part of the surviving spouse's taxable estate.*