What is Portability, and Is It Right for You?

Portability was first introduced in 2010 and is now a permanent fixture in the estate planning world as a result of the American Taxpayer Relief Act (ATRA) of 2012 that took effect this past January. It allows married couples to “carry over” any unused federal estate tax exclusion amount, also known as the estate tax exemption, of a deceased spouse until the death of the surviving spouse. As a temporary option, originally enacted only through the end of 2012, many estate planners were reluctant to rely on its transitional benefits. But now, with portability of one’s federal estate tax exemption permanent, will it simplify your estate planning strategy?

The following article examines portability and the more traditional bypass trust approach, taking into consideration future appreciation, state estate taxes, the generation skipping transfer tax (GSTT) and remarriage, to better assist you and your professional financial advisors in determining the most prudent estate planning course of action.

Portability and the Bypass Trust

Prior to portability, an individual’s unused estate tax exclusion amount died with him – it was in a sense a coupon that expired at death. To ensure that this “coupon” was redeemed, estate planners commonly built bypass trusts – also called credit shelter or family trusts – into nearly all estate plans of married couples. Does portability render these widely used trusts obsolete? As is often the case in financial planning… it depends.

Bypass trusts have long been used and funded with assets up to the remaining amount of a decedent’s estate tax exemption. The balance of the assets of the first spouse to die is either given directly to the surviving spouse or held in a marital trust for the benefit of the surviving spouse. Since all assets that pass to the surviving spouse are entitled to a marital deduction, and assets within the family trust are exempt from – or bypass – federal estate taxes, because the first spouse to die has applied his or her estate tax exemption to the assets in the family trust, there is no estate tax on the death of the first spouse. By exempting assets, greater wealth is available to be transferred to future generations.

Currently, the federal estate tax exclusion amount is $5.25 million per person. As such, a married couple could shelter as much as $10.5 million from federal estate taxes.
It should be noted that foregoing a bypass trust also removes several issues and potential complexities from the estate planning equation:

- **Estate planning documents become simpler and may be less costly to create.**
- **Deciding how to split assets between spouses is no longer necessary.** This was especially challenging for families with significant wealth tied up in only a few large and often illiquid assets such as real estate or businesses. Sometimes such assets made it hard to “balance” a family's estate.
- **A surviving spouse will have fewer restrictions with which to contend.** In order to avoid being included in the surviving spouse’s taxable estate, the bypass trust must contain provisions that limit the surviving spouse's access to trust assets to an ascertainable standard – health, education, maintenance, and support (or HEMS). Such provisions prevent a survivor from having unfettered access to funds in a bypass trust. By foregoing bypass planning, the surviving spouse can have complete control of assets.

The chart below outlines advantages of portability versus the advantages of a credit shelter/bypass trust.

Despite the simplicity and flexibility that portability allows in a family’s estate plan, it may not be the best plan for all families. In some circumstances, traditional bypass planning is still something to consider.

### Future Appreciation

In electing portability, one foregoes the immediate opportunity of sheltering assets from estate taxes as well as the opportunity to shelter future earnings on the assets that would have been used to fund a bypass trust. Whether this tradeoff is worthwhile depends on such factors as level of wealth, nature of assets and age of family members.

For ultra affluent families, bypass planning will typically be preferred to portability. Such families are likely to have complex estate plans to begin with, splitting assets between spouses is not likely to be difficult, and having restrictions on a small portion of the overall estate will not be punitive to the surviving spouse. Hence the benefit of sheltering future asset appreciation outweighs the benefits that portability would offer.

On the other hand, most families with net worth well below the $10.5 million threshold can be reasonably comfortable with foregoing the sheltering of future appreciation. Less clear cut is the choice for families nearing that net worth threshold, or those with rapidly appreciating assets. Younger individuals or those with younger spouses also need to weigh the pros and cons of portability, as they would tend to have longer life expectancies and thus greater potential for future appreciation of assets.

<table>
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<th>PORTABILITY - ALL TO SURVIVING SPOUSE</th>
<th>CREDIT SHELTER / BYPASS TRUST</th>
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<tr>
<td>Simpler estate planning documents</td>
<td>Future appreciation removed from taxable estate</td>
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<td>Avoids re-titling assets to balance estate of each spouse</td>
<td>May help minimize state estate taxes</td>
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<td>Surviving spouse has complete control over assets</td>
<td>Preserves GSTT exemption if trust is a generation skipping trust</td>
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<td>Step-up in basis upon death of first spouse and second spouse - minimizes impact of capital gains</td>
<td>Provides asset protection</td>
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<td>Avoids expense of creating an irrevocable trust at death of first spouse - no separate fiduciary income tax return</td>
<td>Protects expectancy of children to inherit assets after spouse dies, especially in cases of second marriages and blended families</td>
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<tr>
<td>Income earned after death of first spouse is not subject to tax at compressed fiduciary income tax rates</td>
<td>Preserves exemption amount, even if spouse remarries or the law changes</td>
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<td>Single investment pool</td>
<td>May avoid the filing of an estate tax return upon the death of the first spouse</td>
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<td>Surviving spouse has discretion to engage in gift planning after the first spouse dies</td>
<td>Allows ‘first spouse to die’ to control ultimate disposition of assets</td>
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State Estate Taxes

Perhaps the most important caveat to portability consideration is that it is applicable only to federal estate taxes, not state estate taxes. Nearly half of all states impose their own death tax – some in the form of an estate tax, others in the form of inheritance tax, or both in a couple of instances. While foregoing bypass planning at the federal level may be the preferred path, it may be a costly one to take at the state level. State estate tax exemption amounts vary widely. As such, the potential costs of portability will also vary widely. Careful consideration must be given to potential state death tax consequences when determining whether or not to rely on portability as part of an estate plan.

Remarriage

When it comes to remarriage, it is important to recognize that the only portable federal estate tax exemption is the one from an individual’s last deceased spouse. For example, assume Jack and Jill have an estate plan that relies on portability. Jack dies with his exemption amount fully intact. Jill marries Bob several years later and Bob dies suddenly soon thereafter. Jill can no longer utilize Jack’s exemption because Bob is her last deceased spouse. Jack’s exemption has effectively been wasted.

A family trust may protect the assets of the first spouse to die and help insure that those assets will pass to his or her children after the death of the surviving spouse. If all of the family assets pass to the surviving spouse and he or she gets remarried, his or her new spouse may have access to those assets.

Generation Skipping Transfer Tax (GSTT)

At the federal level, estate tax planning needs to consider an additional, separate layer of taxation known as generation skipping transfer tax (GSTT). This tax is imposed on transfers to beneficiaries more than one generation removed from the transferor. For example, if an individual decides to leave his entire estate to his granddaughter instead of his son, the transfer would be subject to GSTT. Note: an exception applies. In the preceding example, if the son predeceases his daughter, GSTT would not apply.

While GSTT and regular estate taxes are entirely separate taxes, they both afford the same $5.25 million exemption. However, unlike the federal estate tax exemption, the GSTT exemption is not portable. For highly affluent families with the intention of passing wealth to multiple generations, bypass planning remains quite relevant in order to preserve one’s GSTT exemption and shelter assets and appreciation from this additional layer of tax.
4. **While trusts are only taxed on income retained in the trust, distributing the income to beneficiaries can severely undermine one of the key objectives of such a trust: transferring the assets, including the appreciation of those assets to the next generation without inclusion in the surviving spouse’s estate.**

5. **Upon death of the surviving spouse, assets in the bypass trust do not get a step-up in basis. (A step-up effectively erases any built in gains on trust assets. By erasing the gains, you thereby eliminate the income taxes attributable to those gains.)**

Note: If trust assets were instead left to the surviving spouse under a portability plan, these assets would in fact receive a step-up in basis.

**Portability “Cost” Consideration**

A federal estate tax return must be filed upon the first spouse’s passing in order for the surviving spouse to elect portability upon their subsequent passing. There could be significant estate tax return preparation fees.

**Conclusion**

Now that portability has its permanent place as a viable estate planning option, many if not most families may have a simpler wealth transfer road ahead. As discussed, foregoing traditional bypass planning has the possibility of reducing both costs and potential complications. However, it is critical to understand, in consultation with a trusted financial advisor and estate planner, the various nuances associated with portability versus bypass and which path may more effectively meet your estate planning objectives.

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