PLANNING FOR PORTABILITY OF THE ESTATE TAX EXEMPTION

The American Taxpayer Relief Act of 2012 (ATRA) permanently enacted the concept of "portability" of any unused estate tax exemption which may now be carried over from the first death to the second death of a married couple.

Technically, this is known as the **"Deceased Spousal Unused Exclusion" (DSUE)** and must be formally elected on the Form 706 U.S. Estate Tax return of the first spouse to die according to the guidelines of Revenue Procedure 2022-32. The estate tax exemption in 2023 is currently $12,920,000 and it is also permanently indexed each year for inflation.

Prior to the enactment of ATRA, if the estate tax exemption was not used on the first death, it was not available at the second death. Since the Economic Recovery Tax Act of 1981 (ERTA), the common planning technique to assure that this exemption was not "wasted" at the first death was the Marital-Credit Shelter Trust, commonly known as the A-B Marital / Family Trust or A-B Marital / By-Pass Trust.

The credit shelter portion (B) was typically allocated estate property equal to the estate tax exemption then available (ranging from $600,000 in 1986 to $12,920,000 in 2023) with the remainder of the estate allocated to the marital portion (A) via the unlimited marital deduction. This widely used A-B technique would result in $0 estate taxes at the first death and defer all estate taxes to the second death.

The Portability Question After ATRA 2012

After 2012, one important question for estate planning is whether "portability" (DSUE) should be elected at the first death. After all, electing "portability" could mean that a surviving spouse could have double the estate tax exemption at the second death (currently $12,920,000 x 2 = $25,840,000). The need for splitting the estate into the traditional "marital" and "credit shelter" portions at the first death would be eliminated. Or would it?

Planning on a case-by-case basis may still involve a marital-credit shelter A-B split at the first death for a number of reasons. In these cases, the survivor may NOT want to elect portability (DSUE) so that the estate tax exemption can be used at the first death.

- At what age did the first spouse die? If the first spouse died in their 60s or 70s, a surviving spouse may have a life expectancy of 15-25 years or more. Even for a first death in the early 80s, a surviving spouse may live 10 years or more. The question of future asset appreciation from the first death to the second death against a current estate tax rate of 40% needs to be taken into account. For states that levy state estate taxes, the combined federal/state net marginal rate can be close to 50%.

- Was the marriage a second marriage for the couple? In this case, children from the first marriage need to be considered, possibly as remainder beneficiaries of a special trust known as a Q-TIP Marital-Credit Shelter Trust. In a Q-TIP trust, the second spouse has only a limited income interest in the trust with the trust principal preserved for children from the first marriage.
- Splitting the estate into A-B marital-credit shelter portions at the first death can protect the credit shelter portion ($12,920,000) from subsequent marriages by the survivor.
- Splitting the estate into A-B marital-credit shelter portions at the first death can protect the credit shelter portion ($12,920,000) against creditors of the surviving spouse.

Let's take a look at a hypothetical case where we compare electing "portability" of the estate tax exemption versus NOT electing "portability" and using a Credit Shelter / By-Pass B trust instead at the first death

Case Study Example of Electing DSUE Portability v. Not Electing DSUE Portability

Mr. And Mrs. Johnson are each 67 years old and have a combined estate of $40,000,000. They are Florida residents and have no state estate taxes to worry about. However, federal estate taxes are a major concern. They want to make sure that their 3 adult children receive the maximum inheritance.

A conservative growth rate for the estate is assumed to be 4%. Their estate planning advisors have informed them that federal estate taxes can be deferred to the death of the survivor with certain planning techniques. These techniques may or may not involve utilizing "portability" (DSUE) of the estate tax exemption at the first death.

It is assumed that the estate tax exemption will be indexed into the future at a 3% rate. It is also assumed that the estate tax exemption does not decrease by 50% ("sunset") on 12/31/2025. Based on these assumptions, does it make sense to elect "portability" if Mr. Johnson died unexpectedly today and Mrs. Johnson died at her life expectancy which is age 85 (18 years)?

I. $40,000,000 Estate Electing Portability Growing at 4% for 18 Years

- $40,000,000 Estate in 2023 …..... 100% estate tax marital deduction at first death
- $80,000,000 Estate of Survivor in 2041
- Minus $34,915,000 Exemption …... $12,920,000 DSUE current exemption
- + $21,995,000 indexed exemption of survivor
- = $45,085,000 …..... Taxable estate at 2nd death in 2041
- x 40% …..... Estate tax rate
- = $18,034,000 …..... Federal estate tax at 2nd death in 2041

= $61,996,000 …..... Net inheritance to heirs in 2041

II. $40,000,000 Estate NOT Electing Portability Growing at 4% for 18 Years Marital-Credit Shelter A-B Plan at First Death

Marital Portion (A)

- $40,000,000 Estate in 2023 ..... Portability is NOT elected at first death
- Minus $12,920,000 Exemption …..... Credit shelter (B) portion at first death
- = $27,080,000 …..... Marital deduction (A) portion in 2023
- $54,160,000 Estate of Survivor in 2041
- Minus $21,995,000 Exemption …..... Indexed exemption of survivor
- = $32,165,000 …..... Taxable estate at 2nd death in 2041
- x 40% ..... Estate tax rate
- = $12,866,000 …..... Federal estate tax at 2nd death in 2041

= $41,294,000 …..... Net inheritance to heirs from A portion in 2041

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Credit Shelter "By-Pass" Portion (B)

- $12,920,000 …..... Credit shelter (B) portion in 2023
- $25,840,000 …..... Value of credit shelter (B) portion in 2041
- (Not included in estate of survivor)

= $25,840,000 …..... Net inheritance to heirs from B portion in 2041

….....

- + $41,294,000 ..... Net inheritance from Marital Portion (A) in 2041
- + $25,840,000 ..... Net inheritance from Credit Shelter (B) Portion in 2041
- **= $67,134,000 …..... Total net inheritance to heirs in 2041**

Summary Case Study of Electing DSUE versus NOT Electing DSUE at First Death

- **$61,966,000 …..... Net inheritance to heirs by electing DSUE**
- **$67,134,000 …..... Net inheritance to heirs by NOT electing DSUE**
- **$5,168,000 …..... Net increased inheritance to heirs by NOT electing DSUE**

What can we conclude from the hypothetical electing DSUE versus not electing DSUE example above? We can generally conclude that if the estate is expected to grow at a modest rate between the first and the second death of a married couple, that it may make sense NOT to elect DSUE at the first death.

This is especially true if the survivor has 10 or more years of life expectancy after the death of the first spouse. By NOT electing DSUE, the traditional and well-known marital-credit shelter A-B plan can be implemented at the first death instead.

The growth on the B portion "by-pass" amount will not be included in the estate of the survivor. The projected estate tax free growth on the B portion is important considering that this growth will avoid the 40% federal estate tax rate at the death of the survivor. This contrasts with electing DSUE at the first death with an unlimited (100%) marital deduction for the surviving spouse. The growth of the estate will not avoid the 40% federal estate tax rate at the surviving spouse's death if DSUE was elected.

With this information, the married couple can make an informed decision about whether or not DSUE should be elected at the first death. Then, they can decide how much life insurance may be needed to offset projected estate taxes at the second death.

This insurance would probably be some form of survivorship universal life owned by an Irrevocable Life Insurance Trust (ILIT). The death proceeds would be income tax free and estate tax free and allow the heirs to inherit upwards of 100% of the estate value without any shrinkage.

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