A Lower Tax Rate, Higher Exemptions, and Portability: *The New Estate Planning Landscape for Married Couples*

Federal estate and gift taxes have changed dramatically in the last few years. The top tax rate has declined. The exemption amount has skyrocketed to $5,000,000 and now adjusts each year to keep pace with inflation (this year it's $5,340,000).[1] Congress also has made the exemption "portable." This means that, for married couples, any exemption amount not used in the estate of the first spouse to die may become available to shelter assets from tax later when the second spouse dies.

These changes raise new questions in estate planning for our married clients. With combined exemptions of $10,680,000, should they still be concerned about estate tax issues? Can they take advantage of portability to simplify their estate plans?

Conventional estate planning for married couples

The conventional estate plan for a married couple requires a "credit shelter" trust to take maximum advantage of the estate tax exemption of the first spouse to die. Upon that spouse's death, the credit shelter trust is funded with his or her assets up to the exemption amount. This trust can benefit the surviving spouse, as well as others, but "bypasses" that spouse's later estate. As a result, any assets sheltered from estate taxes by the first spouse's exemption and remaining in the trust at the surviving spouse's death are available for future generations free of estate taxes.

Any assets of the first spouse in excess of the exemption amount pass to the surviving spouse outright or in trust, and qualify for a marital deduction in the first spouse's estate. To the extent still owned at the surviving spouse's later death, these assets are included in his or her gross estate, but can be sheltered by that spouse's exemption.

Depending upon the total value and make-up of their assets, some couples find it challenging to take full advantage of each spouse's exemption. The first spouse to die has to own in his or her name assets having a total value at least equal to the exemption amount. This might require retitling jointly owned assets and attempting to balance assets between spouses. If the couple's net worth is more than the exemption amount, but less than twice that amount, and their ages, health, and genes make it impossible to predict which one might die first, no amount of asset shifting can ensure the full use of the first spouse's exemption.

Additional complications arise when funding the credit shelter trust with certain assets. For example, it is cumbersome to fund the trust with a full or partial interest in the principal residence, and it might not feel right emotionally for the surviving spouse's home to be in a trust. If the first spouse has a large IRA, using it to fund the credit shelter trust complicates the design of the trust and raises income tax issues. Due to these and other impediments, some couples just opt to under-utilize (or "under-fund") the estate tax exemption of the first spouse to die.

[1] The technical term in the tax code for the estate and gift tax exemption is the "basic exclusion amount."

Lower estate tax rates and higher exemptions

Over the last 10 years, the top estate and gift tax rate has decreased from 47% to 40%, and the exemption amount has increased from $1,500,000 to $5,340,000. Barring legislative changes, the exemption amount should increase steadily now that it is indexed for inflation. One commentator estimates that, at a 3% inflation rate, the exemption amount would exceed $7,300,000 by 2025.[2]

Portability and its nuances

Portability increases the likelihood that married couples will benefit fully from their combined exemption amounts. Congress introduced portability in 2010 and made it "permanent" in 2013. The goal was to simplify estate planning by eliminating the need for a credit shelter trust. With portability, the surviving spouse's exemption amount is increased by the deceased spouse's unused exemption amount (referred to as the "DSUE" amount).

Example:

Frank and Ingrid are married and have two adult daughters. They have a conventional estate plan, but have been reluctant to reconfigure their assets as part of their planning. Their total net worth is $10,000,000. They jointly own a home worth $1,500,000. Other jointly owned property includes furniture, jewelry, autos, and bank accounts worth $500,000. Frank has a $1,000,000 investment portfolio in his revocable trust and a $1,000,000 IRA naming Ingrid as the primary beneficiary. Ingrid has a $6,000,000 investment portfolio in her revocable trust.

If Frank dies first in 2014, the home, other jointly owned assets, and the IRA will pass directly to Ingrid and qualify for the marital deduction. Under the terms of his plan, the $1,000,000 in his trust will fund a credit shelter trust for Ingrid and their daughters. His unused exemption, or DSUE amount, will be $4,340,000.

If Ingrid dies later in 2014, her gross estate will include assets worth $9,000,000. It will be completely sheltered from federal estate taxes by the $4,340,000 DSUE amount from Frank plus her $5,340,000 exemption. In contrast, under the estate tax law before portability, $4,340,000 of Frank's exemption would have been lost. On Ingrid's death, her gross estate would have exceeded her exemption amount by $3,660,000, resulting in a federal estate tax of $1,464,000.

In this example, portability rescued the family from Frank's and Ingrid's unwillingness to retitle and balance their assets. Before we consider how couples might use portability in their estate planning, we should note the following nuances:

- To elect portability, the personal representative of the first spouse's estate must file a federal estate tax return, regardless of whether such a return otherwise would be required. *This is a big trap for the unwary.*

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[2] Abendroth, Thomas W., *Portability: Now Available in Generic Form*, outline for a presentation delivered at the 48th Heckerling Institute on Estate Planning (January 2014).

- The DSUE amount from a deceased spouse remains fixed and is not adjusted for inflation during the spouse's remaining lifetime. In contrast, a credit shelter trust will shelter from tax any future appreciation in the trust's assets.

- The DSUE amount is defined as the unused exemption of a person's *last* deceased spouse. This means that it's possible through remarriage to lose the unused exemption of the first spouse to die.

  In the example above, Ingrid received a $4,340,000 DSUE amount after Frank's death. Assume that she then marries Bill who, due to prior gifting to his family, has an unused exemption amount of $1,000,000. If Ingrid dies before Bill, her last deceased spouse will be Frank and a total exemption of $9,680,000 will be available on her death. If Bill predeceases Ingrid, however, her DSUE amount will be $1,000,000 and the total exemption available upon her subsequent death will fall to $6,340,000.

- A surviving spouse can use a DSUE amount to shelter gifts. Under a special ordering rule, the DSUE amount will be applied to gifts before the surviving spouse's exemption. Thus, after marrying Bill, Ingrid could reduce the risk of losing the DSUE amount from Frank by making gifts to her daughters while Bill is still living.

- Portability does not apply to the generation-skipping tax exemption. *Therefore, portability is thought to offer fewer benefits to married couples at higher wealth levels.* To maximize the benefits of their generation-skipping tax exemptions (also $5,340,000), these couples often fund GST-exempt grandchildren's trusts during their lifetimes or at death.

- All of the New England states except New Hampshire impose a state estate tax. New York and several other states do as well. With perhaps one exception, these states have not made their exemptions portable.

  Residents of these states may use portability to some extent, but will need a credit shelter trust to take full advantage of the state estate tax exemption. For example, the Massachusetts estate tax exemption is $1,000,000. If a married couple relies completely on portability, they risk paying up to $160,000 in Massachusetts estate taxes that could have been avoided by funding a credit shelter trust with at least $1,000,000.

Portability as a strategic tool in estate planning

It's tempting to think that many married couples now can drastically simplify their estate plans because they may have no federal estate tax and, with portability, they can just have all assets go to the surviving spouse outright or in a marital trust. In this new landscape, however, many couples instead should consider using credit shelter trusts and portability in strategic combinations. For example, an estate plan may include credit shelter trusts to

reduce state estate taxes and portability to accomplish other goals, such as deferring income taxes on retirement accounts or reducing capital gains taxes.

Retirement accounts

Portability will greatly benefit married couples who have large IRAs or other retirement accounts. In the past, income tax drawbacks in funding credit shelter trusts with these accounts have made it difficult for these couples to use their full exemption amounts. *With portability, in most cases the account owner now can simply name his or her spouse as the primary beneficiary of the IRA.* This will provide for the maximum deferral of distributions and income taxes allowed under the minimum distribution rules, and the DSUE amount will be available to help shelter the IRA from estate taxes at the surviving spouse's death.

Capital gains taxes

A major advantage of portability is that it allows for a second step-up to fair market value of the tax cost (or "basis") of assets at the surviving spouse's death. In contrast, assets in a credit shelter trust are not stepped up at the second spouse's death because the trust bypasses that spouse's estate. This advantage of portability has added significance due to recent increases in capital gains taxes, including the new 3.8% health care surtax.

If there are reasons to expect significant asset appreciation between the deaths of the first spouse and the second spouse, their estate plan should accommodate making a portability election. Couples who own assets having extraordinary appreciation potential, such as art or private business interests, are candidates for this planning.

Conclusion

Relatively few married couples—at least in states such as the New England states that impose a state estate tax—will be able to have estate plans that simply leave all assets to the surviving spouse and rely completely on portability. Instead, we expect that the plans of many couples should have some combination of credit shelter trust funding and portability.

The factors to consider when deciding the extent to which portability should be used will fluctuate over time. These factors include the value and makeup of the couple's assets; their ages, health, and state of residence; federal and state estate tax rates and exemption amounts; and income tax brackets and rates. Therefore, for many couples the best approach may be to defer this decision-making until the time that the estate of the first spouse to die is administered. This can be accomplished by redesigning conventional estate plans to provide added flexibility.

Please feel free to contact your Fiduciary Trust officer if you would like to discuss how you might take advantage of portability in your estate plan.

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