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"Portability" of Estate Tax Exemption

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In legislation enacted in December 2010, the federal estate, gift, and generation-skipping transfer ("GST") tax exemptions were all raised to $5 million and the rates were set at 35% for 2011 and 2012. You may have also heard news stories concerning another feature of the legislation—the "portability" of the estate tax exemption between spouses.

Background: Prior Law and Credit Shelter Trusts

The Federal estate tax allows a deduction for property left to a surviving spouse. Under prior law, if the first spouse to die left everything to the survivor no tax would be due. At the survivor's death, however, he or she would only have his or her individual estate tax exemption to apply to the couple's combined property. Therefore, it is common for a married couple to set up a "credit shelter" trust for their spouse to take advantage of both spouses' individual estate tax exemptions. At the first spouse's death, an amount equal to his or her federal estate tax exemption is placed in Trust for the benefit of the surviving spouse and/or children. This property is not included in the survivor's taxable estate, allowing the couple to pass a combined total of up to twice the individual federal estate tax exemption amount to their children or other intended beneficiaries.

New Concept: Portability

The new federal law introduces a new legal concept for the estate tax exemption--commonly called "portability." Through this new concept, the law attempts to approximate the result of credit shelter tax planning without the need to use credit shelter trusts. Under the new law, at the first spouse's death, the executor can file a federal estate tax return and elect to have the first spouse's unused exemption pass to the surviving spouse. If the first spouse leaves everything to the survivor outright, the first spouse uses none of his or her estate tax exemption and the surviving spouse can have a combined $10 million estate tax exemption (the surviving spouse's $5 million exemption plus the first spouse's $5 million exemption). There are, however, some key differences between the use of "portability" and the use of a credit shelter trust, which are briefly summarized in the chart on the following page:

Issue	***Outright to Spouse with Portability***	***Credit Shelter Trust***
Appreciation After the First Spouse's Death	Amount of exemption the surviving spouse receives (e.g., $5 million) is locked at its value as of the first spouse's death, without adjustment for inflation or appreciation.	Appreciation on assets placed in credit shelter trust is excluded from the surviving spouse's estate.
Duration	Only exists in the law for 2011 and 2012, additional exemption is lost in 2013 under current law.	Has been available for many years and is expected to continue indefinitely.
Creditor Protection	Assets are subject to surviving spouse's creditors.	Assets are generally protected from surviving spouse's creditors.
GST Exemption	GST Exemption is not portable. It is lost if not used at first spouse's death.	GST Exemption can be allocated to a credit shelter trust and preserved.
Assets Available for Lifetime Gifts to Children	Yes. Portability increases both the surviving spouse's estate and gift tax exemptions.	Yes. Details depend on the terms of the Trust.
Tax Basis at Second Spouse's Death	Heirs receive full basis step-up at death of surviving spouse.	Property in credit shelter trust will not receive basis step-up at the death of surviving spouse.

Filing a Federal Estate Tax Return	Required regardless of whether or not the first spouse's estate is otherwise taxable.	May not be necessary if each spouse's estate is not otherwise taxable.
Control	Property is left outright to spouse, who may leave it to beneficiaries of his or her choice.	First spouse may choose to limit who can receive Trust property at the second spouse's death.

Estate tax exemption portability provides a new opportunity for estate planning in 2011 and 2012, but it is not an exact replacement for a credit shelter trust planning.

Because of the differences in result between portability and credit shelter trust planning, and because—under present law—portability will cease to exist if one or both spouses is living at the end of 2012, we anticipate that most of our clients, who would otherwise engage in credit shelter trust planning, will still opt to engage in credit shelter trust planning.

Please let us know if you have any questions about the differences in these estate planning concepts.

For more information on this article please contact:

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