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HOW DOES PORTABILITY EFFECT YOUR ESTATE PLAN?

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Portability is the term used to describe a relatively new provision in federal estate tax law that allows a widow or widower to use any unused federal estate tax exemption of his or her deceased spouse to shelter assets from gift tax during the surviving spouse's life and/or estate tax at the surviving spouse's death. Portability was designed to minimize the harsh impact estate taxes may have on married couples who did not properly plan for maximizing each spouse's federal exemptions from estate taxes. However, in trying to fix one issue, portability has become another complication in planning to reduce overall federal and state taxes.

Portability's Effect on Tax-Efficient Estate Tax Planning

Currently, the federal estate tax exemption is $11,400,000 per spouse. However, that exemption is scheduled to return to $5,000,000 as adjusted for inflation in 2026. Prior to the enactment of the portability law in 2010, most estate plans for married couples set aside at the first death the amount that could pass free from federal or state estate tax to a Trust Exempt from Estate Tax (often referred to as a "Credit Trust" or "A/B Planning"). The Trust Exempt from Estate Tax utilized the exemption of the first spouse to die and protected the assets at the surviving spouse's death from estate tax. Without portability, if the first spouse died with an estate of $3,000,000 all of which passed to the Trust Exempt from Estate, the deceased spouse's unused estate tax exemption of $8,400,000 would be lost. If the surviving spouse died with assets exceeding the federal estate tax exemption, the surviving spouse could not use the lost exemption.

Under portability the deceased spouse's unused estate tax exemption of $8,400,000 (referred to in the law as the "Deceased Spouse's Unused Exclusion" or "DSUE") may, under most circumstances, be transferred to the surviving spouse. The surviving spouse can use the DSUE to shelter an additional $8,400,000 from gift or estate taxes. If the surviving spouse has his or her own $11,400,000 of exemption, he or she can shelter a total of $18,800,000 from federal gift and estate taxes.

Now that portability is permanent, some clients may consider simplifying their estate plans so that assets are left to a surviving spouse instead of funding a Trust Exempt from Estate Tax to capture the first spouse's exemption. Whether to rely on portability or to fund a Trust Exempt from Estate Tax at the first spouse's death can depend upon a variety of factors. Some of the factors that should be considered are as follows:

- There are currently very few states that allow portability of state estate tax exemptions, meaning that such state exemptions may be wasted if not used at the first spouse's death and state estate taxes increased by relying on portability;
- Under the traditional tax-efficient estate plan of using the exemption of the first spouse to fund a Trust Exempt from Estate Tax the exempt amount *plus all of the appreciation on that amount between the death of the first spouse and the death of the surviving spouse* escapes estate tax as the surviving spouse's death, whereas

- portability only protects the unused exemption amount from estate tax at the survivor's later death, and the DSUE is not indexed for inflation;
- The exemption transferred to the surviving spouse under portability is no longer available in the surviving spouse's estate if the surviving spouse remarries and the new spouse also predeceases the surviving spouse;
- The surviving spouse may use the exemption to benefit different individuals than the first spouse intended to utilize the DSUE before the surviving spouse's own exemption amount.
- The generation?skipping transfer tax exemption (the "GST exemption") is *not portable* and in most cases the best way to use GST exemption is to combine it with the estate tax exemption when the first spouse dies (i.e., by allocating it to a Trust Exempt from Estate Tax); and
- A Trust Exempt from Estate Tax can provide additional benefits beyond tax planning such as enhanced protection against creditors (including a new spouse) and certainty that the trust property will pass to the intended beneficiaries upon the surviving spouse's death.

Portability's Effect on Income Tax Planning

As a result of the 2017 Tax Act, very few families will actually face a federal estate tax if the higher federal estate tax exemptions remain in effect. Tax efficient estate plans prior to the enactment of portability focused exclusively on reducing the federal estate tax due to its 55% rate even if doing so meant potentially paying a capital gains tax after the death of the surviving spouse. After the enactment of portability, a married couple must weigh both the income and estate tax consequences in reviewing their estate plan to make sure they are best positioned to minimize the total tax impact. The assets placed in a Trust Exempt from Estate Tax at the first spouse's death will be "stepped-up" to the fair market value at the death of the first spouse but will retain that cost basis after the death of the second spouse. If those assets appreciated and were sold at the surviving spouse's death, a gain would be recognized. However, under an estate plan where the assets pass to the surviving spouse (i.e. don't use exemption), and rely on portability to transfer the deceased spouse's unused exemption to the surviving spouse, the assets owned by the surviving spouse will receive a step up in tax basis at the death of the first spouse and a second step up in tax cost basis at the surviving spouse's death because they are included in the surviving spouse's estate and may also be sheltered from estate tax due to combination of both spouses' exemptions.

How to Make the Portability Election

In order to make the DSUE available to the surviving spouse, the Executor of the estate of the first spouse to die must file a federal estate tax return and an make an election for the DSUE to transfer to the surviving spouse even if the estate of the first spouse is under $11,400,000 and otherwise would not require a federal tax return be filed.

Conclusion

Portability was intended to simplify estate planning and provide married couples with a mechanism to use both spouses' exemptions without the need for a Trust Exempt from Estate Tax at the first spouse's death, and for some couples it may serve that purpose. For certain couples, the estate and generation-skipping tax savings from using a Trust Exempt from Estate Tax is still compelling but now must be compared to the income tax savings that can be generated by planning for portability. If you have any questions about how portability impacts your estate plan, you should review your estate plan and consult your Cummings & Lockwood attorney.