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Portability of Applicable Exclusion Amount between Spouses

What is the applicable exclusion amount?

The applicable exclusion amount is the amount that can be sheltered from federal gift and estate tax by the unified credit. The applicable exclusion amount is equal to the sum of the basic exclusion amount of the surviving spouse and the unused applicable exclusion amount of the last deceased spouse.

The Tax Cuts and Jobs Act doubled the basic exclusion amount to $11.18 million in 2018 (indexed annually for inflation). The exclusion is $12.06 million in 2022. After 2025, the exclusion is scheduled to revert to its level prior to 2018 and be cut by about one-half.

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 introduced a portability provision allowing a surviving spouse to use any unused applicable exclusion amount of a deceased spouse for gift and estate tax purposes. The American Taxpayer Relief Act of 2012 permanently extended portability of the unused applicable exclusion amount between spouses. Portability of the exclusion between spouses and an increase in the basic exclusion amount would seem to make estate planning easier for many estates.

Planning before portability

Prior to the 2010 and 2012 tax acts, many married couples with estates that were greater than the applicable exclusion amount would set up an A-B (or A-B-C) trust arrangement. The first spouse to die would transfer an amount equal to the applicable exclusion amount to the "B" or credit shelter bypass trust. The B trust could benefit the surviving spouse and their children, but the B trust would be designed to bypass the surviving spouse's estate. The balance of the estate would be transferred to the surviving spouse, either outright or using an A marital trust. In some cases, a "C," "Q," or QTIP marital trust was also used if the first spouse to die wanted to control who received the marital trust property at the second spouse's death.

With a typical A-B trust arrangement, there would be no estate tax at the first spouse's death. The B trust portion was protected by the applicable exclusion amount of the first spouse to die, and the A trust portion qualified for the marital deduction. The A trust would be includable in the second spouse's estate, but would be protected (at least in part) from estate tax by that spouse's applicable exclusion amount. The A-B trust arrangement ensured that neither spouse's applicable exclusion amount was wasted.

In some cases, especially if the married couple's combined estates would exceed the total amount of both spouses' applicable exclusion amounts, the spouses' planning would also attempt to equalize estates in order to use both spouse's applicable exclusion amounts, avoid higher graduated tax rates on the surviving spouse's estate, and reduce total tax on both estates. In other cases, especially where the combined estates were less than the applicable exclusion amount, the first spouse to die might simply transfer everything to the surviving spouse and defer estate tax (if any) to the second spouse's death.

Planning with portability

If you're planning today, you could transfer everything to your spouse when you die, and your estate can elect to transfer your unused applicable exclusion amount to your surviving spouse. Your spouse will then have an applicable exclusion amount equal to the sum of his or her own basic exclusion amount and your unused applicable exclusion amount, which your spouse can use for gift or estate tax purposes. For example, if your estate transfers your $12,060,000 unused applicable exclusion to your surviving spouse, who also has an $12,060,000 basic exclusion amount, your spouse then has a $24,120,000 applicable exclusion amount to shelter property from gift and estate tax in 2022.

The portability provision would seem to make planning easier, and there may be far less need to use A-B trust arrangements. But there are a few potential pitfalls to watch out for.

- If you are predeceased by more than one spouse, the unused applicable exclusion of an earlier spouse could be lost. That is because you use the unused applicable exclusion amount (if any) of your last deceased spouse. This may be another factor to consider when planning for remarriage.
- The unused applicable exclusion amount that you transfer to your surviving spouse is not indexed for inflation after you die. If the property you transfer to your spouse appreciates after your death, the value of such property in your spouse's estate could exceed your unused applicable exclusion amount and could result in estate tax. With an A-B trust arrangement, appreciation on property in the

The portability of the applicable exclusion amount between spouses and an increase in the basic exclusion amount may make estate planning easier for many estates. Your estate plans and documents may need to be revised to reflect these tax changes, as well as any tax changes in the future. Flexibility to deal with future changes is key.

The use of trusts involves a complex web of tax rules and regulations and usually involves upfront costs and ongoing administrative fees. You should consider the counsel of an experienced estate conservation professional before implementing a trust strategy.

B trust would be sheltered by your applicable exclusion amount.

- In order to make the unused applicable exclusion election, an estate tax return needs to be filed even if estate tax is not owed.

Using the applicable exclusion amount now

Even with portability, it may be useful to take advantage of the increased applicable exclusion amount by making gifts now that can reduce your taxable estate. Some reasons for using the applicable exclusion amount now might include the following situations:

- There are family members or individuals other than your spouse whom you would like to provide for during your lifetime. The applicable exclusion amount could be used to shelter gifts to such persons from gift tax. (Consider also lifetime gifts that qualify for the annual gift tax exclusion, $16,000 (in 2022, $15,000 in 2021) per donor/donee, or as qualified transfers for medical or educational purposes. These gifts are not taxable and do not use up your applicable exclusion amount.)
- Tax laws can always change. In the future, the available applicable exclusion amount may be less, portability may not be available, and tax rates may be higher.
- Appreciation on gifts you make is removed from your gross estate. For example, if you made a gift of $12,060,000 now and the property doubles in value to $24,120,000 in the future, the $12,060,000 of appreciation would be removed from your gross estate. On the other hand, such property will not receive a stepped-up (or stepped-down) basis at your death for income tax purposes.
- If you would like to benefit your grandchildren and later generations, it may also be useful to use your $12,060,000 (in 2022, $11,700,000 in 2021) generation-skipping transfer (GST) tax exemption now. The GST tax exemption is not portable between spouses. Applicable exclusion amounts will often be used with generation-skipping transfers to protect the transfers from gift and estate tax.
- State inheritance or estate taxes can be saved. Most states do not have a gift tax. Making a gift can remove the property from your estate for state death tax purposes. Also, state exclusion amounts may be different than the federal applicable exclusion amount and may not be portable between spouses. Consult a tax or estate planning professional familiar with the laws in your state.

For many of the same reasons discussed above, it might also be useful to have your estate use all of your applicable exclusion amount at your death rather than transfer the unused exclusion to your spouse. For example, it might make sense if there are persons other than your spouse whom you would like to benefit prior to the death of your spouse. In some cases, it may be useful to use A-B trust arrangements.

Estate plans and documents

Estate plans and documents written prior to the 2010 and 2012 tax acts may no longer carry out your intended wishes because of the portability provision or the increased basic exclusion amount. Your trusts and wills should be reviewed to see if they still meet your needs.

For example, if you have an estate of $12,060,000 and an A-B trust arrangement that would fund your credit shelter trust with the applicable exclusion amount, would you want your B trust to be funded with the full $12,060,000, with nothing passing to your spouse (other than whatever interests your spouse might have in the B trust)? Or might you want to transfer the $12,060,000 to your spouse, who would be able to use your applicable exclusion amount to protect the $12,060,000 from gift and estate tax? But what if the basic exclusion amount is reduced or portability is not available?

Your documents and plans may need to be revised to reflect the tax changes and any uncertainty for the future. Flexibility to deal with future changes is key. Everyone's situation is unique and the issues are complex. To help guide you through these opportunities and uncertain times, consult an experienced estate planning attorney.

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