

Guidance on Post-ATRA Estate Planning—Portability and A-B Trusts

PASSAGE OF THE AMERICAN TAXPAYER RELIEF ACT of 2012 (ATRA) established rules for the estate tax that include a relatively new transfer tax rule known as portability. While portability contributes to the complexity of the estate planning process, the rule also provides for new estate planning opportunities that were previously unavailable. It is particularly relevant in estate planning for married couples with estates of less than \$10.9 million, since this year the estate tax exemption has been raised to \$5.45 million for individuals (thus \$10.9 million between the spouses) with an estate tax rate of 40 percent.

Portability allows the surviving spouse (SS) to use the unused estate tax exemption, if any, of the deceased spouse (DS) if a portability election is made on a timely filed estate tax return and the DS has passed away after December 31, 2010. In other words, if the DS has not used his or her permitted estate tax exclusion in its entirety, the unused portion, referred to as deceased spousal unused exclusion (DSUE) amount can be transferred to the SS for his or her use in addition to the SS's own exclusion amount at death. If the community estate is \$8 million and the DS deceases in 2016 bequeathing his or her \$4 million to the adult children, \$1.45 million of exclusion may be used by the SS spouse at his or her death in addition to his or her own exclusion amount. Although simple in concept, portability has many nuances. For instance, if the SS remarries, the applicable DSUE amount is the one belonging to the last DS, meaning the SS may use his or her former-late-spouse's DSUE amount if he or she predeceases the current spouse but may not if he or she survives the new spouse. Portability cannot be used to transfer the DS's unused generation-skipping transfer (GST) tax exemption.

Portability vs. A-B Trust Plans

Before the introduction of portability, if the DS did not use his or her entire estate tax exclusion, the DSUE amount was wasted. Before ATRA, the traditional A-B trust plan was regarded as the best estate planning tool for a married couple that desired that the SS receive benefits of the DS's estate without subjecting those assets to estate tax. Under an A-B plan, the community trust estate is divided into two shares upon the DS's death. The share representing the SS's one-half interest in the community estate and any of his or her separate property is allocated to the survivor's trust or A, which is a revocable trust for the SS's benefit. The SS serves as trustee and retains the power to amend and revoke A, the unlimited right to withdraw income and principal, and the power to dispose of assets in favor of any third parties either during lifetime or at death. The community property passing to A will receive a step-up in basis on the DS's death, and upon the SS's death, all assets of A will be subject to estate tax and receive another step-up in basis.

The share representing the DS's one-half interest in the community estate and any of his or her separate property is allocated to the bypass trust or B, which is an irrevocable trust. The SS will not have the power to revoke B nor amend any of B's provisions, including those provisions regarding B's remainder beneficiaries. The DS may

provide the SS with a limited power of appointment over B, allowing the SS to dispose of B's assets to permissible third parties, either during the SS's lifetime or upon death. Generally, B will provide that the SS may act as sole trustee and that the SS shall receive all of the net income and a right to invade principal, limited to an ascertainable standard for the SS's reasonable health, education, maintenance, and support in his or her accustomed manner of living.

There are advantages to the A-B plan in lieu of making a portability election. B places restrictions on distributions to the SS to ensure that the DS's assets are ultimately distributed to the DS's remainder beneficiaries. This may be a factor when the DS has children from a prior marriage. B's assets will receive a step-up in basis only upon the DS's death and not on that of the SS. This may be a factor when the DS's estate is anticipated to appreciate in excess of his or her DSUE amount given the life expectancy of the SS. If basis considerations are significant, A-B trusts may be drafted to confer upon an independent trustee the power to grant the SS a general testamentary power of appointment over a portion or all of B so that those assets may receive a step-up in basis by virtue of their inclusion in the SS's estate. Another advantage of B is that all appreciation will pass to the remainder beneficiaries free of estate taxes. B offers some level of asset protection from the SS's creditors and has the ability to preserve the DS's GST tax exclusion for tax planning for more remote descendants.

Married couples, post-ATRA, may plan to utilize the unlimited marital deduction, make a portability election, and allocate the entire community estate to A for the benefit of the SS. This plan achieves a step-up in basis in the community assets at both deaths, avoids any estate tax upon the DS's death, and minimizes or avoids the estate tax upon the SS's death. One advantage—or disadvantage—of this plan is that the SS will have unfettered control over the community estate and any of the DS's separate property, including the power to disinherit the DS's issue in favor of a new spouse and new children. The SS will have no duty to segregate assets or account to remainder beneficiaries. This plan may be desirable when the settlors care more about the financial security and welfare of the SS than that of any surviving children. This plan is less desirable with blended families, when the SS will almost certainly be remarried, or the DS's estate is anticipated to appreciate in excess of his or her DSUE amount.

There will likely be a tension between the SS's control over the DS's estate, opportunities to receive a step-up in basis, and other tax and nontax considerations. Nonetheless, successful estate planning requires a fundamental understanding of the couple's objectives, needs, values, the nature and character of their assets, and some speculation as to what the remainder beneficiaries will do with the inherited assets. ■

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