Portability of the estate tax exemption

The American Tax Relief Act of 2012 (ATRA) signed into law on January 3, 2013, by President Obama extended the opportunities for “portability” of a decedent’s unused estate tax exemption. The surviving spouse can use the unused portion of the predeceased spouse’s estate and gift tax exemption, if the predeceased spouse’s executor affirmatively elects portability on a timely filed estate tax return.

Estate and gift tax exemption

ATRA includes a unified estate and gift tax exemption which means an individual can pass $11.18 million (2018) worth of assets to someone other than their spouse without a federal estate or gift tax, and a married couple can shelter up to $22.36 million of their estate.

The estate tax exemption available at the decedent’s death is reduced by any amount of gift tax exemption that is used during the decedent’s lifetime. For example, if the decedent gifted $2 million in 2017 and passed away in 2018, their estate tax exemption would be reduced by the $2 million lifetime gift, leaving $9.18 million of the estate tax exemption available at death.

Transfers between spouses at death are unlimited if the recipient spouse is a US citizen (or becomes a US citizen within 9 months of the decedent’s date of death). Prior to 2011, if the decedent’s estate passed outright to the surviving spouse, there was no immediate federal estate tax due, but the decedent spouse’s federal estate tax exemption was lost. The first spouse to die would have had to pass assets to someone other than the surviving spouse in order to use their estate tax exemption amount.

As a result, individuals often created a family trust (sometimes known as a credit shelter trust, an exemption equivalent trust, a bypass trust or a residuary trust) in their will or revocable trust that is funded at death with the decedent’s remaining unused exemption amount to shelter the maximum amount of their assets from estate tax. This ensured that the first spouse to die did not lose the benefit of the credit in their estate.

For example, without portability, if a couple with a combined net worth of $25 million leave their assets to the surviving spouse at their death, the surviving spouse will have a net worth of $25 million assuming no further appreciation. At death, the survivor will only have their single estate tax exemption of $11.18 million to protect the assets from estate taxes. The exemption amount of the first deceased spouse is lost thereby causing the heirs to pay taxes that could have been eliminated with proper planning.

Under the portability provisions, the surviving spouse is allowed to use the unused portion of the predeceased spouse’s estate tax exemption. Consequently, a married couple is no longer penalized for doing little or no planning. Allowing the unused estate tax exemption amount to be portable to the surviving spouse would dramatically change the outcome in the prior example. Now, if one spouse were to pass away with $11.18 million of their estate tax exemption available, the surviving spouse could essentially “tack on” the unused exemption and shelter up to $22.36 million from estate tax liability.

Factors to consider if portability is right for you

Portability is beneficial for those individuals who have not proactively created ways to shelter their estate tax exemption at the death of the first spouse. However, individuals should contemplate the following factors when determining whether to incorporate a family trust to shelter the unused estate tax exemption in a will or revocable living trust.

Asset protection

Assets of the decedent placed in a family trust, which is an irrevocable trust, are protected from the claims of beneficiary’s creditors because a beneficiary’s creditor can not force a distribution from the family trust. This provides a layer of protection for the beneficiary, who is often the decedent’s surviving spouse or children.

Assets in a family trust are also protected in the case of a divorce. They are not considered available to the beneficiary in a divorce proceeding. Assets passing outright to the surviving spouse or remainder beneficiaries, such as the decedent’s children, are not provided this same protection.

Appreciation

Under the portability election, the amount of the decedent's unused estate tax exemption does not appreciate. Consequently, all of the appreciation in these assets may be exposed to estate taxation at the time of the surviving spouse's death. (Note: these assets would receive a step-up in basis at the surviving spouse's death.)

If a family trust was created to shelter the deceased spouse's exemption, the assets transferred, as well as the growth of the assets in the trust, would pass free of estate tax upon distribution to the remaining beneficiaries. If the assets have appreciated from the stepped-up basis, once these assets are liquidated, they would still be subject to capital gains tax. (Note: these assets will not receive an additional step-up in basis at the surviving spouse's death.)

Consequently, the disparity between the capital gains tax rate and the estate tax rate is important to consider.

For example, using the facts above, if $11.18 million of the deceased spouse's assets were placed in a family trust and after several years the assets appreciated to $15 million, the entire trust could be distributed to the remainder beneficiaries without further estate taxation. If this same $11.18 million passed to the surviving spouse and appreciated to $15 million, the portable exemption was locked in at $11.18 million and the subsequent growth, or the remaining $3.82 million, may be subject to estate tax, depending on the size of the combined estate at the surviving spouse's death.

Remarriage

The crux of estate planning is to ensure that assets pass to the intended beneficiaries of the decedent. Assets in a family trust will pass according to the wishes of the decedent spouse. This is of particular importance if the surviving spouse were to remarry. If the assets of the decedent spouse were to pass outright to the surviving spouse, he or she may reallocate these assets to individuals not intended by the decedent, such as the surviving spouse's new spouse.

Portability applies only to last deceased spouse

Portability is limited to the unused exemption amount of the last deceased spouse as of the date of death of the surviving spouse. A spouse who has been widowed more than once can only use the exemption of the most recent deceased spouse, which eliminates the possibility of serial marriages to accumulate the exemption amount.

Portability of the predeceased spouse's unused estate tax exemption applies to the surviving spouse only if the predeceased spouse died after December 31, 2010.

Statute of limitations

Once the election is made, there is no statute of limitations on an Internal Revenue Service (IRS) examination of the predeceased spouse's return for the purposes of determining the amount of the unused exemption available to the surviving spouse. This may be difficult for hard to value assets, such as business interests, several years after the death of the first spouse. In other words, if you elect portability, you give the IRS as much time as they want to audit the estate tax return of the decedent spouse.

Generation skipping transfer tax

The Generation Skipping Transfer Tax (GST) is a separate federal tax on transfers of property an individual makes either during their lifetime, or at their passing, to an individual who is more than one generation removed, or transfers into a trust for the benefit of skip persons such as grandchildren. For instance, a transfer from a grandparent to a grandchild would be a generation skipping transfer because it skipped the child of the grandparent, or the second generation.

The GST exemption can be allocated to a family trust. If the executor of the decedent elects to transfer the unused exemption of the deceased spouse to the surviving spouse using portability, the GST exemption can not be carried forward along with the federal estate tax exemption. Consequently, the GST exemption of the deceased spouse would be lost leaving only the surviving spouse's GST exemption available.

Conclusion

The availability of the surviving spouse to use the decedent spouse's unused exemption amount is a very positive aspect of the current estate tax provisions, particularly if a married couple have a significant estate but have done very limited wealth transfer planning. However, there remain significant reasons to create or continue to utilize a trust that shelters the decedent's exemption at first death. If you have any questions, please contact your financial advisor to discuss the benefits of a family trust in more detail.

