

Client Alert

Current Issues Relevant to Our Clients

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Portability: Utilization of Both Spouses' Federal Estate Tax Exemptions

The Federal gift and estate tax exclusion amount (or "exemption") shelters gifts and testamentary bequests from gift and estate tax. The exclusion amount for gifts made in 2014, or bequests by decedents dying in 2014, is \$5,340,000. The exemption is adjusted for inflation each year. For married couples with combined assets of more than the exclusion amount, a traditional estate tax plan has involved utilization of both spouses' exemptions, effectively doubling the amount of assets that can pass free of federal estate tax to their beneficiaries at the death of the survivor. Until recently, this required both the funding of each spouse's separate estate with sufficient assets during lifetime, and the use of some form of shelter trust in the deceased spouse's estate plan, to assure that the exemption of the first spouse to die was utilized and not wasted.

The Federal Tax Code now provides for the portability (assignment) of a deceased spouse's unused exemption to a surviving spouse by an election made on a timely-filed U.S. estate tax return. In such a circumstance the surviving spouse's exemption, available to shelter lifetime gifts or testamentary bequests, is increased to the sum of the survivor's own exclusion amount plus the Deceased Spousal Unused Exclusion Amount ("DSUE amount") assigned to the survivor through a portability election.

Consider the example of a married couple when, at Husband's death, he owns a qualified retirement plan valued at \$4,000,000 payable to Wife, and a residence valued at \$2,000,000 and securities valued at \$4,000,000 jointly owned with Wife, all of which pass directly to Wife at Husband's death. Historically this scenario would have led to unnecessary estate tax. While no estate tax would be due at Husband's death because all of his property passing to Wife qualifies for the unlimited federal estate tax marital deduction, at Wife's subsequent death estate tax would be applied to the excess of her gross estate of \$10,000,000 over her single exclusion amount (currently \$5,340,000), resulting in approximately \$1,864,000 of federal estate tax at current rates. However, under current law if a timely portability election is made on Husband's estate tax return, Husband's unused exclusion of \$5,340,000 is transferred to Wife, so that at her subsequent death she could apply her combined exemption of \$10,680,000 to shelter her entire \$10,000,000 estate from federal estate tax.

While the portability election may appear as a way to simplify one's estate plan, avoiding the use of shelter trusts and having to reallocate assets between spouses, there remain a number of important qualifications regarding the use of the portability election, which suggest

the continued use of shelter trusts and asset allocation in many estate plans.

- The funding of a shelter trust on the first spouse's death freezes the value of the assets used to fund the shelter trust, avoiding estate taxation of any post-death appreciation of those assets at the survivor's death. Conversely, if no shelter trust is used the post-death appreciation of assets passing directly to a surviving spouse will be taxable as part of the survivor's gross estate.
- Portability does not apply to the generation-skipping transfer tax exemption. Clients with estate plans that will ultimately distribute to grandchildren must use a traditional shelter trust to which the deceased spouse's GST tax exemption may be applied at the time of the death of the first spouse in order to use the first spouse's GST exemption.
- Portability may not be available for state estate tax purposes. For example, any part of the \$4,000,000 Illinois estate tax exemption not used on the death of the first spouse to die cannot be assigned to a surviving spouse, and will be lost.
- Assets passing directly to a surviving spouse may be subject to the claim of a creditor or subsequent spouse, whereas assets passing to a shelter trust can be insulated from both.
- A deceased spouse's unused exemption which was assigned to a surviving spouse may be lost or reduced if the surviving spouse remarries and the surviving spouse's second spouse also predeceases the survivor. Portability only applies to the unused exemption of the survivor's "last deceased spouse."

On the other hand, the portability election can provide opportunities.

- Portability can help salvage unused federal exemption which otherwise might be lost due to insufficient estate planning (*i.e.*, no shelter trust) or the underfunding of the estate of the first spouse to die.
- In the case of remarriage of a surviving spouse following the death of the first spouse, it may be possible for the surviving spouse to fully utilize the unused exemption from the estate of the first spouse, even during the marriage to the second spouse, to shelter lifetime gifts by the surviving spouse, while remaining eligible to receive the unused exemption of the second spouse through a portability election should the second spouse also predecease the surviving spouse.
- In situations where it is clear there will be no federal or Illinois estate tax due in the estate of the surviving spouse, having assets pass directly to a surviving spouse in conjunction with a portability election may be preferable to the use of a shelter trust at the death of the first spouse to die. Assets included in a surviving spouse's gross estate will receive an income tax basis step-up to date of death value, effectively eliminating potential capital gain on the appreciation in value of the assets following the death of the first spouse to die. Assets held in a shelter trust following the death of the first spouse to die will not receive a step-up in basis at the death of the surviving spouse.

In conclusion, the continued use and funding of traditional shelter trusts at the death of the first spouse to die remains an important estate tax planning consideration. On the other hand, portability of the unused estate tax exemption of a deceased spouse will be important when insufficient estate planning or asset allocation would otherwise result in loss of the deceased spouse's unused federal exemption, or when potential income tax savings through tax basis adjustment in the estate of the surviving spouse is more important than estate tax savings.

For More Information

For more information, please contact [Robert Lewis](mailto:Robert.Lewis@chapman.com) (312.845.3733), [David Crossett](mailto:David.Crossett@chapman.com) (312.845.3011), [David Lullo](mailto:David.Lullo@chapman.com) (312.845.3902), [Rebecca Wallenfelsz](mailto:Rebecca.Wallenfelsz@chapman.com) (312.845.3442), [Molly Carney](mailto:Molly.Carney@chapman.com) (312.845.3438) or your primary Chapman attorney, or visit us online at chapman.com.

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