Portability of the Estate Tax Applicable Exclusion Amount

The rule applicable to federal estate taxes was been made permanent and adjusted for inflation with passage of the American Taxpayer Relief Act of 2012 (“ATRA 2012”). Originally created and effective for decedents dying and gifts made after December 31, 2010, ATRA 2012 permits the Applicable Exclusion Amount created to increase where a decedent is survived by his or her spouse. The shorthand expression for that increase is “portability”.

Portability now means that from 2013 forward, any or all of the $5,250,000 Applicable Exclusion Amount not used by the estate of a deceased spouse may now be transferred to a surviving spouse by making an election on a timely filed estate tax return. The carryover is called the Deceased Spousal Unused Exclusion Amount (“DSUEA”).

Commentary and Summary:

Assets of a decedent subject to the federal estate tax are reduced by an amount called the “Unified Credit” or “Available Exclusion Amount”. This will be referred to as the Unified Credit going forward. The Unified Credit is equal to the amount of tax that the estate would incur if the taxable estate were exactly equal to an amount called the Applicable Exclusion Amount. It’s the Unified Credit amount that’s often thought of as the exemption amount or exemption equivalent. For decedents dying in 2013, the Unified Credit amount for estate and gift tax purposes is $5,250,000 per decedent. In future years, this amount will be subject to change annually based on inflation rates.

This portability augmentation of the surviving spouse’s Unified Credit amount will reduce gift and estate taxes of the surviving spouse, but it’s also complicated to use. The net result of portability is that very few estates of married individuals will be subject to the federal estate tax. However, the real complication will be deciding whether and how to use it, both in planning and in estate administration.

First, Congress created portability so that complex will and trust drafting to use the exclusion amounts of a predeceased spouse could be avoided. Second, my concern is that this will lull some clients into a false sense of security if they believe that no estate taxes mean they have no need to plan their estates. This attitude can create serious problems for surviving family members and other heirs. We still have beneficiaries requiring planning protection. A few examples of this would be special needs planning for disability benefits, life time trusts involving grandchildren, marriages with step family members, creditor protection, educational support, and divorce protection to name just a few issues.

Election Requirements:

The first two hurdles in qualifying for the election are that a timely estate tax return must be filed and an election must be made in order to carry the DSUEA from the predeceased spouse to the surviving spouse. Both of those acts are required in order to effectively endow the surviving spouse with the “Deceased Spousal Unused Exclusion Amount”. Logically, the net result of making the election is that the time for auditing the estate tax return that contains the election is extended indefinitely until the death of the surviving spouse.

From a practical standpoint, the audit extension will be limited by the statute of limitations on assessment and collection applicable to the deceased spouse’s estate that receives the DSUEA. Simply imagine the entertainment value of digging up a valuation report to be examined decades after the valuation date. I would not want to be involved in an IRS audit requiring such old information and the need for such long term records retention. The good news is that the language of the extended statute of limitations appears to limit the extension to the determination of the DSUEA. So, we expect that it will not be possible to assess estate taxes against the predeceased spouse’s estate after the “normal” time for assessing and collecting tax has expired. This should also leave unchanged the length of time for transferee liability exposure.

Practical Tips:

Once the DSUEA is elected, the effect of that election somehow must pass into the hands of the preparer of the surviving spouse’s gift tax returns and, eventually, to the preparer of the surviving spouse’s estate tax return. Return preparer checklists should add an item to screen for the carryover amount. One way of increasing the likelihood that such information will wind up on the returns where needed would be for the surviving spouse to make a taxable gift after the election has been made and file a gift tax return. That should help because all gift tax returns are required to be attached to the estate tax return. Of course, estate tax return preparers will now need to read each decedent’s gift tax returns with an eye to picking up the added DSUEA that wasn’t used up on lifetime gifts. Taxpayers and their return preparers will now likely have to track separately the gift and estate tax DSUEA versus the Generation Skipping Tax DSUEA.

What About ALL Predeceased Spouses?

None of us can predict the future financial fortunes (or misfortunes) of every surviving spouse. Even the poorest of the poor might create wealth in an unforeseen way or win a lottery. That being true, it will always be prudent to pass on any unused DSUEA to a surviving spouse because there is always a probability that it could be needed upon the death of that surviving spouse. This could mean that an estate tax return should be filed and the election made for all predeceased spouses.

But let's recognize that filing the return and making the election costs something, and no one wants to pay for something that is highly unlikely to be used. A more sensible solution might be to include Revocable Living Trust ("RLT") or Last Will & Testament ("Will") provisions stating whether the trustee or executor WILL (a) never, (b) sometimes, or (c) always file an estate tax return and make the election. As an incentive to deal with the election, the RLT or Will should include so-called exculpatory language to hold the trustee or executor harmless from acting or failing to act. Alternatively, the RLT or Will could provide that the trustee or executor shall notify the surviving spouse of the potential election and that the executor will make the election or not as the surviving spouse may direct. This would put the surviving spouse in charge of whether the trustee or executor would make the election.

If the Trust or Will has no provision regarding the election, the trustee or executor could nevertheless seek the surviving spouse's written direction. If the surviving spouse wants the election, there could be some negotiation and written agreement about who will bear the costs and responsibilities. If the surviving spouse doesn't want the election, the trustee or executor could ask the surviving spouse to sign off and hold the trustee or executor harmless in an agreement binding on the estate of the surviving spouse, including heirs and devisees. Whatever method is used to decide, the estate tax return due date of the predeceased spouse should always be extended in order to provide the maximum amount of time to make that decision, gather return filing information, file the return, and make the election.

Current and Future Planning: More of the Same or Different?

Typical estate plans for a married person include a so-called credit shelter trust and a marital bequest (either outright or in trust).

Credit shelter trusts are designed to maximize avoidance of federal estate taxes by taking advantage of the available exclusion amount ("AEA") while providing benefits to one's surviving spouse, yet ultimately passing remaining assets to descendants after the death of the surviving spouse. This is the type of trust the portability law change was designed to eliminate. It is expected that estate planners will use the credit shelter trust anyway to avoid the potential of having to meet marital deduction requirements. This type of planning would give increasing control over the ultimate disposition of the property of the predeceased spouse and also avoid estate taxes on future principal growth and accumulations of income.

Further, this planning would seem to be a good idea when a surviving spouse remarries and has an AEA of more than $5,250,000 because the election made in respect to the predeceased spouse should use a credit shelter trust. Here's an example. Alan and Betty are married but Betty dies during the year 2013. Her estate timely files an estate tax return and makes the election to pass Betty's unused AEA to Alan in the amount of $4,250,000. Alan now has an AEA of $9,500,000. In 2016, Alan marries Christine. If Alan dies before Christine does, the maximum amount of Alan's unused exclusion amount that can be added to Christine's Basic Exclusion is $5,250,000 (adjusted for inflation). But Alan's AEA is $9,500,000, not $5,250,000. In that case, $4,250,000 will be wasted if Alan dies before Christine does. On the other hand, if Alan's Will establishes a credit shelter trust for at least $4,250,000, that would prevent the limitation on Christine's AEA from wasting the $4,250,000 AEA. Of course, Alan may prefer to leave all $9,500,000 to such a trust.

Marital bequest trusts are designed to take advantage of the unlimited marital deduction in order to defer estate taxes until the death of the surviving spouse. Under the AEA rules, as in the past, the use of a marital deduction trust could be used to take advantage of the surviving spouse's Base Exclusion Amount that might otherwise go unused should the testator's surviving spouse die without sufficient assets to absorb the remaining AEA. Typical marital bequests include outright transfers and transfers in trust allowing the surviving spouse the right to all income for life and some decision on what happens to the trust balance on his or her death. Generation skipping trust provisions could be used with both Marital Trusts and Credit Shelter Trusts to ultimately leave family assets to grandchildren while providing for the surviving spouse and children in the interim.

MJT 06.13.13 formatted 03.07.17