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Married Couple's Guide To The New Estate Tax Law

The sweeping tax overhaul that President Obama signed Dec. 17, raising the exemption from federal estate tax to \$5 million a person, includes a wonderful new break for widows and widowers. Starting in 2011, they can add the unused estate tax exemption of the spouse who died most recently to their own. This dramatic change enables spouses together to transfer up to \$10 million tax-free. It also eliminates the need in many cases for the tax-planning gyrations that lawyers routinely recommended to preserve each spouse's estate tax exemption amounts.

Portability, as tax geeks call it (though that term does not actually appear in the new law), was a surprise goodie. Various estate tax bills proposed in Congress over the years would have permitted it. Many people favored it. But it seemed to be off the table until it resurfaced in the bill Senate Majority Leader Harry Reid, D-Nev., introduced following the Obama-Republican compromise.

The law doesn't change the fact that you can give an unlimited amount to your spouse, during life or through your estate plan (provided she or he is a U.S. citizen) with no tax applied. But until now, without proper planning, when the second spouse died anything above the exempt amount not going to charity would be taxed. In other words, the first spouse's exemption would be lost. Bypass trusts (also called family trusts) addressed that problem.

Here's how these trusts work: When the first spouse dies, the trust is funded with up to the tax-free exemption amount. The trust distributes income and principal to the survivor or other family members (usually the couple's children) while the surviving spouse is alive, then passes on whatever is left to

family. Funds in the bypass trust are covered by the exemption amount and are not taxed when the first spouse dies. Nor are they considered part of the survivor's estate, so they are not subject to tax when she dies.

All this is still true, but portability makes it unnecessary for spouses to use bypass trusts solely to preserve the federal exemption amount. However, 15 states and the District of Columbia still have their own estate taxes, and most have exemptions of \$1 million or less. None, as of now, have any portability provisions. That means residents of those states may still want to use bypass trusts to preserve their state estate tax exemptions. Texas is not one of these states.

As with any new process there will be a shakeout period. Portability takes us into uncharted waters, raising financial planning opportunities and potential pitfalls that are new to us all. Here are answers to what are likely to be some frequently asked questions:

Does this provision help me if my spouse died years ago? No. It applies only to deaths after Dec. 31, 2010.

Does portability apply to lifetime gifts as well as assets that pass through an estate plan? Yes. Under the new law, starting in 2011, the lifetime exemption and the estate tax exemption are expressed as a total amount, and it is possible to use this "unified credit" to transfer assets at either stage or a combination of the two. (From 2004 to 2010, the two amounts were different; the gift tax exemption remained at \$1 million, while the estate tax exemption went up.)

The estate tax exemption amount is reduced for lifetime taxable gifts. So if, for example, you have used \$1 million of the exemption to make taxable lifetime gifts, the unused exemption when you die will be \$4 million, rather than \$5 million.

Is portability automatic? No. The executor handling the estate of the spouse who died will need to transfer the unused exemption to the survivor, who can then use it to make lifetime gifts or pass assets through his or her estate.

The prerequisite is filing an estate tax return when the first spouse dies, even if no tax is due; one would hope that the Internal Revenue Service will develop a short form for the purpose.

This return is due nine months after death with a six-month extension allowed. If the executor doesn't file the return or misses the deadline, the spouse loses the right to portability. Spouses should file it even if they're not wealthy today, because someday, who knows?

For example, let's say Harry has an unused exemption amount of \$2 million when he dies next year (say because he left \$3 million to his children outright). His widow Sally has a \$5 million exemption amount of her own. As the executor of Harry's estate, Sally can file a return, transferring Harry's unused exemption, so that she will then be able to pass \$7 million tax-free (her own \$5 million exemption plus Harry's \$2 million unused exemption).

Is the amount that's portable adjusted for inflation? No, but the surviving spouse's own exemption amount is after 2011.

What happens if you remarry? This is where things may get complicated. The law clearly indicates that if, for example, Sally remarries after Harry's death, she can no longer use Harry's unused exemption amount--only the one of her new husband (call him Joe), assuming she survives him too. If Joe's unused exemption is less than Harry's (or if he has no unused exemption at all), Sally is out of luck.

What if Sally dies first? Sally came into the marriage with a \$7 million exemption amount, including the \$2 million unused exemption from Harry. Assume she leaves \$3 million to the children she and Harry had together. Posing a similar situation, a report by the Joint Committee on Taxation indicates that Joe can use the remaining \$4 million exemption, along with his own.

Can I use my exemption instead to provide for children from a previous marriage? Yes. You can do this with just part of your exemption amount--or the whole thing--by leaving assets to them outright or in a bypass trust.

Is this a subject that should be covered in prenuptial agreements? Macabre as it may sound, inheritances often are the subject of prenups, especially when there are children from a previous marriage. And wills often specify the funds from which estate taxes should be paid (for instance, it's not tax efficient use retirement assets for this purpose). So while this is certainly a new topic, if it concerns you, it's something you should address.

Does portability also apply to the exemption from generation-skipping transfer tax? No. This tax applies, on top of estate or gift tax, to assets given to grandchildren (or to trusts for their benefit). Although there is no portability at death, for transfers during life married couples can combine each of their exemptions to give away a total of \$10 million without incurring the tax.

Do I still need a bypass trust? The trust has the advantage of sheltering appreciation and could also be helpful in situations where you want to protect assets from creditors or benefit children from a previous marriage. But for most other cases, where couples have combined estates of \$10 million or less, they might be better off just leaving everything outright to each other in what is called an "I love you will."

When outright bequests to the surviving spouse make sense for estate tax reasons, there may also be income tax benefits down the line. When the second spouse dies, these assets, included in her estate, get an adjustment in basis to their date of death value, which minimizes the capital gains tax heirs must pay when they are sold. In contrast, the basis on assets that went into the bypass trust when the first spouse died will not have changed since then.

Is portability here to stay? Along with all the other estate tax rules in the new law, this provision is set to expire on Dec. 31, 2012. Unless portability proves completely unworkable though, Congress is likely to renew it because the new system simply makes it easier to accomplish something that many couples have been doing anyway. But we might expect some refinements or clarifications to be necessary as the law gets applied in real life.