

FEDERAL ESTATE TAX EXCLUSION PORTABILITY UNDER THE 2010 TAX ACT

Adding Complexity to Otherwise Simple Estates

Last year Congress passed the Tax Relief, Unemployment Insurance Authorization and Job Creation Act of 2010. One aspect of the Act was to set the exclusion amount for Federal Estate tax purposes at \$5,000,000 per individual. This simply means that if an individual dies with an estate that is less than \$5,000,000 he will pay no Federal Estate taxes regardless of to whom he leaves his assets. For most Americans this means they will be paying no Federal Estate Taxes. As was the case under the previous law, there is no Federal Estate Tax on assets passing to a spouse, no matter the amount. The major change under the 2010 legislation is that in 2011 and 2012 a spouse that does not use his \$5,000,000 exclusion can pass the unused portion to a surviving spouse if certain requirements are met.

The best way to understand the change is to look at a few examples.

2009 Death

NOTE: In 2009, the exclusion amount was \$3,500,000 per person and there was no provision allowing the transfer of a spouse's exclusion to another spouse.

Combined assets of husband and wife of \$2,000,000, either owned jointly or some owned individually but combined the total assets are \$2,000,000.

Wife dies during the year 2009 leaving all of her assets to her husband.

Estate Tax Consequences:

Regardless of how the assets were owned between husband and wife (i.e. wife had title to all \$2,000,000, the wife owned 50%, etc.) all of the wife's assets would pass to husband with no Estate Tax. Under the law in 2009, if husband then died, all assets up to \$3,500,000 would pass to his heirs without Estate Tax. If husband's assets had grown to \$4,000,000, at his death, \$500,000 would be subject to Estate Tax.

Combined assets of husband and wife of \$10,000,000

Wife dies during the year leaving everything to her husband.

Estate Tax Consequences:

In this case under the law in 2009 if the wife dies and leaves everything to her husband whether she owns all \$10,000,000 in assets or ½ or any other amount, the entire amount would pass without Estate Tax. However, at the husband's death any amount over \$3,500,000 would be subject to Estate Tax. Often Estate planning would be done so that at the time of the first spouse's death a portion of the estate would pass to heirs other than the other spouse. This would be done in an attempt to take advantage of the spouse's \$3,500,000 exclusion. In this case, if \$3,500,000 was passed to other heirs at the first spouse's

death, at the second spouse's death (assuming no asset growth) only \$3,000,000 would be subject to Estate tax (the \$6,500,000 estate minus the \$3,500,000 exclusion).

2011 Death

Combined assets of husband and wife of \$2,000,000, either owned jointly or some owned individually but combined the total assets are \$2,000,000.

Wife dies in 2011 leaving all of her assets to her husband.

Estate Tax Consequences

Again all of the wife's assets would pass to the husband with no Estate Tax. The difference between 2011 and prior years is that the surviving husband can use any of the deceased wife's exemption that was not used at her death. In this case the total estate is \$2,000,000 at the wife's death so the logical question is why would the husband need the wife's \$5,000,000 exemption in addition to his \$5,000,000 exemption. The answer is the only way the husband would need this additional exemption is if after his wife's death and prior to his death, his estate has increased in value to an amount over \$5,000,000. If that is the case, at his death, if he has not followed the procedures to transfer his wife's exemption to himself, there will be Estate Tax on the amount of his estate that is over \$5,000,000. If the husband follows the procedures to transfer the wife's exemption he will have a \$10,000,000 exemption at his death. **In order for the husband to preserve the wife's exemption, the executor of the wife's estate must file a federal estate tax return (Form 706) at the time of the wife's death. This may turn out to be unnecessary if at husband's death his estate is under the \$5,000,000 exemption amount.** However it is impossible to determine that at the time of the wife's death what the value of the husband's estate will be. What if he wins the lottery, discovers that painting in the living room is a Vermeer, strikes oil??? This has to be considered at the time of the wife's death.

Combined assets of husband and wife of \$10,000,000

Wife dies during the year leaving everything to her husband.

Estate Tax Consequences:

At the wife's death all of her assets will pass to the husband with no federal estate tax. This is a clear case where the husband will want to transfer the \$5,000,000 of unused exemption from his wife. A 706 will need to be filed by the wife's estate to allow the transfer of the exemption to the surviving husband. At husband's death his estate would be able to claim his exemption as well as his wife's.

Important Note: The "portability" of the exemption from one spouse to another is currently only available for 2011 and 2012. The prevailing thought is that the portability will be made permanent.

State law will determine if the individual will pay State Inheritance tax. In Pennsylvania for instance, an individual leaving his estate to his spouse will pay 0% inheritance tax, assets passing to Class A heirs (to parents, grandparents or children) are taxed at 4.5%, transfers to siblings at 12% and assets to Class B heirs (all other) are taxed at 15%.