SEVEN REASONS FOR ALL HIGH NET WORTH MARRIED COUPLES TO CONTINUE TO USE A CREDIT SHELTER TRUST EVEN AFTER "PORTABILITY"

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To Our Clients and Friends:

Our Client Update of February 15 reported on the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (the "Act"), which sets the amount exempt from all federal transfer taxes at $5 million per individual and $10 million for married couples, and reduces the rate of transfer taxes on amounts in excess of such exemption to 35%.[1] In addition, the Act allows for "portability" of the gift and estate tax exemptions between spouses. As more fully described below, this allows a surviving spouse to apply a deceased spouse's unused $5 million estate or gift tax exemption (the "Unused Exemption Amount") to shelter taxable transfers made by the surviving spouse during life or at death. If Congress takes no action, portability will end in 2012.

This update focuses on the most common question about portability: why should a married couple still use credit shelter trusts or bequests?

WHEN IS PORTABILITY AVAILABLE?

There are important pre-conditions and exceptions to the use of portability:

- **Election Required.** The executor of the deceased spouse must make an election on the federal estate tax return to permit the surviving spouse to use the deceased spouse's Unused Exemption Amount. This would necessitate a federal estate tax filing where it would not otherwise be required (*i.e.*, where the deceased spouse's gross estate is less than $5 million and therefore not subject to federal estate tax).

- **Effects of Remarriage.** There are certain restrictions in the context of remarriage because a surviving spouse may only use the Unused Exemption Amount of the last deceased spouse, as explained below.

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1 *Client Update: http://www.debevoise.com/newseventspubs/publications/detail.aspx?id=55089b1d-80e9-4563-8756-8c67ba52b1b2*

- **Inapplicable to GST Exemption.** Portability applies only to the estate and gift tax exemption amounts. The $5 million exemption amount for generation skipping transfer ("GST") tax is not transferable.

- **Non-Resident Aliens.** Portability is not available to non-resident aliens (who are generally allowed only a credit of $13,000).

ESTATE PLANNING BEFORE PORTABILITY

Prior to the new law, gift and estate tax exemptions were strictly "use it or lose it": any exemption not used by the deceased spouse was gone forever and unavailable to the surviving spouse. To deal with this issue, estate planners often recommended that each spouse leave his or her exemption amount to children or to a "Credit Shelter Trust" of which descendants and usually (but not necessarily) the surviving spouse were discretionary beneficiaries, with only the amount in excess of the exemption amount passing to the surviving spouse outright or in a trust qualifying for the martial deduction. To ensure funding of the Credit Shelter Trust in the estate of the first spouse to die, the assets owned by the couple also had to be arranged so that each owned enough to fund the Credit Shelter Trust, rather than holding all assets jointly, as is common. (This requirement became more onerous for some couples as the exempt amount is a moving target; over the last decade the exemption has been, in different years, $675,000, $1 million, $2 million, $3.5 million and now $5 million.)

The reason for these twin requirements—a credit shelter formula legacy and exempt asset ownership—is that if the deceased spouse had simply bequeathed everything to the surviving spouse, there would have been no estate tax due at that time because of the marital deduction, but all of the assets would then be taxed in the surviving spouse's estate, with only the surviving spouse's exemption available to shelter the second estate from tax. Likewise, even if there were a suitable formula bequest, if the first spouse owned nothing but joint property, all of those assets would pass outside the will to the surviving spouse by operation of law, so there would be nothing available to fund the formula legacy (absent a disclaimer by the surviving spouse, which might or might not work depending on the circumstances). In either case, the deceased spouse's exemption amount would have been wasted.

EFFECTS OF PORTABILITY

If the deceased spouse dies in 2011 or 2012 leaving everything to his or her spouse, as long as the executor makes the appropriate election on the deceased spouse's estate tax return, the surviving spouse can use the deceased spouse's Unused Exemption Amount (if the surviving spouse also dies before the end of 2012). We therefore face the question of whether the use of a credit shelter legacy is still important in light of this new feature of the estate tax regime. We believe

Credit Shelter Trusts (or corresponding non-trust legacies to descendants) are still important for the following reasons:

- **Expiration of Portability.** As mentioned above, if Congress takes no action, portability will expire at the end of 2012. Credit Shelter Trusts or legacies provide protection from the possible loss of the deceased spouse's Unused Exemption Amount if portability expires, or if portability remains intact but the exemption amount is smaller after 2012, and either spouse lives past 2012.

- **Appreciation and Inflation.** Any appreciation in the assets held in a Credit Shelter Trust (or by recipients of credit shelter legacies) would be sheltered from estate tax at the death of the surviving spouse, whereas portability will shield assets from future estate tax only to the extent of the deceased spouse's Unused Exemption Amount. In addition, although under the Act the exemption amount is indexed for inflation beginning in 2012, the Unused Exemption Amount of a deceased spouse is not indexed for inflation. Thus, the Unused Exemption Amount available to the surviving spouse will lose value over time due to inflation if the assets are not held in a Credit Shelter Trust (or left in a similar legacy) established under the first spouse's will.

  For example, assume the deceased spouse leaves to a Credit Shelter Trust $5 million of stock in Company A. At the surviving spouse's death, the stock is now worth $10 million and he or she has other assets in the amount of $5 million. There is no estate tax on the $10 million in the Trust, and the $5 million in the second estate is sheltered with the surviving spouse's own exemption amount. If the deceased spouse had left the stock in Company A to the surviving spouse, the surviving spouse would only be able to shelter a total of $10 million of assets at his or her death and there would be an estate tax on $5 million of assets. The Credit Shelter Trust thus keeps any growth on the $5 million out of the surviving spouse's estate.[2]

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[2] *On the other hand, if the entire estate of the first spouse passes to the surviving spouse (for example, if all assets are held jointly or if the will bequeaths the entire estate to the spouse without a credit shelter legacy), when the assets are included in the estate of the second spouse, their income tax basis (for computing capital gains) is adjusted to market value at the second death (usually resulting in a stepped-up basis in a growth environment). By contrast, when assets are put in a Credit Shelter Trust, there is no step-up in basis at the surviving spouse's death because there is no estate tax inclusion. While most couples with more than $10 million in assets would rather have appreciated assets escape estate tax than receive the income tax step-up to fair market value at the surviving spouse's death, there could be instances where a step-up in basis would be more beneficial. Particular situations should be analyzed on this point.*

- **Remarriage.** Credit Shelter Trusts are important for both the surviving spouse and deceased spouse due to the restrictions on portability in the context of remarriage. If a surviving spouse remarries and the new spouse dies, the surviving spouse can only use the Unused Exemption Amount of the new spouse, not that of the original deceased spouse. In addition, if the deceased spouse relied on portability, the surviving spouse could use the deceased spouse's Unused Exemption Amount to make tax-free transfers to whomever the surviving spouse chooses, which may not be in line with the deceased spouse's intent.

  Example 1: Deceased spouse dies with Unused Exemption Amount of $5 million, and surviving spouse remarries new spouse. New spouse makes taxable transfers during life to his or her own children and dies with no remaining Unused Exemption Amount. As a result, surviving spouse can only use the Unused Exemption Amount from new spouse, which is zero. If deceased spouse had left his or her Unused Exemption Amount to a Credit Shelter Trust (or to his or her descendants), his or her Unused Exemption Amount would not have been wasted.

  Example 2: Deceased spouse dies with Unused Exemption Amount of $5 million, and surviving spouse marries new spouse. Surviving spouse uses his or her own $5 million exemption amount and the deceased spouse's $5 million Unused Exemption Amount to transfer $10 million to new spouse's family. If deceased spouse had left his or her Unused Exemption Amount to a Credit Shelter Trust (or to his or her own descendants), he or she could have ensured that the Unused Exemption Amount passed to his or her own family.

  Based on the language of the new law, if a surviving spouse remarries but dies before the new spouse, the surviving spouse should be able to use the original deceased spouse's exemption since he or she was the surviving spouse's "last…deceased" spouse. While there is no guidance yet on this question, the surviving spouse should also be able to use the original deceased spouse's exemption if he or she later divorces the new spouse.

- **No Portability for State Tax Purposes.** Under current New York law, as an example, there is a $1 million exemption from estate tax that is not portable. Therefore, if the deceased spouse does not utilize his or her $1 million exemption (for example, through a bequest to a Credit Shelter Trust), this New York exemption would be lost.

- **Non-Tax Reasons for Trusts.** If the Unused Exemption Amount is held in a Credit Shelter Trust, the assets are available for the surviving spouse in the case of need, but the assets would be protected from the creditors of the surviving spouse, and, as noted above, the

surviving spouse would not be able to divert those assets away from the family of the deceased spouse.

- **State Income Tax.** A Credit Shelter Trust may be able to avoid state income tax on the income produced by the trust's assets, where the same assets held outright by the surviving spouse may be subject to state income tax.
- **GST Exemption.** As mentioned above, the deceased spouse's GST exemption amount is not portable to the surviving spouse. If the deceased spouse creates a Credit Shelter Trust for multiple generations and allocates his or her GST exemption amount to such a trust, the GST exemption amount of the deceased spouse would be preserved.[3]

WHAT ABOUT SAME-SEX SPOUSES?

On February 23, 2011 the Department of Justice announced that it would no longer defend the constitutionality of Section 3 of the federal Defense of Marriage Act ("DOMA"), which excludes same-sex couples from the definition of marriage for purposes of federal programs and tax treatment. Due to the requirements of DOMA, the IRS currently does not recognize a same-sex marriage for federal income, gift or estate tax purposes, even if the marriage is valid under the law of the state where the couple resides.

The Department of Justice specifically stated that it will not defend the constitutionality of Section 3 of DOMA in *Windsor v. United States*, a pending appellate case in which a surviving spouse is challenging the IRS's denial of the federal estate tax marital deduction in the estate of her deceased same-sex spouse. It is possible that Congress will now participate in this lawsuit to defend DOMA, but the Administration's decision may make a victory for the taxpayer in the case more likely.

The announcement does not address Section 2 of DOMA, which says that no state needs to recognize the validity of a same-sex marriage that is valid in the state where it took place despite the general requirement under the U.S. Constitution that the states extend "full faith and credit" to the decisions of each other. New York, for example, does not allow same-sex couples to marry within the state but will recognize as valid such a marriage if it took place in a jurisdiction where it was valid (as happened in *Windsor*). Under Section 2 of DOMA, New York does not have to go that far under the full faith and credit clause, but several New York courts have held

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[3] *Note that, during the spouses' lives, the gift and GST tax exemptions can potentially be used for lifetime transfers to trusts for grandchildren and further generations in ways that may be more effective than using the GST exemption amount for a Credit Shelter Trust under the will of the first spouse to die.*

that New York's own choice of law rules will recognize such marriages for state law purposes. Application of New York's estate tax may be affected by the outcome in *Windsor*, though, because notwithstanding the general New York choice of law rule noted above as applied to inheritance rights, New York generally follows federal tax law for state income, gift and estate tax purposes.

If the courts declare Section 3 of DOMA invalid, or if it is repealed, standard estate planning considerations and opportunities would be available to same-sex married couples, including Credit Shelter Trusts and marital deduction legacies and trusts. But if the law stands, estate plans prepared on the assumption that the marital deduction would be available may yield bad tax results. One possible approach for same-sex spouses while the outcome of this issue is uncertain is to provide for a conditional bequest that takes effect only if the federal estate tax marital deduction becomes available. For example, the residue of the estate could be left to a trust for the surviving spouse that qualifies for the marital deduction (*i.e.*, a "qualified terminable interest property" or a "QTIP" trust) only in the event the marital deduction is allowed.

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Please feel free to contact us or any other member of our Trusts and Estates Group with any questions you may have on these issues or about any other trust or estate planning or administration matter.

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