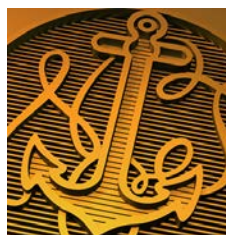


GIFT AND ESTATE TAX EXCLUSION PORTABILITY

What you need to know

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Portability is permanent and the regulations are final. For Federal gift and estate tax purposes every individual has what is known as a “basic exclusion amount.” For a married couple, with proper tax return filing and elections, the surviving spouse may use the decedent’s deceased spousal unused exclusion (DSUE) amount in addition to his or her basic exclusion, effectively sheltering significant wealth from Federal gift and estate taxation. Portability first came into effect in 2010 and the associated regulations were made final in June 2015.¹

WHAT IS PORTABILITY?

The gift and estate tax portability election, enacted as part of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 and made permanent by the American Taxpayer Relief Act of 2012, allows the estate of a U.S. decedent who is survived by a spouse to make what is known as a “portability election.”² The election generally allows the surviving spouse to apply the decedent’s DSUE amount to the surviving spouse’s own taxable transfers during life and at death. As a result, an estate that properly elects portability for a decedent can provide a surviving spouse with up to a \$5 million, indexed annually for inflation, DSUE amount that can be used for the gift and estate tax purposes of the survivor. In other words, with the portability election in effect, a surviving spouse can transfer up to \$10 million, indexed, gift and estate tax-free, and get a basis adjustment for the assets held by the surviving spouse at his or her death for future income taxation purposes. The combined basic exclusion and DSUE are referred to as the “applicable exclusion.”³

Year	Basic Exclusion Amount	Potential Combined Basic Exclusion Amount and DSUE
2011	\$5.00 million	\$10.00 million
2012	\$5.12 million	\$10.24 million
2013	\$5.25 million	\$10.50 million
2014	\$5.34 million	\$10.68 million
2015	\$5.43 million	\$10.86 million

It is important to understand how portability fits into the transfer tax system. The gift and estate tax exclusions are “unified,” meaning that if some (or all) of the \$5 million, indexed, basic exclusion amount is used to shield lifetime gifts from tax, the exclusion amount available to shield subsequent transfers from the gift or estate tax is reduced accordingly.

For example, Wilma and Harry are a U.S. married couple. Wilma’s first lifetime taxable gift of \$1 million would use up \$1 million of her basic exclusion amount. If Wilma subsequently died in 2015, she would only have \$4.43 million of basic exclusion amount remaining to cover any estate tax. If Wilma’s entire estate passed to her surviving spouse, Harry, she would not need to use any of her remaining basic exclusion due to the unlimited marital deduction. Assuming the executor of Wilma’s estate properly made the portability election, in 2015 Harry would have \$9.86 million of applicable exclusion – Harry’s own \$5.43 million basic exclusion in 2015, plus Wilma’s \$4.43 million DSUE – available to shield Harry’s subsequent taxable transfers from tax.



Although generally a very taxpayer-friendly provision, the portability election and its use are subject to a number of requirements and restrictions. The Internal Revenue Code (Code) and final regulations provide guidance on how to make the portability election for the estate of the first deceased spouse and the surviving spouse's use of the DSUE.

ELECTING PORTABILITY

In order to obtain the benefits of portability, the requirements for a valid election must be followed.

- *Election required.* Portability must be properly elected or it will be lost. A portability election is effective *only* if made by the executor on a timely filed Federal estate tax return.
 - If the first decedent's gross estate exceeds the basic exclusion amount in the year of death, a Federal estate tax return is required to be filed within nine months of death. However, with the filing of an application, an automatic six month extension to file the estate tax return is available. The portability election is required to be made with the filing of the timely estate tax return (including any extension for the filing of the return) and no separate extension of time to make the portability election is allowed.
 - If the first decedent's gross estate does *not* exceed the basic exclusion amount, the filing of a Federal estate tax return will nonetheless be required in order to make a portability election. Where the gross estate does not exceed the basic exclusion amount and filing a Federal estate tax return is only required for the purpose of making the portability election, additional extension relief may be applied for under applicable regulations.

In summary, in order for the surviving spouse to utilize the decedent's DSUE amount, the executor of the first-to-die *must* file an estate tax return no matter what the size of the first decedent's gross estate.

- *Opting out of portability.* In some circumstances the decision may be made to forego the portability election. The executor of the decedent's estate may opt-out by making an affirmative statement to opt-out on the decedent's timely filed estate tax return (or on an attachment to the return). If a timely return is filed and no affirmative opt-out statement is made, a portability election will be deemed to be made. Conversely, if the executor does not file a timely estate tax return no portability election will have been made.
- *Making the election.* The portability election is required to be made by the appointed executor of the decedent's estate, or if there is no appointed executor, by what the Internal Revenue Service (IRS) refers to as the "non-appointed executor." A non-appointed executor is a person who is in possession of assets of the decedent. We refer to both an appointed executor and a non-appointed executor simply as the executor.

The portability election becomes irrevocable once it is made and the due date for filing the return, with any extensions, has passed. The election may only be made for estates of U.S. decedent's dying on or after January 1, 2011, who are survived by a spouse. The election may not be made for a non-U.S. citizen, who is not a U.S. resident at the time of his or her death.

- “Complete and properly prepared” estate tax return required. The return the portability election is made on is required to be “complete and properly prepared,” meaning it is prepared in accordance with the instructions for the Federal estate tax return (Instructions for Form 706). If the decedent’s estate is not greater than the basic exclusion amount (and the return is being filed solely for the purpose of making the portability election), there unfortunately is no “short-form” for filing.

There is, however, some simplification in how certain assets are required to be reported for estates not greater in value than the basic exclusion amount for purposes of making the portability election. If there are assets included in the decedent’s gross estate for which a marital or charitable deduction is being made, the value of the assets is generally not required to be reported – just a description of the property, its ownership, and how the property will pass by reason of the decedent’s death to qualify for the marital or charitable deduction. In some estates this can avoid the expense of valuing hard-to-value assets, such as closely held business interests.⁴ However, in general, if an interest in property will transfer to both a recipient that will qualify the transfer for the marital or charitable deduction as well as to a recipient that will not so qualify, the property needs to be valued for completing the estate tax return so that the value of the non-deductible portion can be determined for calculation of the DSUE amount.⁵

- The amount of the DSUE. The executor of a decedent’s estate is required to include a computation of the DSUE amount on the estate tax return. The DSUE amount of a decedent with a surviving spouse is the lesser of:
 - (1) the basic exclusion amount in effect in the year of the death of the decedent; or
 - (2) the excess of –
 - (a) the decedent’s applicable exclusion amount, over
 - (b) the sum of the amount of the taxable estate and the amount of the adjusted taxable gifts of the decedent, which together is the amount on which the tentative tax on the decedent’s estate is determined.

There are special rules where gift tax has been paid by the decedent and in the case of property passing to a non-U.S. citizen spouse in what is known as a qualified domestic trust.

- Portability election v. QTIP election. There is some continuing ambiguity even under the final regulations in certain circumstances when an estate makes both a portability election and an election to treat qualified terminable interest property (QTIP)⁶ as passing to the surviving spouse for purposes of the marital deduction. Rev. Proc. 2001-38 provides a procedure by which the IRS will disregard and treat as a nullity for Federal gift, estate and generation-skipping transfer tax purposes a QTIP election made in cases where the election was not necessary to reduce the estate tax liability to zero. As is common in estate planning, with the introduction of portability of a decedent’s DSUE amount, an executor may purposefully elect both portability and QTIP treatment to maximize the DSUE amount and reduce the estate tax at the first death to zero. The final regulations note that the Treasury Department and the IRS intend to provide guidance by publication to clarify whether an otherwise “unnecessary” QTIP election may be disregarded when an executor has also elected portability.

APPLICATION OF DSUE BY THE SURVIVING SPOUSE

Once portability has been properly elected, the question of how the surviving spouse may use the elected DSUE becomes material. A surviving spouse may only use the DSUE of his or her “last deceased spouse.” This is the most recently deceased spouse who, at the individual’s death after

December 31, 2010, was married to the surviving spouse. Identifying the last deceased spouse of the surviving spouse is important in the case of remarriage and intervening deaths and, depending on the particular circumstances, can be a bit difficult to comprehend in the portability regime.

Recall, that a surviving spouse has available his or her own basic exclusion amount and the elected DSUE amount, which together, constitute the survivor's applicable exclusion. This can be as much as \$10 million, indexed for inflation. A portability election is effective as of the date of the decedent's death, and thus, the DSUE amount, if any, may be included in determining the applicable exclusion amount of the surviving spouse with respect to all taxable transfers by the survivor occurring after the death of the decedent.

It is not uncommon for a surviving spouse to remarry. Remarriage by the survivor alone does not affect who will be considered the last deceased spouse. Remarriage also does not prevent the surviving spouse from including in the surviving spouse's applicable exclusion amount the DSUE amount of the deceased spouse who most recently predeceased the surviving spouse. Furthermore, for purposes of portability, the *identity* of the last deceased spouse of the surviving spouse is not affected by whether the estate of the last deceased spouse elects portability or whether the last deceased spouse has any DSUE amount available. These somewhat complicated rules may be better understood by way of example.

For example, Betty died in 2012, having never made a taxable gift during life, leaving her entire estate to Bob. No estate tax was due because of the unlimited marital deduction. The executor of Betty's estate properly elected portability of Betty's DSUE amount, which was computed to be \$5.12 million. Bob married Jane in 2013. Despite his remarriage to Jane, Bob can still apply Betty's DSUE amount to shield his taxable transfers from tax so long as Jane is still living.

Jane dies in 2015, having made over \$10 million in taxable gifts during her life. Jane is now Bob's last deceased spouse. Since Jane used up her basic exclusion amount to shield lifetime gifts from tax, no DSUE amount is available for Bob's use. As a result, as of the date of Jane's death, Bob has only his basic exclusion amount of \$5.43 million (for 2015) to apply to future taxable transfers. Even though Bob had the use of Betty's DSUE after he married Jane, now that Jane is deceased he no longer can utilize any more of Betty's DSUE as Jane is now Bob's last deceased spouse.⁷

As noted above, for purposes of determining a surviving spouse's applicable exclusion amount when the surviving spouse makes a taxable gift, the surviving spouse's last deceased spouse is identified as of the date of the taxable gift. In cases where there are multiple last predeceased spouses, the final regulations provide an ordering rule for determining the applicable DSUE amount that may be applied to taxable transfers by the surviving spouse before the survivor's basic exclusion amount is used.

For example, Jason died in 2012, leaving his entire estate to Sarah. The executor of Jason's estate properly elected portability, with the DSUE amount computed to be \$5 million, taking into account his previous lifetime gifts. Later during 2012, Sarah made taxable gifts to her children valued at \$2 million. Sarah is considered to have applied \$2 million of Jason's DSUE amount to shield the gifts from tax. After the gifts, Sarah has an applicable exclusion amount remaining of \$8.12 million (\$3 million of Jason's remaining DSUE amount plus Sarah's own \$5.12 million basic exclusion amount for 2012). In 2013, Sarah marries Tom. Tom subsequently dies in 2014. The executor of Tom's estate elects portability, with the DSUE amount computed to be \$2 million. Sarah dies in 2015.

The DSUE amount to be included in calculating the applicable exclusion amount available to Sarah's estate is \$9.43 million, which is the sum of Sarah's basic exclusion amount of \$5.43 million (for 2015), plus the \$2 million DSUE amount from Tom as Sarah's last deceased spouse and the \$2 million DSUE amount from Jason that Sarah applied to her 2012 taxable gifts to her children. The unused portion of Jason's DSUE amount is not available for the estate's use, but there is no recapture or clawback of the amount of Jason's DSUE that Sarah used while Jason was still her last deceased spouse.

KEY LIMITATIONS OF PORTABILITY

Although portability affords a number of advantages, a few key limitations should be noted.

- *Applies only to Federal gift and estate tax.* Portability is a feature of the Federal gift and estate tax regime. For married couples resident in states that have an estate or inheritance tax regime in effect, additional planning may be necessary to achieve the desired estate plan with regard to gift and estate tax consequences under applicable state law. In some circumstances, failure to plan taking state tax considerations into account will result in a state tax at the first death. State tax considerations are discussed in greater detail below.
- *Does not apply to GST tax.* Portability is not a feature of the Federal generation-skipping transfer (GST) tax, and thus does not apply to transfers subject to the GST tax.
- *First spouse must die after 2010.* The portability election is only available with respect to a surviving spouse of a decedent spouse dying after December 31, 2010. A surviving spouse of a decedent who died in 2010 or earlier cannot claim a DSUE amount from the deceased spouse.
- *Effective date.* The final portability regulations are effective as of June 12, 2015 for decedents dying on or after that date. Note that the temporary regulations (REG-141832-11) published in June 2012 still apply for decedents dying on or after January 1, 2011 and before June 12, 2015.

PORTABILITY IN STATES WITH ESTATE OR INHERITANCE TAX

Married couples resident in states that have their own estate and inheritance tax regimes in effect need to keep in mind that portability is only a feature of the Federal gift and estate tax and not applicable to state taxing regimes. In 2015, fifteen states and the District of Columbia have an estate tax, and six states have an inheritance tax.

For example, Illinois imposes an estate tax on taxable transfers of property belonging to decedents who were either resident of Illinois or nonresident of Illinois with property located within the state at the time of death. For persons dying in 2015, the Federal exclusion for Federal estate tax purposes is \$5.43 million, while the corresponding exemption amount for Illinois estate tax purposes is \$4 million. Accordingly, tentative taxable estates with adjusted taxable gifts between \$4 million and \$5.43 million will owe an Illinois estate tax without any corresponding Federal estate tax liability. Further, the state estate tax exemption is merely a threshold to taxation and not a unified credit to reduce Illinois estate tax due.

Since portability of the Federal estate tax exclusion amount is not applicable to the state estate or inheritance tax, married couples and their advisors will need to consider the differential in the applicable Federal estate tax exclusion and the applicable state estate or inheritance tax exemption to determine how to plan for any state estate or inheritance tax consequences.

Planning with portability provides opportunities, but is also subject to limitations. There are many technical aspects that should be considered with one's tax and legal advisors, including, by way of example, non-U.S. citizen spouses and remarriage and intervening deaths. Readers are advised to confer with their personal tax and legal advisors to determine if and how portability may be relevant to their individual wealth transfer planning.

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¹ T.D. 9725, 80 FR 34279-01 (June 16, 2015).

² I.R.C. § 2010(c).

³ Treas. Reg. § 20.2010-1(d)(2).

⁴ Despite not adopting a recommendation to broaden the application of this special rule so more estates could avoid the expense of a potentially-complicated appraisal to value assets includible in the gross estate, the final regulations provide flexibility to refine the rules in sub-regulatory guidance at any time in the future when the IRS may determine that additional guidance would be appropriate with regard to the application of the special rule to particular types of transfers.

⁵ Treas. Reg. § 20.2010-2(a)(7)(ii).

⁶ I.R.C. § 2056(b)(7)(B).

⁷ Treas. Reg. § 20.2010-3(a)(2).