Estate Planning

The basics of "tax-wise" estate planning for married couples.

By Eva Stark, JD, LL.M.

Married, high net worth clients may not be aware of the potential need to incorporate "tax-wise" planning into their estate planning documents. The goal of tax-wise planning is generally to:

- Eliminate estate tax at the first spouse's death; and,
- Minimize overall transfer taxes at the surviving spouse's death.

Generally, there are three strategies for tax-wise estate planning:

1. Reliance on portability,
2. Bypass trust funding, or
3. A hybrid approach utilizing a combination of the two.

The strategy that may be optimal will depend on a client's specific circumstances. These strategies are described in more detail, below, following a brief overview of the current federal estate tax planning environment.



Background

While there is a federal estate tax regime, not all property owned at death is subject to estate tax. Federal tax law currently allows for a lifetime exemption amount. Generally, this is the combined amount that an individual may gift away either during lifetime or at death to persons other than his or her spouse without triggering federal gift or estate tax.

Currently, the federal lifetime exemption amount is $10 million, adjusted for inflation ($12,920,000 per individual in 2023).[1] Bequests to a spouse (or to certain trusts that qualify for the marital deduction) qualify for an unlimited marital deduction and thus, generally do not trigger estate tax or utilize the decedent's lifetime exemption.[2] Bequests to persons other than a spouse that exceed the decedent's lifetime exemption amount are generally subject to estate tax at a rate of 40%.

Three strategies to tax-wise planning

Reliance on portability

Federal tax law makes a deceased spouse's unused exemption "portable," meaning such unused exemption may be "transferred" to his or her surviving spouse provided that a portability election is made on the predeceased spouse's estate tax return.

With this strategy, a decedent leaves all his or her assets to the surviving spouse either outright or in a trust that qualifies for the marital deduction. Estate taxes are thus eliminated at the first death. A portability election is made, availing the survivor of the decedent's unused exemption amount in addition to his or her own exemption amount.

Assets that are left to the survivor or in a trust that qualifies for the

1 Absent legislative change, this amount is scheduled to revert to $5 million in 2026, adjusted for inflation (for an estimated exemption amount of approximately $6.4 million in 2026).
2 Special rules apply to non-U.S. citizens.

marital deduction are includible in the survivor's taxable estate.

KEY ADVANTAGES OF RELIANCE ON PORTABILITY:

- Simplicity.
- Assets generally receive a second basis adjustment upon the survivor's death.

KEY DISADVANTAGES OF RELIANCE ON PORTABILITY:

- Any appreciation that occurs between the first death and the survivor's death will be included in the survivor's estate.
- Even where a portability election is successfully made, the deceased spouse's unused exemption may be lost in some circumstances where the survivor remarries.
- The generation-skipping transfer tax exemption is not portable, which may be a concern any time an asset is left to persons other than a spouse or child.

Fully funded bypass trust

The second tax-wise planning strategy is to utilize the decedent's exemption by funding a "bypass trust" (also known as credit shelter trust) at the first death.

This strategy channels an amount equal to the decedent's remaining federal exemption amount to the bypass trust. The bypass trust generally benefits the surviving spouse and/or descendants and does not qualify for the marital deduction.

If the decedent's estate exceeds his or her remaining lifetime exemption amount, the balance of the estate is channeled to the surviving spouse or to a trust that qualifies for the marital deduction, thus deferring estate tax on amounts above the exemption amount at the first death.

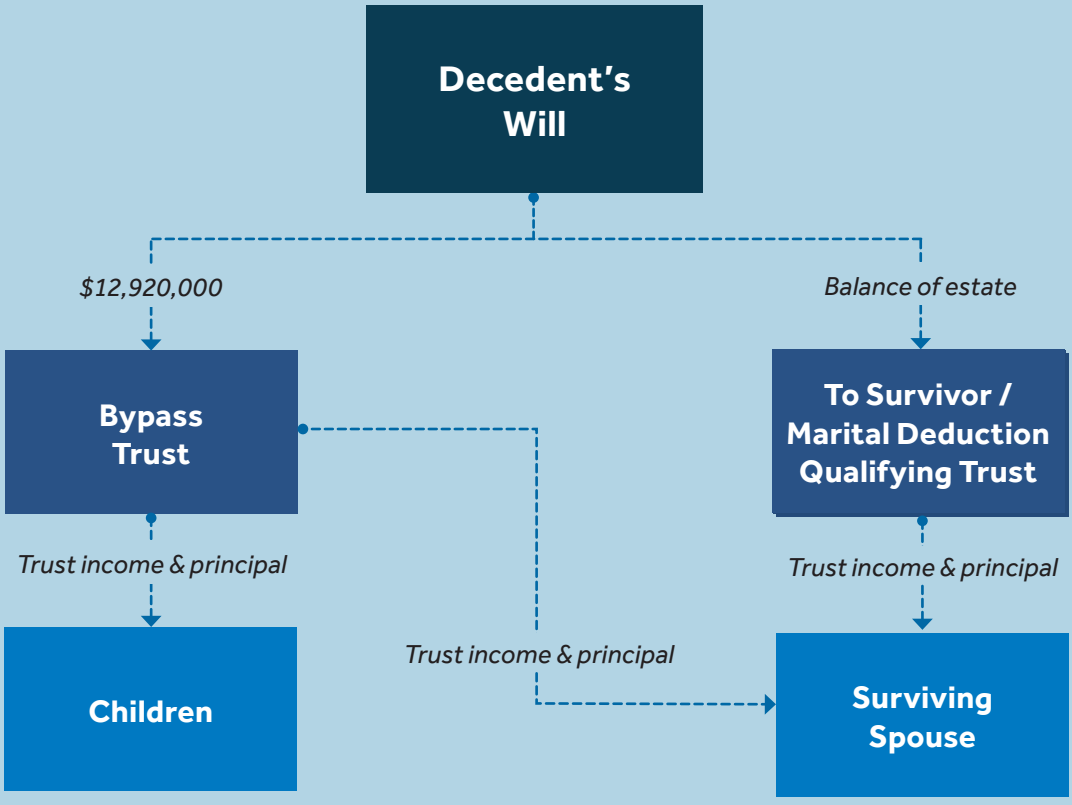
KEY ADVANTAGES OF A BYPASS TRUST

- Assets in the bypass trust, including any appreciation that occurred between the first and second deaths, are generally not includible in the survivor's taxable estate.
- The bypass trust can also utilize the decedent's remaining generation-skipping transfer tax exemption, if any.

KEY DISADVANTAGES OF A BYPASS TRUST

- Assets in a bypass trust generally do not receive a second basis adjustment at the survivor's death. This could increase the capital gains exposure for beneficiaries when bypass trust assets are subsequently sold.
- Added complexity.

Illustration of fully funded bypass trust strategy.



A NOTE ON STATE-LEVEL ESTATE TAX

Many states impose a state-level estate tax in addition to the federal estate tax regime.

Exemption amounts, tax rates, and whether or not a decedent's state-level exemption amount is portable, will all depend on the laws of the state.

Where state-level estate tax is a concern, the estate plan should address state-level estate planning strategies as well, the techniques for which are beyond the scope of this discussion.

Hybrid approach

The third, and increasingly popular, strategy is to incorporate flexibility into estate planning documents to allow for reliance on portability, funding of a bypass trust, or a combination of the two. Under this approach, bypass trust funding decisions can be made after the first death, when the tax picture is likely to be somewhat clearer.

For example, a hybrid approach might utilize a "Clayton QTIP," where funding of a marital deduction eligible trust and/or bypass trust depends on elections made by the executor. A hybrid approach could utilize "disclaimer" provisions, which permit the survivor to channel assets between the bypass trust and a marital deduction eligible trust.

These, as well as several other possible techniques, all have advantages and limitations that clients should discuss with their estate planning attorney.

The upshot is that the added flexibility generally allows for the focus of the estate plan to be shifted to minimizing estate taxes, minimizing capital gains exposure of beneficiaries, or to other objectives as circumstances or tax laws change.

Looking forward

Clients who are establishing or revising their estate plans may wish to discuss tax-wise planning strategies with their attorneys.

They also may wish to explore strategies for incorporating flexibility into their estate plans with their professional advisors to allow the focus of the plan to shift with changing circumstances and tax conditions.



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