

PORTABILITY VS. CREDIT SHELTER TRUSTS FOR MARRIED COUPLES **(UPDATE TO MARCH 1, 2011 NEWSLETTER)**

On January 2, 2013, President Obama signed into law the American Taxpayer Relief Act of 2012 (the "Act"). The Act made permanent the concept of portability of unused federal estate tax exemptions between a deceased spouse and the surviving spouse (i.e., any federal estate tax exemption not utilized when one spouse dies may be used by the surviving spouse or his or her estate, subject to rules governing remarriage and subject to the first deceased spouse's executor making the election on a timely filed federal estate tax return). Portability effectively creates a \$10.5 million exemption (as of 2013) for married couples without the need for any planning with credit shelter trusts (which is a trust that holds assets equal to a deceased spouse's estate tax exemption amount) or equalizing of assets between spouses. The federal estate tax rate for estates over the exemption amount is a flat 40%.

Portability does not apply to state estate taxes. The Connecticut estate tax exemption is \$2 million, and tax rates for estates over that amount start at 7.2% and increase to a maximum 12%.

PROS

1. No Need For Trusts for Moderate Estates.

A. If your combined estate will be less than \$2 million on the surviving spouse's death and you wish to leave your entire estate outright to each other, portability allows you to avoid federal and Connecticut estate tax on both deaths without the use of trusts (assuming portability is in effect when first spouse dies, executor makes timely election, and surviving spouse does not remarry - see paragraphs #7 and 8 under "Cons").

B. If your combined estate will be less than \$10.5 million on the surviving spouse's death and you wish to leave your entire estate outright to each other, portability allows you to avoid federal estate tax on both deaths without the use of trusts (subject to same assumptions as above). However, there will be additional Connecticut estate tax on the surviving spouse's death since the first spouse's Connecticut estate tax exemption will have been wasted. (See paragraph #2 under "Cons"). It is advisable to fund a credit shelter trust with the \$2 million Connecticut exemption amount (or gift that amount during life) and then leave the balance outright to your spouse. The state estate tax will then be deferred until the surviving spouse's death.

2. Can Be Used If You Have Specific Assets You Wish to Pass Outright to Spouse. If you will not fully fund your credit shelter trust because you have specific assets which are owned jointly or will pass outright to the surviving spouse (e.g., retirement assets or a residence), portability can be used for the unused exemption.

3. Avoids Need to Retitle Assets Between Spouses. If you will not fully fund your credit shelter trust because most assets are titled in the other spouse's name (e.g., corporate benefits that must be held by the employee), portability can be used for the unused exemption.
4. For NY Residents and Those Owning NY Property: Can Defer State Estate Taxes And Still Use Federal Exemption. If you live in, or own property in, New York or another state which has a low state estate tax exemption (\$1 million) and no state "qtip" election (Connecticut has a state qtip election available), any assets held in a credit shelter trust which exceed the state exemption will be subject to state estate tax at the first spouse's death. Portability allows you to fund the credit shelter trust with the state exemption amount (or gift that amount during life) and then leave the balance outright to the spouse. The state estate tax will then be deferred until the surviving spouse's death; however, the marginal tax rate on the surviving spouse's death will be higher than it would have been if the tax had been paid on the first spouse's death.
5. Avoids Trust Administration Costs and Burdens. If you have most assets passing outright to your spouse and the credit shelter trust would otherwise be fairly small, a trust may be too burdensome. For any size trust, trust administration fees can be avoided with portability since no trust is needed.
6. Step-Up in Basis. Assets which pass outright to the surviving spouse receive a step-up in basis to fair market value at the surviving spouse's death. (If assets go down in value, then assets get a step-down in basis.) Assets in a credit shelter trust, on the other hand, get a step-up in basis at the first spouse's death, but not at the surviving spouse's death.
7. May Be Advantageous For Clients With Large Estates. If the surviving spouse has sufficient assets, he or she may transfer his or her exemption amount (including the deceased spouse's unused exemption) into an irrevocable grantor trust for the benefit of the children and grandchildren (the grantor may not be a beneficiary). The grantor can pay the income taxes on the trust income without that being considered an additional gift to the trust. In addition, the grantor may swap assets without any capital gains consequences. This is advantageous in the event a trust asset appreciates in value and the grantor wishes to have it included in his or her estate in order to get a step-up in basis at death. Note, however, that this transfer may incur Connecticut gift tax.
8. Surviving Spouse Who Moves Out of Connecticut. If the surviving spouse is likely to move away from Connecticut after the first spouse's death, and if the new state does not have an estate tax, then there is no need to shelter \$2 million in trust, and portability may be used for the full federal exemption.

CONS

1. Future growth is not sheltered. A credit shelter trust shelters from future estate tax on the surviving spouse's death the appreciation in value between the first and second spouse's death. Portability shelters only the first spouse's unused exemption amount.
2. Portability does not apply to state estate taxes. No states recognize portability for state estate tax exemption purposes. If you leave all assets outright to your spouse, you are wasting your state estate tax exemption. For Connecticut residents, this is an issue if your combined estate at the surviving spouse's death is over \$2 million. For example, if the combined estate is \$4 million on the surviving spouse's death, Connecticut estate tax will be almost \$146,400 on the surviving spouse's death, but if a credit shelter trust had been used, then this tax would have been avoided.
3. GST Exemption is Not Portable. Portability does not apply to the generation skipping tax (GST) exemption, so any amounts eventually passing to grandchildren in excess of the surviving spouse's \$5.25 million exemption (as of 2013) will not be sheltered from the GST tax. It might be possible to use a marital trust, do a reverse QTIP election and use first decedent's GST exemption, and take advantage of portability and get a step-up in basis when the surviving spouse dies. However, the law is not settled yet whether this technique is possible.
4. No Protection From Creditors. Trusts can be used to protect assets from a beneficiary's future creditors.
5. No Management. Trusts are useful to help a beneficiary manage money.
6. No Protection for the Children. Trusts can be used to protect assets for your children in case your spouse remarries. Similarly, if this is your second marriage, trusts can be used to protect assets for children from your first marriage.
7. May Be Forfeited If You Remarry. Since portability is between you and your last deceased spouse, at your death you will lose the exemption of your first spouse if you remarry and your second spouse also predeceases you. (In that case, your second spouse's exemption may or may not be available for you to use.) You can avoid this potential problem by making lifetime gifts after the death of your first deceased spouse but prior to the death of your second deceased spouse.
8. Requires a Timely Filed Federal Estate Tax Return. If the executor of the first spouse to die does not timely file a federal estate tax return (even if none is otherwise required), portability will not be available and exemption may be wasted.
9. Potential to Lower Income Taxes Payable. If a credit shelter trust for spouse and other family members is used for the full federal exemption amount (though some

Connecticut estate tax would be payable) or just the \$2 million Connecticut exemption amount, distributions can be made to children who are in a low income tax bracket instead of to the surviving spouse (assuming he or she does not need the income). This may avoid the 3.8% Medicare surtax which would have been payable by the surviving spouse if he or she reached the income threshold.

Planning Hedge For Those Who Don't Like Trusts. If the only reason you have a trust is to save estate tax, but you don't want to waste your state estate tax exemption, you can leave your estate to your spouse and set up a "disclaimer trust" under your Will or revocable trust agreement, i.e., you give your spouse the right to decide within nine months of your death that any assets he or she does not accept will pass into a trust. Alternatively, you can leave the amount exempt from state estate tax to a credit shelter trust, and leave the balance to your spouse, with the right to disclaim any portion to a trust. (These options have certain restrictions which we can explain in more detail.)

Bottom Line: Portability is most appropriate for first marriages where the combined estate will be under \$2 million on the surviving spouse's death and where trusts are not desired for non-tax reasons. It also can be used for estates up to \$10.5 million (as of 2013) where trusts are not desired, but there will be additional Connecticut estate tax which could have been avoided if a trust had been used. In that case, it is best to have credit shelter trust for \$2 million and leave the balance outright. It also is useful where you have a credit shelter trust set up but you have particular assets that are not conducive to being held in a trust, or you do not have sufficient assets in your name to use the full amount of your exemption. However, even if portability is appropriate for your plan, remarriage by the surviving spouse may forfeit use of the exemption.