WILLMS, S.C.

LAW FIRM

TO: Clients and Friends of Willms, S.C.

FROM: Maureen L. O'Leary

DATE: August 16, 2013

RE: Two Ways to Save Taxes: Portability Election and a Credit Shelter Trust

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The "estate tax exclusion amount" refers to the amount of assets that a decedent can shelter from estate tax upon their death.[1] The estate tax exclusion amount has been steadily rising for years. (See Exhibit A.)

Exclusion Amount	Years
$675,000	2000-2001
$1,000,000	2002-2003
$1,500,000	2004-2005
$2,000,000	2006-2008
$3,500,000	2009
unlimited	2010
$5,000,000	2011
$5,120,000	2012
$5,250,000	2013

The estate tax exclusion amount is scheduled to continue to increase annually for inflation in 2014 and beyond, until such time as Congress may change the law again.

Many people who die in 2013 will not use their entire $5,250,000 estate tax exclusion amount. For example, if a married person dies and simply leaves their entire estate outright to their spouse without taking any further action, the decedent's entire estate tax exclusion amount is wasted.

If a married couple has a combined estate worth $10,000,000 and the husband dies and gives his half of the estate directly to his wife, then his wife's estate would be $10,000,000. No estate tax would be due upon the husband's death because of the unlimited estate tax

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[1] This article focuses exclusively on federal estate tax because Wisconsin does not currently have an estate tax.

marital deduction that allows a married person to give an unlimited amount of assets to their spouse estate tax free. However, if the wife dies when the estate tax exclusion amount is $5,500,000[2], the wife's $5,500,000 estate tax exclusion amount will not be sufficient to shelter her entire $10,000,000 estate from estate tax. $5,500,000 of her estate could be sheltered by her estate tax exclusion amount, but the remaining $4,500,000 in her estate would be subject to estate tax. The estate tax rate is currently 40% (although this rate is likely to change in future years). Estate tax on $4,500,000 at an estimated 40% rate would result in an estate tax bill of $1,800,000 due within 9 months of the surviving spouse's death.

With proper planning, there are at least two ways to avoid this estate tax bill under current law. One way is by making a Portability Election and another way is to establish a Credit Shelter Trust. It is also possible to combine these two techniques.

1. **Portability Election**

Portability is the ability of a surviving spouse to receive the unused portion of a deceased spouse's estate tax exclusion amount by making a portability election. The portability election is available to estates of married decedents who die after December 31, 2010.

For example, if the wife with the $10,000,000 estate in the example above made a timely portability election after her husband's death, then her husband's $5,250,000 unused estate tax exclusion amount can be "ported" (i.e. transferred) to the wife. If the wife dies with a $10,000,000 estate when the estate tax exclusion amount is $5,500,000, the wife will have not only her own $5,500,000 estate tax exclusion amount but will also have her husband's unused $5,250,000 exclusion amount, for a total of a $10,750,000 exclusion amount. That $10,750,000 exclusion amount is enough to shelter her entire $10,000,000 estate from estate tax. As a result, no estate tax is due and $1,800,000 of estate tax is avoided.

A portability election can also be a good idea for smaller estates. If a married couple has a combined estate of $5,000,000 and the husband dies in 2013 and gives his half of the estate directly to his wife, the wife's estate will be $5,000,000. If the wife made a portability election upon her husband's death and later dies with a $5,000,000 estate when the estate tax exclusion amount is $5,500,000, she would not need her husband's unused estate tax exclusion amount because her own $5,500,000 exclusion amount would be sufficient to shelter her entire $5,000,000 estate from estate tax. However, there is no guarantee that the estate tax exclusion amount will remain at such high levels. It is possible that Congress could reduce the estate tax exclusion amount in future years.

If Congress reduces the estate tax exclusion amount to $1,000,000 per person and the wife dies with a $5,000,000 estate, only $1,000,000 will be sheltered from estate tax and the remaining $4,000,000 of her estate will be subject to estate tax if the wife did not make a

[2] $5,500,000 is a hypothetical estate tax exclusion amount used for illustration purposes only.

portability election upon her husband's death. At a 40% estate tax rate, $1,600,000 of estate tax would be due upon her death. In contrast, if the wife made a portability election upon her husband's death, her husband's unused $5,250,000 exclusion amount would be available to her estate in addition to her own $1,000,000 exclusion in the year of her death, for a total of $6,250,000. A $6,250,000 estate tax exclusion amount is sufficient to shelter her entire $5,000,000 estate from estate tax. As a result, the $1,600,000 estate tax bill would be avoided.

What about even smaller estates? It is probably not necessary for estates less than $1,000,000 to make a portability election because even if the estate tax exclusion amount is reduced to $1,000,000 per person, the surviving spouse's exclusion amount will be sufficient to shelter the entire estate from estate tax upon the survivor's death.

However, it may be tricky to decide whether a married couple with a combined estate in the $2,000,000 - $5,000,000 range should make a portability election upon the death of the first spouse. For such estates, the surviving spouse should consider to what extent he or she believes Congress may reduce the estate tax exclusion amount in the future. Consideration should also be given to the possibility that the size of your estate may grow if you have a long life expectancy, if you own assets that are expected to appreciate or if you play the lottery and are feeling lucky!

Portability can only be elected on a timely-filed estate tax return for the deceased spouse, so a failure to file the return will result in a loss of the opportunity to make a portability election. An estate tax return is required to be filed for estates that exceed the estate tax exclusion amount. Even if the deceased spouse's estate is not large enough to require filing a federal estate tax return, executors should consider filing a return solely to make the portability election. There are no special boxes to check or statements needed to make the election. Merely by filing the estate tax return the portability election has been made. If you are filing an estate tax return and for some reason do not want to make a portability election, you need to expressly opt-out of the election on the estate tax return.

The estate tax return is due within 9 months of the decedent's date of death, although an automatic 6 month extension can be obtained if an extension request (Form 4768) is filed before the 9 month deadline has passed. If you missed the 9 month deadline to file the estate tax return or apply for an extension, the IRS has the discretion to grant an additional extension of time to file if "good cause" is shown. If you find yourself in this situation, you need to file the Form 4768 as soon as possible along with an explanation of why the automatic extension was not requested and why a complete return was not filed by the due date. However, there is no precedent to show exactly what constitutes "good cause" for failure to file by the deadline because the portability election is relatively new. You should try to avoid this situation at all costs by filing a timely return or automatic extension request within the 9 month deadline if you want to make a portability election.

It is also important to note that even if a portability election is made, the surviving spouse's ability to use the decedent's estate tax exclusion amount will be lost if the surviving spouse remarries and survives the new spouse because a surviving spouse can only use the unused estate tax exclusion amount of the last deceased spouse.

2. Credit Shelter Trust

Before portability was an option, a common method for a surviving spouse to take advantage of a deceased spouse's estate tax exclusion amount was to fund a Credit Shelter Trust. Credit Shelter Trusts are still a very good idea for many estates. Some estate plans require a Credit Shelter Trust be established, some estate plans allow for an optional Credit Shelter Trust, while other estate plans do not have any provisions for a Credit Shelter Trust. If a Credit Shelter Trust is an option you would like your spouse to have, it is important to set up your estate plan accordingly during your joint lifetimes.

A Credit Shelter Trust is designed to receive some or all of a decedent's estate upon death. The assets in a Credit Shelter Trust are not considered part of a surviving spouse's taxable estate upon the surviving spouse's death, even though the surviving spouse can be the Trustee and beneficiary of the Credit Shelter Trust.

For example, consider a couple with a $10,000,000 estate. Upon the first spouse's death $5,000,000 is put in a Credit Shelter Trust and $5,000,000 is kept by the surviving spouse. When the surviving spouse dies, the balance remaining in the Credit Shelter Trust (including any appreciation on its assets) is not subject to estate tax. Accordingly, if the estate tax exclusion amount was $5,500,000 and the surviving spouse's estate was $5,000,000 (excluding the assets in the Credit Shelter Trust) upon the surviving spouse's death, no estate tax would be due even though no portability election was made upon the first spouse's death.

A portability election and a Credit Shelter Trust both allow a surviving spouse to take advantage of a deceased spouse's estate tax exclusion amount, but there are many differences between a Credit Shelter Trust and a portability election. Following is a brief summary of a few key differences.

1. Credit Shelter Trusts are irrevocable, which means that the surviving spouse generally cannot change the distribution provisions for the assets that remain in the Credit Shelter Trust upon the surviving spouse's death.

2. Credit Shelter Trusts must file their own annual income tax returns if they have any taxable income.

3. Assets in a Credit Shelter Trust may be better protected from the creditors of the surviving spouse than if the assets were owned by the surviving spouse outright.

4. The assets in a Credit Shelter Trust do not get a step-up in basis for income tax purposes upon the death of the surviving spouse, unless if the surviving spouse has a general power of appointment over the trust's assets.

5. The decedent's generation skipping transfer tax exemption can be allocated to a Credit Shelter Trust's assets. In contrast, a portability election does not preserve any of a decedent's generation skipping transfer tax exemption. Generation skipping transfer tax is a tax that is imposed when your assets pass to persons two or more generations younger than you (i.e. grandchildren). However, every person has a generation skipping transfer tax exclusion amount, just like they have an estate tax exclusion amount. For large estates in particular, the ability to allocate the decedent's generation skipping transfer tax exemption to a Credit Shelter Trust can make a Credit Shelter Trust far preferable to a portability election.

Conclusion

The decision of whether to make a portability election, fund a Credit Shelter Trust, or both, is complicated and should be discussed with an estate planning attorney. It is never too early to start planning. If you have any questions regarding the issues discussed in this article, please do not hesitate to contact us.

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