Portability provisions and their impact on an estate plan

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"Portability" is a provision that allows a deceased spouse's unused estate tax exclusion amount to transfer to the surviving spouse, helping to alleviate any wasted exclusion amount and creating greater flexibility for families. For many, portability eliminates the need for bypass trust planning, but in some cases, there are still compelling reasons to utilize bypass trusts.

Under the Tax Cut and Jobs Act passed in December 2017, the federal estate and gift tax exemption was doubled from $5 million to $10 million per person (adjusted annually for inflation). For 2021, the exemption from federal estate and gift tax increased to $11,700,000 per person. The 2017 tax plan does include a sunset provision causing a reversion of the current exemption back to $5 million per person (adjusted annually for inflation) at the end of 2025. As part of the American Taxpayer Relief Act of 2012, portability of the estate and gift tax exemption was permanently added to the estate and gift tax regulations. Portability is the ability for a surviving spouse to preserve and take advantage of the other spouse's unused exemption by timely filing a federal estate tax return after the first spouse's passing away and making the appropriate election. Portability remained unchanged by the 2017 tax plan and will remain in effect through the sunset of the 2017 tax plan at the end of 2025.

Historically, married couples who wanted to fully use both spouses' exclusion amounts needed careful planning to ensure the full estate tax exclusion amount of the deceased spouse could be used at the first of their deaths and the full estate tax exclusion amount could be used by the surviving spouse at the second death, regardless of the order. This form of planning typically required that a bypass trust (often called a "unified credit trust," "family trust" or "credit shelter trust") be established within each spouse's estate planning documents. With such planning, upon the first spouse's death, his or her trust could be funded with his or her estate tax exclusion amount. Doing so ensured the deceased spouse's exclusion would be used, and when the surviving spouse died, the assets were not included in the survivor's taxable estate.

Portability allows the unused estate tax exclusion amount of the first deceased spouse to roll over to the surviving spouse—helping alleviate any “wasted” exclusion amount and creating greater flexibility for married couples in their estate planning. With portability of a deceased spouse’s unused estate tax exclusion amount, spouses can ensure the full amount of their respective exclusion amounts are used even if their planning doesn’t do so through asset titling and trust planning on the first spouse’s death.

Example: Spouses George and Mary each have $5 million estates, and neither has used any of his or her exemption to shelter lifetime taxable gifts. If George leaves his entire estate to Mary at his death, subject to the unlimited estate tax marital deduction, he will not use any of his estate tax exemption. If Mary elects to claim the unused exemption on George’s federal estate tax return (Form 706), that amount is available to shelter her estate, along with her own estate tax exemption, at her subsequent death. Note, a federal estate tax return with a portability election must be filed by George’s estate even if no estate tax is due.

With bypass trust planning, a surviving spouse has less flexibility because the trust provisions are irrevocable. A bypass trust also requires the trustee to maintain separate records and file a separate fiduciary income tax return (Form 1041) annually. If the assets are simply transferred outright to the spouse, rather than to a bypass trust, these administrative requirements and expenses are not applicable. However, there are several compelling reasons to consider traditional trust planning, including:

Asset appreciation

With bypass planning, the amount exempted from federal estate taxes for the first deceased spouse is placed in an irrevocable trust. The assets in this trust, no matter their amount, are considered “outside” the surviving spouse’s estate for estate tax purposes. This means that this trust can appreciate in value to any size and will not be subject to federal estate taxes when the surviving spouse dies.

If you believe one or more of your assets has the potential of appreciating above the federal estate tax applicable exclusion amount, you may want to capture them in a trust. Doing so will allow you to “freeze” the value on the date of the first death rather than including the appreciated value in the estate of the surviving spouse, at his or her death.

Conversely, if the assets are appreciating, but the total estate is expected to be less than the total exemptions for both spouses, it may be more tax efficient to have the value included in the survivor’s estate. The beneficiary of the surviving spouse’s estate will inherit that asset with a cost basis “stepped up” to the value on the survivor’s date of death rather than locking in the basis as the value on the date of death of the first to die spouse. This could result in a capital gains tax savings.

Estate tax law volatility

What Congress has given, Congress may take away. During the past 20 years, the estate tax exclusion amount has grown substantially from $675,000 to $11.70 million for 2021 per estate. Congress could lower the federal estate tax exclusion amount at any time. As previously mentioned, pursuant to the sunset provision in the 2017 tax plan, the current $10 million exemption (annually indexed for inflation) will expire at the end of 2025, and individuals will see their exemptions cut in half as it will go back to the earlier $5 million exemption amount. If that occurs, having a fully funded credit shelter trust in place from the first spouse's death would permanently exclude the trust assets from inclusion in the survivor's estate.

Credit shelter trusts can be drafted in a manner to give the surviving spouse access to trust income and principal. For larger estates, there is considerable merit in continuing to use a credit shelter trust at the first spouse's death to ensure those assets are always sheltered from estate tax, even if the exclusion amount is reduced in years following the first spouse's death.

Remember, all assets in a credit shelter trust are excluded from the survivor's estate for tax purposes, including any gain such as appreciation on the assets from the time of the first spouse's death until the survivor's death. If a married couple has an estate large enough to possibly cause the survivor to incur a federal estate tax, fully funding a credit shelter trust at the first spouse's death will also exclude all appreciation on the assets during the survivor's life from estate tax.

Remarriage

Relying on portability to ensure both spouses' estate tax exclusion amounts are used can present risks if the surviving spouse later remarries. If a surviving spouse is predeceased by more than one spouse, the amount of unused exclusion available for use by the surviving spouse is limited to the lesser of the then-applicable exemption or the unused exclusion of the last such deceased spouse. Such restrictions make the application of portability unpredictable in many situations. Given the possibility of future tax changes, using a traditional credit shelter trust as a means to "lock in" the use of the first spouse's estate tax exclusion amount remains prudent in many situations.

Multigenerational planning

Multigenerational trust planning that provides for the benefit of a child during his or her life, and then continues beyond the child's death for the benefit of grandchildren, can provide numerous benefits for many families. When a generation-skipping transfer (GST) tax exemption—currently equal to the estate tax exclusion amount—is applied to such a trust, the assets may continue in trust for multiple generations without being subject to estate tax at the death of each generation. Likewise, trust planning allows for the ability to control when and how assets are used by beneficiaries and protects the assets from a descendant's creditors, malpractice claim, civil lawsuit and a divorcing spouse. If multigenerational trust planning is appropriate in your family's situation for tax or other planning reasons, keep in mind that portability does not currently apply to a deceased spouse's unused GST tax exemption.

State estate tax planning

In many instances, portability may seem to provide adequately for asset transfer. However, the concept currently only applies at the federal level and in a limited number of states. For residents that currently live in a state with its own state-level estate tax system, or individuals that own real property in states with its own state-level estate tax system, the use of credit shelter trust planning within their estate planning documents may continue to make sense in order to assure the full use of exemptions available at the state level and federal level. A number of states have estate tax exemptions far below the current federal level.

In this situation, funding a credit shelter trust with at least the state estate tax exclusion amount may be wise even where portability could suffice to shelter assets from federal estate taxes. However, the use of credit shelter trust planning during 2021 could depend on your state's gift and estate tax rules. While credit shelter trust planning may, in many instances, make sense to shelter the full federal estate tax exclusion amount at the first spouse's death, some state-specific circumstances may merit careful review with an attorney.

Making the right decision for your situation

The ability to port, or carry over, the unused estate tax exclusion amount of a deceased spouse to the surviving spouse is a potentially significant development that could affect existing estate planning. However, it's important to review estate planning documents in light of changes within the family, with assets and with general planning goals. This may be a good reason to discuss with an attorney whether it's time to review and update existing estate planning documents.

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