

The Time for Portability May Have Arrived

By Joseph P. Rubin

For many years, minimizing estate taxes has been addressed by including a specific kind of trust in the wills of married persons.¹ President-elect Obama reportedly supports the proposal to simplify estate tax planning by getting rid of this trust requirement. However, this simplicity has its costs. This article explores these issues.

Basic Estate Tax Concepts

Depending on how much you own when you die, your estate may have to pay federal estate taxes. The amount of estate tax is generally based on your net worth at the time of your death. The estate tax rate is 45% in 2008 and 2009. Except for assets passing to your spouse, your estate will generally have to pay federal estate tax if its net value, when you die, is more than the following "Tax-Free Amounts" as set by federal law:

<u>Year of Death</u>	<u>Tax-Free Amount</u>
2008	\$2 million
2009	\$3.5 million
2010	unlimited (estate tax repealed)
2011 and thereafter	\$1 million

President-elect Obama has reportedly taken the position that legislation should be enacted causing this Tax-Free Amount to remain at \$3.5 million for years after 2009.

A fundamental estate planning strategy for married couples facing potential estate tax liability is to preserve the Tax-Free Amounts of both spouses. The following two examples illustrate the right way and the wrong way to achieve this objective.

Example (1). Anthony and Cora are married. Together, they own assets with a net value of \$7 million, all of which is Texas community property. They both die in 2009. Anthony dies first. His will leaves his half of the community property (valued at \$3.5 million) outright to Cora resulting in Cora owning outright assets with a net value of \$7 million. No estate tax would be due on Anthony's death because his assets passed to his surviving spouse. When Cora dies, her \$7 million estate uses her \$3.5 million Tax-Free Amount. The estate tax due on the remaining \$3.5 million is \$1,575,000 because Anthony's Tax-Free Amount is not available to Cora under current law.

To avoid this estate tax liability, the first spouse to die must leave assets in a trust rather than the assets passing outright. Example (2) illustrates this strategy.

Example (2). A tax-planning provision in Anthony's will provides that his assets valued at an amount not exceeding the Tax-Free Amount (\$3.5 million in 2009) shall be contributed to a specific type of irrevocable trust which includes Cora as trustee (the trust administrator) and beneficiary (the recipient of the trust assets). Anthony dies in 2009. The trust created under

¹ These tax-saving trusts can also be created in revocable trusts created during the lives of married persons.

Anthony's will owns \$3.5 million in assets and Cora owns outright her assets valued at \$3.5 million.

Anthony's estate uses his \$3.5 million Tax-Free Amount resulting in no estate tax liability. When Cora subsequently dies in 2009, the assets in the trust created by Anthony's will are excluded from Cora's taxable estate.

Cora's taxable estate includes her assets (her half of the community property) valued at \$3.5 million. Cora's estate uses her \$3.5 million exemption. This results in no estate tax on Cora's death. In other words, the \$1,575,000 in potential estate taxes in Example (1) are entirely eliminated resulting in this amount passing to their descendants rather than the IRS.

Portability

In the estate tax world, "portability" refers to the unused Tax-Free Amount of the first spouse to die being available for the estate of the surviving spouse. With portability, a married couple would no longer have to include a trust in the will of the first spouse to die in order to have the benefit of the both spouses' Tax-Free Amounts. The following example illustrates this scenario.

Example (1) Revisited. Anthony and Cora are married. Together they own assets with a net value \$7 million, all of which is Texas community property. They both die in 2009. Anthony dies first. He leaves his half of the community property (valued at \$3.5 million) outright to Cora, so no estate tax is then due because it passed to Anthony's surviving spouse. When Cora dies, her \$7 million estate uses her \$3.5 million exemption and Anthony's unused \$3.5 million exemption. This results in no estate tax on Cora's death. Consequently, if estate tax law allowed portability, the estate tax due on Cora's death would be zero without having a trust in Anthony's will.

Legislative Aspects of Portability

Portability was included in H.R. 5970, which passed the U. S. House of Representatives on July 29, 2006, but failed in the U. S. Senate. It was also the subject of a hearing in the U. S. Senate Finance Committee on April 3, 2008. President-elect Obama reportedly expressed his support for portability during the recent presidential campaign.

Consequently, portability may become law in 2009. If so, H.R. 5970 may provide some clues about how the law would be structured. Following are some of the portability provisions included in H.R. 5970.

1. Transfer of Unused Exemption and Capping. The surviving spouse's total Tax-Free Amount was capped at twice the amount of the surviving spouse's individual Tax-Free Amount. This prevents the surviving spouse from marrying several ill paupers to accumulate their unused Tax-Free Amounts.

2. Required Election on Estate Tax Return. Portability of the Tax-Free Amount of the first spouse to die requires that the spouse's estate do the following on an estate tax return filed with

the IRS: (1) affirmatively elect portability, and (2) report the value of the unused Tax-Free Amount.

3. No Portability for Generation-Skipping Transfer ("GST") Tax. The Tax-Free Amount was portable for gift and estate taxes but not for the GST tax. An explanation of the generation-skipping transfer tax is beyond the scope of this article. However, as was pointed out at the U.S. Senate committee hearings, linking the GST Tax-Free Amount to gift and estate tax Tax-Free Amount would simplify estate planning and there is no reason to make different the portability of these Tax-Free Amounts.

Simplicity and Its Costs

When weighing estate planning options, some people understandably consider simple wills the holy grail. For those people, portability is an outstanding idea in many situations because outright gifts can replace trusts without losing any estate tax benefits.

However, there are at least three reasons that may cause others to choose against the simplicity of outright gifts and include an irrevocable trust in their will:

1. Asset Protection. Trusts can protect assets from lawsuits against the surviving spouse and other trust beneficiaries. Assets owned outright are subject to liabilities of the surviving spouse. Also, assets held in trust, as opposed to assets owned outright, provide better protection against the surviving spouse's future spouse(s).

2. Estate Tax Reduction. Appreciation of trust assets is excluded from estate tax imposed on the estates of both spouses. Appreciation of assets owned outright by the surviving spouse is included in the surviving spouse's taxable estate.

Example (2) revisited. In example (2) above, if the trust holds \$3.5 million in assets and those assets appreciate in value between the death dates of the spouses, this asset appreciation is excluded from the taxable estate of the surviving spouse. Assume that this appreciation is \$1 million. If the trust owns these assets, the \$1 million appreciation is not subject to estate tax on the death of both spouses. However, if a trust is not included in the will of the first spouse to die and this \$1 million appreciation is owned by the surviving spouse rather than the trust for the surviving spouse's benefit, the \$1 million appreciation will give rise to an estate tax of \$450,000 on Cora's death in 2009.

3. No Estate Tax Return. Including the trust in the will of the first spouse to die may eliminate the need to file an estate tax return to report the unused Tax-Free Amount. There is no requirement to file an estate tax return if the estate's value is not more than the Tax-Free Amount. Therefore, in "Example (2) Revisited," there would not be a requirement to file an estate tax return due to the death of the first spouse to die. On the other hand, an estate tax return would be required if portability were elected after the death of the first spouse to die.

Conclusion

Portability of the Tax-Free Amount may become law in 2009. It would result in many wills being less complex because the tax saving trust would not be required in the wills of both spouses. However, some people may prefer to include trusts in their wills for asset protection and other reasons even if portability becomes the law.