

Planning Strategies

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Portability of a Spouse's Unused Exemption

- *\$11.58 million is the amount each US citizen or resident can transfer free of estate or gift tax. This amount is set to remain at this high level until December 31, 2025, unless Congress changes the law before then.*
- *The possibility exists that the exemption amount will be rolled back to the pre-2018 level of \$5 million, or even less.*
- *When a spouse dies, his or her unused exemption amount can be transferred to the surviving spouse, which greatly expands the amount of wealth the survivor can transfer free of tax.*
- *The "portability" of the deceased spouse's unused exemption will play an important role this year and over the next few years.*

It is well known that federal law allows a certain amount of wealth to be transferred without incurring an estate or gift tax. It is also understood that for married couples the exemption is effectively doubled. Apart from one anomalous year (2010),¹ the exemption amount is now the highest it has ever been – \$11.58 million per person. Effective in 2011, Congress enacted the "portability" rule that allowed married couples to transfer the estate tax exemption from one spouse to the other after death if the deceased spouse had not fully used his or her exemption and the estate makes an affirmative election on a timely filed estate tax return. However, the portability rule does not apply to the generation-skipping transfer (GST) tax exemption.

The portability of a deceased spouse's unused estate tax exemption is an important concept and is even more so in 2020, which is a pivotal year in so

many ways. Portability can enlarge (and even double or triple, depending on the facts) the amount the surviving spouse can pass free of tax during life and at death. However, portability is easy to overlook when no estate tax form is required to be filed. Below we review the concept of portability and how it can impact wealth transfers.

How portability affects the estate and gift tax

In the Tax Relief Act of 2010, Congress introduced for the first time the concept of portability. The rule was made permanent in 2013. Before then, if a person died with wealth below the federal estate tax exemption amount, the exemption was lost forever. The 2010 tax act changed all that and allows for greater post-mortem estate planning and flexibility. While the notion of portability is easy enough to conceptualize, the actual rules are fairly complex. There are a number of key concepts and terms to understand.

¹ Congress repealed the estate tax for 2010 but then gave taxpayers the option to opt in to the estate tax regime with steppe-up basis or opt out and

take carry-over basis on all assets held at death. This option applies only for 2010.

Unified credit: The federal estate tax is computed on all wealth passed at death less certain deductions. The tax due is offset by certain credits. We tend to think of the exemption like a deduction but it's really the "unified credit" that is the key concept. The gift tax operates in much the same way. The credit is said to be "unified" because estate and gift taxes are bundled in one unified taxing regime.

The Basic Exclusion Amount (BEA). The unified credit is keyed to the Basic Exclusion Amount ("BEA" a/k/a the "exemption"). That is, the maximum unified credit is determined by figuring out what the tax is on the BEA and applying that amount as a credit against the estate or gift tax due on the wealth transfer. The BEA, which changes over time and is indexed for inflation, applies to taxable gifts made over one's lifetime and to transfers made at death. As you make lifetime gifts, you use part of your BEA. If your lifetime gifts exceed the BEA in any one year, you will owe gift tax. The gift tax is determined on an annual basis and is cumulative. In 2020, the BEA is \$11.58 million per person. At the death, all of these numbers are reconciled on the estate tax return.

Deceased Spousal Unused Exemption Amount (DSUE): The concept of the DSUE is the key to "portability". When a spouse dies and he or she has not fully used up the BEA, that amount can be ported over to the surviving spouse. This is the essence of portability. The maximum amount that can be ported over is capped at the BEA as of the date of death. However, the actual amount ported will be reduced by any gifts or legacies made by the decedent. A representative of the decedent's estate must file a federal estate tax return (Form 706) to report the computation of the DSUE and make the portability election. The DSUE is fixed at that point and is not indexed for inflation. However, the IRS is able to reopen the estate tax return and review the computation of the DSUE at a later date.

Applicable exclusion amount: To complicate matters further (as the Internal Revenue Code tends to do), the full amount an individual can transfer free of estate or gift tax is referred to as the "applicable exclusion amount", which is the sum of the BEA and the DSUE amount. The "applicable credit amount" is equal to the tax on that grossed-up figure and is applied against the tax due. This comes into play when an individual's "last deceased spouse"

transferred DSUE to the individual who can make tax-free gifts up to this amount. It gets a little more complicated if the surviving spouse remarries.

Effective date: The portability rule applies to decedents who have died after December 31, 2010. Portability is only available to persons whose spouse died after that date.

History of the Estate Tax Exemption (1997-2020)

YEAR	EXEMPTION	TOP TAX RATE
1997	\$600,000	55%
2002	\$1,000,000	50%
2009	\$3,500,000	45%
2010 (repeal w/no step-up)	\$0	0%
2010 (alt. w/ step-up)	\$5,000,000	35%
2012	\$5,120,000	35%
2017	\$5,490,000	40%
2018	\$11,180,000	40%
2019	\$11,400,000	40%
2020	\$11,800,000	40%

The portability election

Many people believe that if an individual dies with assets under the estate tax exemption amount, there is no need to file an estate tax return (Form 706). While it is true that a return may not be required, an executor needs to seriously consider the future benefit of filing a return. Doing so allows for an election to transfer the DSUE amount to the surviving spouse. This "portability" election increases the total exclusion available to the surviving spouse. If you don't file the 706 at the first death, you cannot elect to port over this remaining amount. Normally, Form 706 is due nine months from the date of death with a six month automatic extension available. However, if the 706 is filed only to elect portability, it can be filed anytime on or before the second anniversary of decedent's death.

The impact of portability – Example #1

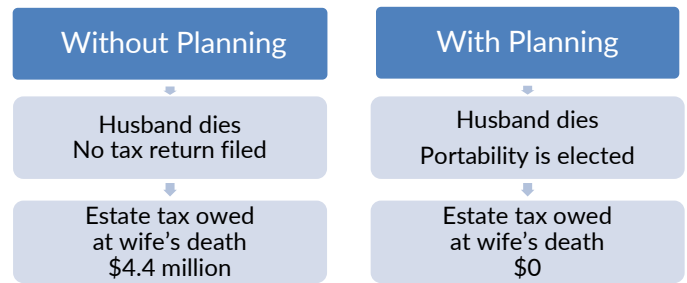
Assume a husband and wife each have \$11 million of exclusion available. The husband dies with \$3 million of assets in his estate, which he is leaving to the couple's children. Because the \$3 million is less than the \$11 million, no federal estate taxes are actually due and no return is required. However, if the husband's estate files an estate tax return and makes the election to transfer the DSUE, the wife's exclusion is increased by \$8 million. Now the wife's estate has \$19 million available to transfer to the heirs free of federal estate tax.

You may say, 'that all sounds great, but there is no way my spouse and I will ever have over \$22 million.' That may be true, but the current exclusion is scheduled to revert back to the pre-2017 amount (\$5 million adjusted for inflation) on January 1, 2026. This should amount to roughly \$6 million after the expected inflation adjustments. The exclusion has been raised and lowered by Congress many times in the past and could be scaled back again any time. Given the upcoming election and economic effects of the COVID-19 pandemic, the BEA could be lowered in 2021.

The Impact of portability – Example #2

Assume a husband and wife each have an \$11 million exclusion. The couple did no estate planning. The husband died in August 2018 with a \$5 million estate which passed to his wife. Since transfers to spouses are free from estate tax, the settling of the husband's estate did not use up any of his \$11 million exemption, and no federal estate tax return was required. Assume further that no portability election was made.

The wife has the entire \$5 million of assets from her husband plus her own assets of \$11 million. Now, assume that in 2021 Congress lowers the exemption to \$5 million (keeping the tax rate at the current 40%). The wife dies in 2021. Her estate will owe \$4.4 million in federal estate taxes ($(16 - 5) \times 40\% = 4.4$). However, if the husband's estate had filed a timely estate tax return and made the election to transfer the DSUE, the wife's exemption at death would be \$16 million (the DSUE of \$11 million plus her exemption of \$5 million), and no estate tax would be due.



Effect of remarriage

A surviving spouse may use the DSUE amount of the "last deceased spouse" to offset the tax on any taxable transfer made after the deceased spouse's death. A surviving spouse who has more than one predeceased spouse is not precluded from using the DSUE amount of each spouse in succession. However, a surviving spouse may not use the sum of DSUE amounts from multiple predeceased spouses at one time nor may the DSUE amount of a predeceased spouse be applied after the death of a subsequent spouse.

What is the effect of portability at the state level??

Portability generally applies only to the federal estate tax exemption. Twelve states and the District of Columbia impose an estate tax.² Only two (Maryland and Hawaii) allow portability of the state's exemption to a surviving spouse. Connecticut is the only state with a gift tax.

What is the possibility of a "claw back" of portability when the exemption is reduced?

The IRS has made it clear that there will be no reduction or "claw back" of any transferred DSUE should the basic exclusion amount be reduced in the future. However, there is a possibility that tax increases in 2021 could be made retroactive to January 1, 2021. This includes a retroactive reduction of the BEA for persons dying after December 31, 2020 but this should have no effect on the DSUE of persons who died before 2021.

² The states are CT, DC, HI, IL, ME, MD, MA, MN, NY, OR, RI, VT, WA, plus DC.

Conclusion

Surviving spouses should seriously consider the potential advantages of timely filing Form 706 to make the portability election even if the tax form is not required to be filed. Doing so, could save your heirs millions of dollars in taxes.

If you have questions about estate planning, we invite you to contact your Portfolio Manager or Client Advisor who would be happy to help you.



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