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O'KEEFE INVESTMENT MANAGEMENT

Estate Tax Exemption Is Portable (For Now)

Introduction

Recent legislation introduced a new, but perhaps temporary, estate planning concept--exemption "portability." In short, the estate of a deceased spouse can transfer to the surviving spouse any portion of the federal estate tax exemption that it does not use. The surviving spouse's estate can then add that amount to the exemption it is entitled to, increasing the total amount that can be passed on to heirs tax free. This new feature makes it easier for married couples to minimize the potential impact of estate taxes.

The federal estate tax exemption defined

The federal government imposes a tax on the value of your property when you pass it along to your descendants at your death. Any amount that is passed to a surviving spouse is generally fully deductible. The estate is also allowed to exclude a certain amount that passes on to nonspouse beneficiaries. That amount is called the "basic exclusion amount," which is \$5 million in 2011.

How the exemption works for married couples

Prior to the new tax law, if a spouse died without having planned for his or her exemption, the deceased spouse's estate would have passed tax free to the surviving spouse under the unlimited marital deduction (assuming all assets passed to the surviving spouse), and the deceased spouse's exemption was lost or "wasted." The surviving spouse's estate could then only transfer an amount equal to his or her own exemption free from federal estate tax. To solve this dilemma, married couples typically set up what is commonly referred to as a credit shelter trust (aka "bypass" or family trust) that sheltered or preserved the exemption of the first spouse to die.

The following example illustrates how portability can achieve a similar result without the use of a credit shelter trust.

Example: Result without portability

Assume Henry and Wilma are married, have all of their assets jointly titled, and have a net worth of \$10 million. Henry dies first, when the federal estate tax exemption is \$5 million and there is no portability. Henry's estate passes to Wilma free from federal estate tax under the unlimited marital deduction and does not use any of his \$5 million exemption. Assume that at the time of Wilma's death, the exemption is still \$5 million, the federal estate tax rate is 35%, and Wilma's estate is still worth \$10 million. With Henry's exemption completely wasted, Wilma can pass on only \$5 million free from federal estate tax. Assuming no other variables, Wilma's estate will owe about \$1,750,000 in federal estate tax: $\$10 \text{ million estate} - \$5 \text{ million exemption} = \$5 \text{ million taxable estate} \times 35\% \text{ estate tax rate} = \$1,750,000$.

Example: Result with portability

Assume Henry and Wilma are married, have all of their assets jointly titled, and have a net worth of \$10 million. Henry dies first, when the federal estate tax exemption is \$5 million and there is portability. As above, Henry's estate passes to Wilma free from federal estate tax under the unlimited marital deduction and does not use any of his \$5 million exemption. Even though Henry's estate owes no tax, Henry's executor files a timely return on which he elects to transfer Henry's unused exemption to Wilma. Assume that at the time of Wilma's subsequent death the exemption is still \$5 million, the federal estate tax rate is 35%, and Wilma's estate is still worth \$10 million. Since Wilma has "inherited" Henry's unused exemption, she can pass on the entire \$10 million estate free from federal estate tax. Portability of the estate tax exemption saves Henry and Wilma's heirs \$1,750,000 in estate tax.

Portability does not eliminate the benefits of credit shelter trusts

Even with portability, there are still tax and nontax considerations that may lead you to use a credit shelter trust, such as:

- The portability feature is in effect for only two years and will expire after 2012, unless Congress enacts further legislation.
- The trust can help protect assets against creditors of the surviving spouse or future beneficiaries (typically children and grandchildren).
- The trust gives the first spouse to die control over the ultimate distribution of his or her assets. For example, in a second marriage situation, one spouse may wish to ensure that any assets remaining after his or her spouse's death pass to his or her children from a previous marriage.
- Appreciation of assets placed in the trust will escape estate taxation in the survivor's estate.
- The portability feature applies only to estate tax; it does not apply to the generation-skipping transfer (GST) tax. Without a trust, any unused GST tax exemption of the first spouse to die will be lost.

Some technical information

To use the exemption portability, the first spouse to die must elect to use portability on his or her estate tax return. An estate tax return must be filed by the first spouse to die to use portability even if the return is not otherwise required to be filed.

Many states have state estate tax exemptions that are less than the federal estate tax exemption. So, while your surviving spouse might not be subject to federal estate tax upon your passing, your surviving spouse may have to pay state estate tax if you rely solely on the federal exemption portability.

Exemption portability is available only from the last deceased spouse. It will be lost if the surviving spouse remarries and is widowed again. In other words, if the surviving spouse survives spouse 1, the surviving spouse can use spouse 1's unused exemption even if the surviving spouse marries spouse 2. However, if spouse 2 also predeceases the surviving spouse, the exemption of spouse 1 can no longer be used. However, the surviving spouse can then use the unused exemption of spouse 2.

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