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Estate Tax Portability: Do We Still Need Credit Shelter Trusts?

Every U.S. citizen may gift during life and/or bequeath at death cash and/or assets to persons who are not his or her spouse (ex., children) free of estate or gift tax up to an aggregate amount (the "basic exclusion amount"). This is in addition to annual exclusion gifts, currently $13,000 per year to any number of individuals. In 2010 and 2011, the basic exclusion amount was $5 million, and in 2012 it is $5,120,000. Prior to 2011, if one spouse died without having used some or all of his or her basic exclusion amount during life (had made no lifetime gifts to non-spouse people, other than annual exclusion gifts) and did not use his or her remaining basic exclusion amount at death (ex., by making bequests to children and/or grandchildren), any unused basic exclusion amount was lost.

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To protect against the loss of unused basic exclusion amount, a standard estate planning tool is to draft a will which includes a credit shelter trust for the benefit of one's spouse and children (which does not qualify for the marital deduction) in an amount equal to one's unused basic exclusion amount. While the funds in the trust are still available for the benefit of the surviving spouse, the assets in the trust (and any appreciation thereon) are not included in the surviving spouse's estate and can pass to children and grandchildren free of estate tax. This permits the surviving spouse to use his or her own basic exclusion amount on additional assets that can pass to children and grandchildren free of gift and/or estate tax. With the enactment of the Tax Reform Act of 2010 in December, 2010, the Internal Revenue Code now permits the executor of the first deceased spouse's estate to "give" any unused basic exclusion amount to the surviving spouse, but only for decedent's dying in 2011 and 2012. This is known as "portability."

Internal Revenue Code ("IRC") § 2010(c), as amended by the 2010 Tax Reform Act, changed the definition of the Estate Tax Applicable Exclusion Amount to provide that it includes: (1) the "basic exclusion amount" ($5 million in 2011 and $5,120,000 in 2012) PLUS; (2) for a surviving spouse, the "deceased spousal unused exclusion amount" (the "DSUEA"). The DSUEA has its own definition as the lesser of (1) the basic exclusion amount, or (2) the basic exclusion amount of the surviving spouse's last deceased spouse LESS the combined amount of the deceased spouse's taxable estate plus adjusted taxable gifts. In essence, the DSUEA is the basic exclusion amount that was not used by the last deceased spouse.

As just mentioned, only the DSUEA of the most recent deceased spouse can be used by the surviving spouse. This applies even if the last deceased spouse has no unused basic exclusion amount, and even if the last deceased spouse's Executor failed to make the portability election (*i.e.*, the surviving spouse can't use the unused basic exclusion amount of a prior spouse). Note that the basic exclusion amount (the $5,120,000 for 2012) will be adjusted for inflation (UNLESS they amend the IRC again and decrease the basic exclusion amount), while the amount of the DSUEA is NOT adjusted for inflation.

The predeceased spouse's Executor makes the portability election for such spouse's DSUEA by timely filing (including extensions) a Federal estate tax return (Form 706), which will permit the surviving spouse to use the DSUEA. Therefore, even estates below the filing threshold ($5,120,000 in 2012) must consider whether to file a Form 706. To make the portability election, there is no need to make an affirmative statement, check a box or otherwise affirmatively elect on the Form 706; the election is made simply by timely filing a properly prepared and complete Form 706. Note that the IRS can examine the return of the predeceased spouse at any time for purposes of determining the DSUEA available for use by the surviving spouse.

Many say a full blown Form 706 is overkill because many states do not require a full Form 706 to be attached to the State estate tax return (New York does), or the estate may be too small to require even a State estate tax return. This results in a huge expense for estates that want to elect portability which would otherwise not be required to file a Form 706. (Note that the portability election is pursuant to Federal law; New York does not recognize portability.)

However, not filing a full Form 706 to elect portability may create a malpractice risk if the second

spouse's estate is in excess of $5 million at the time of the second spouse's death (or whatever the basic exclusion amount is at that time). Since you never know what can happen in life (ex. surviving spouse wins the lottery!), you should advise the executor of the estate of the first spouse to die to file the Form 706 to protect the portability election and, if they decline, obtain a written statement from the executor and the surviving spouse specifically stating that they do not want to take advantage of the portability election and fully understand the consequences thereof, which should be enumerated.

So, with the advent of portability is it still necessary to employ the use of credit shelter trusts? You bet it is! Besides New York State not recognizing the portability concept, Federal estate tax portability only applies to estates of decedents dying in 2011 and 2012. If portability is not extended for the years 2013 and beyond, a decedent dying after 2012 who did not effectively use his or her basic exclusion amount through appropriate estate planning tools (ex., use of a credit shelter trust) will have wasted the basic exclusion amount.

The DSUEA is not indexed for inflation and may decrease if reduced by Congress. For example, suppose husband dies in 2012 leaving all of his $5 million estate to his wife, having used none of his $5 million basic exclusion amount, and relying on portability. Wife dies in 2015, when Congress has reduced the basic exclusion amount to $1 million, which in this case would mean the DSUEA from the husband is reduced to only $1 million for the wife. If the wife also had $5 million of her own in addition to the $5 million she inherited from her husband, only $2 million of assets in her estate would be excluded from Federal estate tax (her $1 million basic exclusion amount and the husband's $1 million DSUEA), and $8 million plus any appreciation on the $5 million received from husband, would be subject to Federal estate tax. If husband had created a $5 million credit shelter trust in his Will, the full $5 million plus any appreciation would have escaped Federal estate taxation, and only $4 million would be subject to Federal estate tax in wife's estate (wife's $5 million less the assumed $1 million basic exclusion amount at wife's death).

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Furthermore, in the example above, if wife remarries and husband No. 2 predeceases her, having completely used up his basic exclusion amount, wife is only eligible to use husband number 2's unused basic exclusion amount, which is $0. In this event, husband number 1's basic exclusion amount would also be completely lost. Keep in mind, also, that the statute of limitations for review of a Form 706 used to determine the DSUEA available to a surviving spouse never runs, whereas the statute of limitations on the values used to fund a credit shelter trust runs upon the expiration of the statute of limitations for auditing the Form 706 (generally, three years from the date of filing).

While portability can be helpful where couples have not had the opportunity to do proper estate planning, in most cases, it should not be relied upon.

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1. IRC § 2010(c)(4)(B)(ii).
2. IRC § 2010(c)(5)(B)(i).
3. IRC § 2010(c)(5)(B).