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THE BOVE & LANGA REPORT

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PORTABILITY: A MOVEABLE FEAST

Welcome to the first Report of the New Year, which is dedicated to the "new" federal estate tax, and how it has moved our thinking in regards to estate planning.

It is undeniable that there has been a great upheaval in the federal gift and estate tax over the past ten years. A federal tax on the gratuitous transfer of property during life and at death at one time captured many Americans when the federal basic exclusion amount (the "tax free amount") languished at $600,000. Today, fewer than 2 out of every 1,000 people who die will pay a federal estate tax because the tax free amount is $5 million per person (indexed for inflation to $5.34 million in 2014).

But this explosion of the tax free amount is not the only seismic change in the federal gift and estate tax. Last year "portability" became a permanent part of the federal transfer tax law. Portability is a flexibility provision that applies to married couples. The general idea behind portability is that whatever tax free amount is unused when the first spouse dies may be used by the surviving spouse at the second death. Plain and simple? Hardly. Ernest Hemmingway once said: "We are all apprentices in a craft where no one ever becomes a master." What is true for a writer, is true for the professional engaged in the ever changing craft of estate planning. For whom do the portability bells toll? It just may be you (or not).

THE BACK STORY

- Portability can save hundreds of thousands of dollars in estate tax, income tax, or both.
- Portability can cost hundreds of thousands of dollars in estate tax, income tax, or both.
- The gap between total income taxes and total estate taxes under current law can be small or large, depending on a number of factors.
- A stepped-up income tax basis in assets upon a decedent's death can add significant value for surviving family members.
- Due to differing state and local tax rates, portability may not be recommended for clients who live in certain states (or clients with beneficiaries who live in certain states).
- To date, only one state (Delaware) has enacted portability for state-level estate tax.
- To use portability, a timely estate tax return must be filed when the first spouse dies, even if the size of the estate would not otherwise require an estate tax return.
- There are many tax tradeoffs involved in portability planning.

TO HAVE OR TO HAVE NOT -- A COUPON

Let's look at portability in a little more depth. It is the option for a surviving spouse to carry over a deceased spouse's unused tax free amount, without using a special trust or other planning tool. The tax free amount is like a $5 million coupon. Everyone has a coupon, so married couples have two.

Before portability, if a person died and did not use the entire coupon, the unused portion effectively expired. It could not be used by anyone else. Use it or lose it. An outright transfer to a spouse did not use the coupon, so before portability, if a person died and left all assets outright to the surviving spouse, the coupon would be lost. The surviving spouse would have all of the couple's assets and only one coupon left. When the surviving spouse died, all of the couple's assets would be subject to tax, but only the surviving spouse's coupon would then apply. For many years, we have arranged for married clients to use both coupons by funding a "family" trust on the first death to hold the coupon (called also a "credit shelter trust or by-pass trust). Now, portability allows the surviving spouse to carry forward any unused portion of the deceased spouse's coupon without using a family trust, simply by filing a timely estate tax return. Using portability, the couple could transfer over $10 million with no federal estate tax and no special advance planning. It sounds easy and attractive, but the many disadvantages to portability in certain cases mean that it is not for everyone. For example, if the surviving spouse remarries and survives the new spouse as well, the remaining coupon from the first spouse's estate disappears. The "last deceased spouse rule" operates to limit the amount of portability.

It is also important to note that the allowable federal generation-skipping tax (GST) exclusion amount is <u>not</u> portable, so to the extent the estate plan of the first spouse to die did not use it, the GST exclusion will be lost. In families where parents and children have taxable estates, the family trust remains a valuable tool to maximize the use of GST exclusion amounts.

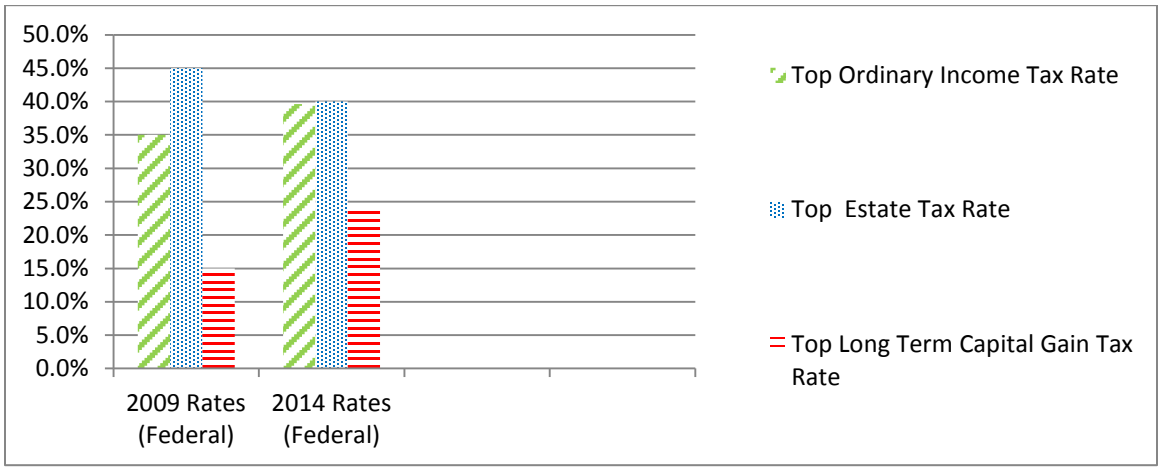
Also, portability is a federal concept and does not apply to Massachusetts' estate taxes, thus failure to plan efficiently for this can be costly not only in our state, but in most other states with estate taxes. In Massachusetts, for example, the estate tax exclusion is only $1 million. If the deceased spouse's estate plan is designed to pass everything to the surviving spouse and rely on the federal portability election to preserve both coupons, it may cost over $100,000 in Massachusetts estate taxes to take "advantage" of portability. That extra tax could be avoided entirely through the use of the typical family trust in the deceased spouse's estate.

The foregoing is but a brief introduction to portability. While good estate plans may include portability, they must include flexibility.

THE INCOME TAX ALSO RISES

The increasing estate tax free amounts that were provided under the American Taxpayer Relief Act and the recent imposition of the 3.8% Medicare surcharge tax have also altered the estate planning landscape. From a tax perspective, the traditional focus of estate planning has generally been to remove as many assets as possible from an individual's estate through various gift and sale transactions in order to avoid the estate tax. The reason? Because the estate tax was typically much more punishing than the income tax.

In other words, the gap between the estate tax rates and the income tax rates was significant. In some cases, that story has now changed.



Under current law, the highest federal income tax rate for top earners has increased to 39.6%. For high-income taxpayers, the long-term capital gain rate has increased to 20% (it can be higher for some assets, such as collectibles), and a new, additional 3.8% tax is imposed on unearned passive income (which includes federal capital gain income). At the same time, the federal estate tax free amount has dramatically increased, and the top estate tax rate has decreased from a high of 55% to 40% currently. As a result of these changes, estate planning now involves a more in-depth analysis of income tax planning. In essence, clients in consultation with their estate planners need to balance estate tax savings against income tax savings. This analysis is centered around a concept called "basis."

For example, if Frederic bought an immaculate, one-of-a-kind rowboat for $1,000, his so-called "cost basis" in the rowboat is $1,000. If the rowboat appreciates to $20,000 (because of rumors that Frederic had caught outlandish amounts of fish when using it) and Frederic sells it, he must recognize $19,000 of capital gains ($20,000 sale price - $1,000 cost basis). Under the Internal Revenue Code, however, if Frederic dies owning the rowboat, his estate will receive a so-called "step-up" in basis equal to the boat's date of death value ($20,000). If his Last Will leaves the rowboat to Catherine (a dear friend), and she subsequently sells it for $20,000, she does not have to recognize any gain ($20,000 sale price - $20,000 stepped-up basis = $0). In other words, there can be a significant income tax advantage to owning an asset at death (i.e., the step-up in basis). On the other hand, if Frederic decides to gift the rowboat to Catherine during life, she must take his basis in the property ($1,000 "carry-over basis"), so that if she subsequently sells it for $20,000, she must recognize the $19,000 of gain ($20,000 sale price - $1,000 carry-over basis). Under these facts, if tax is the primary driver, Frederic should *not* gift Catherine the rowboat, but should instead keep it until death and let her inherit the rowboat in order to achieve the step-up in basis. But the analysis is more complicated than that.

If Frederic owns over $5.34 million of assets and dies in 2014 as a resident of Massachusetts, then his estate will be subject to the Massachusetts and the federal estate tax. As stated above, under the new paradigm (the reduced gap between income tax and estate tax rates), clients and estate planners will need to analyze whether: (i) it is financially prudent for Frederic to die owning the rowboat, meaning it will be subject to a Massachusetts and federal estate tax, but will receive a step-up in basis; or (ii) transfer the rowboat to Catherine during life, lose the step-up in basis, but avoid the Massachusetts estate tax on that property and the federal estate tax on the appreciation of that property after the gift. As a third alternative,

perhaps Frederic could sell some high-basis assets and make cash gifts to Catherine (or simply gift the high-basis assets to Catherine), instead of gifting the low-basis rowboat.

If Frederic is a resident of sunny Key West, where there is no estate or income tax, and owns significantly less than $5.34 million, then for the best tax result, he should keep the rowboat and all other low-basis assets until death. (Florida has no estate or income tax.) Not only will his estate not be subject to an estate tax, but the assets will receive a step-up in basis – the best of both tax worlds. The point is, under the new income and estate tax landscape, estate planners and clients will need to focus more and more on income tax implications of asset ownership, especially for residents of Massachusetts who are subject to state-level income and estate taxes.

THE OLD MAN AND THE SEA OF CHANGE

What a story! So many twists and turns! Portability can be a valuable planning tool (i) where one spouse dies without having ever created an estate plan at all, (ii) for families of moderate wealth who loathe the complexity of administering trusts despite the benefits they offer, or (iii) to permit a surviving spouse to receive a retirement benefit outright (which was always the preferred choice from an income tax perspective, but was not always optimal from an estate tax perspective). It may come as no surprise though that, in response to the question, "Should we plan to use portability?" most estate planning attorneys will answer, "It depends". (The plot thickens …)

Frustrating as such an answer may be, it is nonetheless accurate. Portability should not be regarded as a magic wand which eliminates the need for an estate plan, but neither should its potential utility be ignored. We have found that for most clients, the non-tax benefits of trusts are reason enough to maintain and periodically update an estate plan that utilizes trusts, rather than blindly rely on portability. Further, if generation skipping transfer tax planning is important to a client, trusts definitely are the preferred planning vehicle. What we believe is most important now is to structure an estate plan for spouses which contains the flexibility to postpone until the first death the choice between use of portability or of a family trust, or a combination of both. A farewell to trusts? No. But portability has brought a new chapter to the evolving tale of estate planning.