

Estate Tax Portability – Nothing is Easy

by Matthew K. Donovan

In 1997 a person could pass \$600,000 (\$1,200,000 per couple) estate tax free. For many, the threat of estate tax was real. Because of this, most estate plans for married couples contain a “bypass trust.” The bypass trust holds the property of the first spouse to die, and its property is not subject to estate tax at the death of the surviving spouse. Also, if the deceased spouse did not use all of his or her estate tax exemption, no portion could be later used by the surviving spouse. However, in 2014, a decedent can pass \$5,340,000 estate tax free (indexed for inflation). In addition, if the deceased spouse does not use all of his or her exemption, the unused portion can be transferred to the surviving spouse for later use. This is often referred to as “portability.”

Couples with less than \$10,680,000 no longer need the bypass trust to avoid estate tax. In addition to simplicity, there is another important advantage to eliminating the bypass trust. Under the income tax rules, heirs are deemed to pay fair market value for most property received from a decedent’s estate. For example, if a decedent bought Apple stock at \$100 per share and the stock is trading at \$500 per share at death, the heirs are deemed to have paid \$500 per share for the stock. When the heirs sell the stock, they pay less capital gains tax. This is referred to as a “basis step up.”

After the death of the first spouse, property contributed to the bypass trust receives a basis step up. However, property in the bypass trust is not part of the surviving spouse’s estate and there is no second basis step up at the surviving spouse’s death. From an income tax standpoint, the remainder beneficiaries (e.g. children) are better off if there is a second basis step up at the death of the surviving spouse. But is eliminating the bypass trust the right thing to do? In many situations, the answer is yes. However, there are a number of issues to consider:

- If the estate contains rapidly appreciating property, the estate tax benefit of the bypass trust may outweigh its income tax cost.
- The exemption amount of the deceased spouse does not grow with inflation.
- If there is no bypass trust, 100% of the estate may be exposed to the surviving spouse’s creditors.
- If the surviving spouse remarries, it is possible to lose the deceased spouse’s exemption.
- The surviving spouse may disinherit the children of the deceased spouse.
- If gifts to grandchildren are desirable, the bypass trust may be more efficient.

In the right circumstances, another option exists. The deceased spouse’s property can be transferred to a “marital” trust (also known as a “QTIP” trust) rather than a bypass trust. The marital trust protects property from the surviving spouse’s creditors, and the deceased spouse can specify its beneficiaries after the death of the surviving spouse. However, the marital trust is different than the bypass trust in that (1) the surviving spouse is the only permitted beneficiary during his or her life, (2) the surviving spouse must receive all marital trust income annually, (3) property transferred to the marital trust can qualify for the estate tax marital deduction, which means the deceased spouse’s exemption need not be used and can be transferred to the surviving spouse, and (4) property transferred to the marital trust can be included in the surviving spouse’s estate, which means marital trust property is eligible for a second basis step up for income tax purposes.

For additional information, see <http://www.forbes.com/sites/lewissaret/>.



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