**Portability or the Credit Shelter Trust: What’s best?**

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**An Overview of the Transfer Tax Changes**

The American Taxpayer Relief Act of 2012 (“ATRA” or the “Act”) created “permanency” in the estate planning area for the first time since the passage of the Economic Growth and Tax Relief Act of 2001 (EGTRRA). In the transfer tax area, ATRA permanently establishes the same high exemption amount for gift tax, estate tax and generation-skipping transfer tax purposes, and indexes the unified gift and estate tax exemption amount and the generation-skipping tax exemption amount for future inflation. ATRA also permanently extends “portability”, one of the key features of the Tax Relief Act of 2010 and sets the highest marginal estate/gift tax rate at 40%.[[1]](#footnote-1) Under ATRA, each taxpayer has available a unified gift and estate tax exemption of $5,340,000 in 2014. Importantly, this exemption (also referred to as the Applicable Exclusion Amount) is permanent, unified, indexed for inflation, and portable.

*Permanent.* The exemption amount is not scheduled to sunset or be reduced, as had been the case since 2001. As a result, taxpayers should be able to better estimate their long-term estate tax exposure.[[2]](#footnote-2) Permanence also eliminates concern over taxes caused under an estate tax “claw back” since the applicable exclusion amount will not be less at death than during life.[[3]](#footnote-3)

*Unified.* ATRA unifies the gift tax exemption with the estate tax exemption and creates tremendous gifting opportunities. Wealthy clients can now fully use their gift and GST tax exemption during life, taking full advantage of the absence of state gift taxes, the benefits of a grantor trust, and valuation discounts.

*Indexed.* The unified exemption amount is indexed for inflation, based on a $5,000,000 exemption amount in 2011.[[4]](#footnote-4) It increased by $120,000 in 2012, $130,000 in 2013, and $90,000 in 2014. Scheduled future increases will give taxpayers significant additional lifetime giving capacity. Long term, this indexing feature of the exemption amount will have a significant financial impact on future planning.

*Portable.* The exemption is portable between spouses, meaning that under certain conditions, a surviving spouse may use not only his or her own basic exclusion amount ($5,340,000 in 2014) but also any unused applicable exclusion amount of his/her last deceased spouse.[[5]](#footnote-5) For many taxpayers, exemption portability will simplify planning since it will obviate the need for each spouse to create a traditional bypass trust and have separate property to fund this trust at the first death.

**Portability in General**

Portability is now permanent. Portability attempts to simplify estate tax planning by avoiding the need for married couples to undertake trust planning to fully utilize the basic exclusion amount at the first death. Portability also allows couples to avoid the retitling of assets that was often necessary to maximize the use of the applicable exclusion at the first death. Unfortunately, portability is not simple, nor does it always assure the intended results. For a spouse who dies after December 31, 2010, the Act allows the surviving spouse to use the deceased spouse’s unused exclusion amount in addition to the surviving spouse’s own basic exclusion amount. The executor of the deceased spouse’s estate can transfer this remaining amount to the surviving spouse by making an election on a timely filed estate tax return for the deceased spouse. Therefore, even relatively small estates of married persons must consider whether to file an estate tax return for the first deceased spouse’s estate.[[6]](#footnote-6) This carryover amount is referred to as the Deceased Spousal Unused Exclusion (DSUE) Amount.[[7]](#footnote-7)

**Benefits of Portability:**

The primary intended beneficiaries of portability are couples whose combined assets are, or are expected to be, greater than one exclusion amount but less than two times the exclusion amount. Portability was originally thought to be a “stopgap” planning measure primarily beneficial to married taxpayers who failed to create an estate plan to take advantage of the basic exclusion amount at the first death. However, now that portability has been made a permanent part of the law and can be safely relied upon; it has become a legitimate planning concept.[[8]](#footnote-8) For many of our clients it will no longer be an easy decision as to whether to create an estate plan using a bypass trust or to rely upon portability. This is true even for a couple with a substantial estate. A number of factors will need to be weighed in order to determine whether it is in the client’s best interests to take advantage of portability:

*Simplicity* As noted earlier, estate plans that are based on portability are not free from all complexities associated with transferring assets at death, but it is generally simpler and less expensive than credit shelter trust planning. Portability may also offer a greater sense of security for the surviving spouse than a credit shelter trust. In deciding whether to rely on portability, one should consider not only the cost of creating the bypass trusts and retitling the assets but also the cost of maintaining a trust for future years, including fiduciary fees and bookkeeping and tax return preparation costs and compare that to the costs of filing the estate tax return to elect portability.

*Step-up in Basis* A primary tax benefit of portability is that the assets which pass to the surviving spouse outright or in a marital trust (and which benefit from portability) will receive a step-up in basis at both the predeceasing spouse’s death and the surviving spouse’s death, while assets passing to a credit shelter trust will only receive a step-up upon the predeceasing spouse’s death. The basis step-up is a clear advantage for couples with estates which are or which are expected to be less than twice the applicable exclusion amount.

*Qualified Retirement Plans* Portability will be helpful where one spouse has an unusually large asset and it cannot be easily divided (e.g., a client who has a large qualified plan or IRA and few other assets to fund the credit shelter trust). In this situation there is a tension between leaving the IRA directly to the surviving spouse to benefit from income tax deferral and foregoing the estate tax benefits of utilizing the exemption versus leaving the IRA to a credit shelter trust to realize the estate tax benefits, but consequently losing the income tax benefits of a spousal rollover. Portability largely solves this problem by leaving the retirement and IRA benefits directly to the surviving spouse and relying on portability to use the deceased spouse’s unused estate tax exclusion amount at the surviving spouse’s subsequent death.

*Retitling Assets* Traditionally, if one spouse owned most of the marital assets, in order to utilize the estate tax exemption amount of the less-wealthy spouse if he or she died first, the wealthier spouse would have to retitle assets into the name of the less wealthy spouse or fund an inter vivos QTIP trust for that spouse, often unpopular with wealthy individuals. This reluctance will be even greater with a $5.34 million exemption since a very large amount might need to be transferred to the less-wealthy spouse. Transferring assets can be avoided if the couple is willing to rely on portability to take advantage of the less wealthy spouse’s estate tax exclusion amount. Furthermore, where the assets are owned jointly as tenants by the entireties, retitling the assets into individual names may result in the loss of creditor protection.

*Residence* A residence is another asset that may represent a substantial portion of the couple’s net worth but is often a poor choice to use to fund a credit shelter trust. Trust ownership of the house would impact the protection provided if the home were otherwise held as tenants by the entireties. In many states, trust ownership would also impair the homestead exemption. After the first death, trust ownership will also jeopardize the $250,000 ($500,000 if married) exclusion on sale of a home and the mortgage interest and real estate tax deductions. Portability makes it easier, from a tax perspective, to leave the house in the name of the surviving spouse.

*State Estate Tax Savings*  Fully funding a credit shelter trust at the first spouse’s death might generate significant state estate taxes when the couple lives in a state where the state death tax exemption is significantly lower than the federal exemption.[[9]](#footnote-9) This tax at the first death could be avoided by relying on portability.[[10]](#footnote-10) For example, if a deceased NY resident fully funds the $5,340,000 bypass trust at the first death, then that would generate $438,800 of NY state estate tax in 2014. [[11]](#footnote-11) On the other hand, by relying on portability this NY estate tax could have been avoided. The surviving spouse (who would have both his or her basic exclusion amount and the DSUE amount of his or her deceased spouse) could then make gifts that would not be subject to state transfer taxes.[[12]](#footnote-12) Clients in these low tax threshold states should fund the credit shelter trust up to the state exemption amount and rely on portability for the balance in order to minimize state death tax at the second death.

*Creating Grantor Trust as to Surviving Spouse* Leaving assets to the surviving spouse and electing portability permits the surviving spouse to use this DSUE amount to make gifts to his or her grantor trust.[[13]](#footnote-13) The “tax burn“ of a grantor trust creates significant transfer tax benefits over time and may prove more financially beneficial than a credit shelter trust. This approach may also be attractive for clients who are domiciled in states that have a state estate tax threshold which is lower than the federal exemption amount.

*Consumption Exceeding Growth* Portability may be preferable if the assets in the bypass trust decline in value during the surviving spouse’s lifetime (e.g., note receivables, mineral royalties, qualified retirement plans). In this situation, portability is preferable to using a bypass trust since with portability the surviving spouse has the full unused exemption amount available in addition to his or her own estate tax exemption amount. If a bypass trust had been used, no unused exclusion amount would exist and the bypass trust assets would have declined in value.

**Benefits of Using a Bypass Trust:**

Whether or not to elect portability, however, will not be an easy decision as there are substantial tax and non-tax benefits available in funding a bypass trust at the first spouse’s death:

*Non-Tax Benefits* There are obvious non-tax benefits of using a trust – creditor protection, professional management, and the ability to restrict distributions to the surviving spouse and children.[[14]](#footnote-14)

*Provides Income Tax Planning Opportunities* If the bypass trust contains a sprinkle provision that permits the trustee to distribute income to the spouse and children, then there is an opportunity to shift income to the various family members who are in a lower tax bracket.[[15]](#footnote-15) This may be especially attractive with ATRA’s higher rates and the new 3.8% surtax. Short of gifting the income-producing asset to other family members, portability does not provide an opportunity to shift income to family members in lower tax brackets.

*Removes Future Appreciation from Surviving Spouse’s Estate* The appreciation of the property after it is transferred to the credit shelter trust will not be included in the surviving spouse’s estate. Contrast this with the fact that the portable portion of the exclusion amount is frozen at its date of death value and does not receive the benefit of future inflation indexing. This benefit is especially important with younger clients and for clients with appreciating assets.[[16]](#footnote-16)

*Attractive with Blended Families* A credit shelter trust is attractive in that a person can use a portion, or all, of their exemption amount at his or her death to benefit children from a previous marriage by leaving assets in trust. Similarly, use of a trust can ensure what happens to the property after the death of the surviving spouse. In other words, Mother does not have to worry about Father remarrying and leaving the property to his new family and thereby, disinheriting her own children.

*Avoids Risk of Losing the DSUE Amount*The unused exclusion from a particular predeceased spouse may be lost if the surviving spouse remarries and survives his or her next spouse. This risk is avoided by funding a bypass trust.

*Loss of the GST Exemption*If one relies on portability, the GST exemption of the first spouse to die will have been wasted as there is no portability of the GST exemption. This will be especially troublesome in larger estates where the goal is often to maximize the amount of property held in long-term trusts for descendants. These couples will want to use credit shelter trusts. [[17]](#footnote-17)

*No Statute of Limitations with Portability* There is no running of the statute of limitations from the first deceased spouse’s estate tax return for purposes of determining the unused exclusion amount for federal estate tax purposes. This can be especially troublesome if the estate has non-publicly traded assets that are difficult to value. Conversely, the statute of limitations does run from the time of the filing of the estate tax return for federal estate tax purposes if a bypass trust is funded at the first spouse’s death. This tolling of the statute can mitigate the risk of audit with respect to these assets.

*Avoids Tax Risk to First Decedent’s Spouse’s Family* Use of credit shelter trust avoids the risk that the QTIP trust for the benefit of the first decedent spouse’s family will pay large estate taxes without any benefit of the first decedent spouse’s estate tax exemption. [[18]](#footnote-18)

*Avoids Risk of Losing Survivorship Presumption* It is not clear that survivorship, and thus eligibility to use the DSUE amount, is governed by a survivorship presumption in the wills or other governing instruments of spouses who die “simultaneously,” as the creation of a credit shelter trust would be.

**Conclusion**

While many modest sized estates may choose to rely on portability by default, the question of whether to establish credit shelter trusts or rely on portability may be the most important estate planning issue for many clients. There will be a need to balance the perceived simplicity of portability with the myriad of factors that both favor or cut against the use of credit shelter trusts. Only by evaluating the impact of these many factors on a particular client can the most appropriate decision be made.

If the size of the estate and the age of the client are such that there is high degree of certainty that the couple will pay federal estate taxes, then the benefits of a bypass trust that shelters future growth will generally outweigh the benefits of electing portability and receiving a step-up in basis at the survivor’s death. Every dollar of unrealized appreciation which is sheltered by the credit shelter trust will avoid a 40% federal estate tax but could incur a capital gains tax of up to 23.8%. State income taxes may close this gap especially for California residents and residents of other high income tax states but state death taxes will also need to be considered. In states that have decoupled, this affluent couple could also be a candidate for taking advantage of portability and having the surviving spouse make a gift of the DSUE amount shortly after the death of the first spouse to die.

In summary, portability should be viewed as just another tool. While portability may be appropriate to use in certain situations, it will not be right for everyone. Going forward, whether a credit shelter trust or portability is used will depend upon each client’s unique situation. In some situations, a client may use both portability and a credit shelter trust to implement their estate plan in order to best achieve their goals. In other situations, where there are no clear cut factors favoring one approach over the other, the best advice may be to defer the decision until after the first death when more of the facts are known.

**Comparison of Portability versus Credit Shelter Trust (CST)**

 **Advantages/Disadvantages Portability Plan CST Plan**

|  |  |  |
| --- | --- | --- |
| 1. **Avoids Re-titling of Assets**
 | Yes | No |
| 1. **Simplicity**
 | It is Simpler than CST Planning. | No |
| 1. **Achieves Step-up in Basis at Second Death**
 | Yes | No |
| 1. **Facilitates Spousal Rollovers of Qualified Plans/IRAs**
 | Yes | No |
| 1. **Avoids Issues with Trust Ownership of Primary Residence**
 | Yes | No |
| 1. **Facilitates State Estate Tax Savings**
 | Avoids State Estate Tax @ 1st Death but may Increase State Estate Tax @ 2nd Death | While Full Use of Federal Exemption may Increase State Death Tax at 1st Death, Optimal Use of CST may Minimize State Death Tax @ 2nd Death.  |
| 1. **Avoids issues with assets that decline in value after the first death**
 | Yes | No |
| 1. **Creditor Protection for Surviving Spouse**
 | No | Yes, assuming spouse is not trustee |
| 1. **Professional Management**
 | No | Yes |
| 1. **Restricts Distributions to Spouse**
 | No  | Yes |
| 1. **Removes Future Appreciation from Surviving Spouse’s Estate**
 | No | Yes |
| 1. **Attractive to Blended Families**
 | No | Yes |
| 1. **Loss of First Spouse to Die’s GST Exemption**
 | Yes | No |
| 1. **Provides for Income Tax Planning Opportunities**
 |  No | Yes |

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1. See also the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act (“TRUIRJCA”) of 2010. [↑](#footnote-ref-1)
2. Of course, as with all tax provisions that may be changed. We must keep in mind that the definition of “permanent” in Washington really means “current,” as future legislation could rewrite the rules. [↑](#footnote-ref-2)
3. See IRC § 2001(g) and 2505(a)(2). [↑](#footnote-ref-3)
4. In 2012, the exemption amount of $5,120,000 was an increase of 2.4% over the prior year. The 2013 exemption amount of $5,250,000 is an increase of approximately 2.5%. The 2014 exemption amount of $5,340,000 is an increase of about 1.7%. [↑](#footnote-ref-4)
5. For these purposes, the marriage must be one recognized under federal law. The portable portion of the deceased spouse’s exemption is known as the Deceased Spousal Unused Exclusion Amount (“DSUE Amount”). This provision is retroactive only to 2010 – there is no DSUE Amount for a spouse who died prior to 2010. [↑](#footnote-ref-5)
6. Temporary Regulations T.D. 9593 77 Fed. Reg. 36150 (June 18, 2012) and identical proposed regulations (REG-141832-11) simplify some of the information that must be included on the estate tax return. [↑](#footnote-ref-6)
7. This does not include any unused generation skipping transfer tax amount. Under the Act, “Applicable Exclusion Amount” is now defined as the “Basic Exclusion Amount” (e.g., $5,340,000 in 2014) plus the “Deceased Spousal Unused Exclusion Amount.” [↑](#footnote-ref-7)
8. This assumes that the executor of the first-to-die’s estate makes an election on a timely filed estate tax return. [↑](#footnote-ref-8)
9. This is true where the QTIP election, or nonelection for federal estate tax purposes, is binding for state estate tax purposes (e.g., NY, NJ). In these states, if a QTIP trust is created and the executor decides to fully fund the exemption for federal estate tax purposes, the estate would be precluded from electing the marital deduction for state estate tax purposes, triggering a state estate tax on the federal exemption amount. This unsatisfactory result can be largely avoided in states where the QTIP election for federal estate tax purposes is not binding for state estate tax purposes. For example, in MA the executor can make separate QTIP elections for federal and state tax purposes and thereby utilize the full federal estate tax exemption but still avoid the state estate tax at the first death. [↑](#footnote-ref-9)
10. Relying on portability, however, may result in unnecessary state death taxes being paid at the second death because of the failure to take advantage of the state death tax exclusion of the first spouse to die. One possibility is to leave the state exemption amount to a bypass trust and rely on portability for the balance of the first decedent spouse’s estate, which would have the effect of deferring all state taxes until the second spouse’s death. [↑](#footnote-ref-10)
11. Effective April 1, 2014, New York changed its state estate tax law, increasing the New York estate exemption from $1,000,000 to $2,062,500 per person ($4,125,000 per married couple). But, the benefit of the increased basic exclusion amount is phased out for estates valued at more than 100% of the exclusion amount. Once the value of the estate reaches 105% of the basic exclusion amount, the entire estate is taxed at the applicable rates. Under the new law, the exemption will continue to increase each year until January 1, 2019 when it will equal the federal estate exemption in effect at that time.  New York continues to have an Unlimited Marital Deduction and no gift tax except for “New York” gifts made within three years of death and only if the gift was made during the period between April 1, 2014 and December 31, 2018. In addition, the new law did not change New York’s current estate tax rates. [↑](#footnote-ref-11)
12. Only one state, Connecticut, has a gift tax, as Minnesota retroactively repealed its gift tax. [↑](#footnote-ref-12)
13. In most states, however, the surviving spouse could not be a discretionary beneficiary of this trust without subjecting the trust assets to inclusion in the surviving spouse’s estate. [↑](#footnote-ref-13)
14. A decedent can achieve roughly the same protective benefits of a credit shelter trust by creating a marital trust for the surviving spouse, who still can claim the DSUE amount. However, when a QTIP trust is combined with portability, the client’s estate plan may not operate as intended, especially in a second marriage situation. The surviving spouse could make gifts of the DSUE amount to his or her family and the QTIP trust would have to contribute to cover the taxes attributed to it, unless the estate plan waives reimbursement. In these situations, a better approach may be to use a traditional credit shelter trust. [↑](#footnote-ref-14)
15. The Trustee has 65 days after the end of the tax year to determine which beneficiaries are in a lower tax bracket and make payment to them. [↑](#footnote-ref-15)
16. To determine whether to use a bypass trust or not, it will be important to run the numbers to illustrate the estimated estate tax savings of each strategy and allow the client and his or her tax advisors to ultimately decide which strategy to implement. [↑](#footnote-ref-16)
17. If the client wants to rely on portability and still use his or her GST exemption at the first death, consider funding a QTIP trust where the executor can elect the marital deduction and still make a reverse QTIP election under Section 2652(a)(3) to enable the use of the decedent’s GST exemption. The income that must be paid to the spouse in a QTIP trust will result in some leakage for GST tax purposes and will not be as tax-efficient as a bypass trust. [↑](#footnote-ref-17)
18. For example, assume wife passes all of her assets to a QTIP trust with remainder to her children from a prior marriage. Husband, as executor, can elect QTIP, obtain the wife’s DSUE amount, and then make gifts of his property to his children from a prior marriage using up both the DSUE amount and his applicable exclusion. On his death, the QTIP trust will bear the tax burden it would not have otherwise had. Husband’s children from his prior marriage will benefit at the expense of Wife’s children from her prior marriage. This issue could be addressed in a prenuptial agreement. [↑](#footnote-ref-18)