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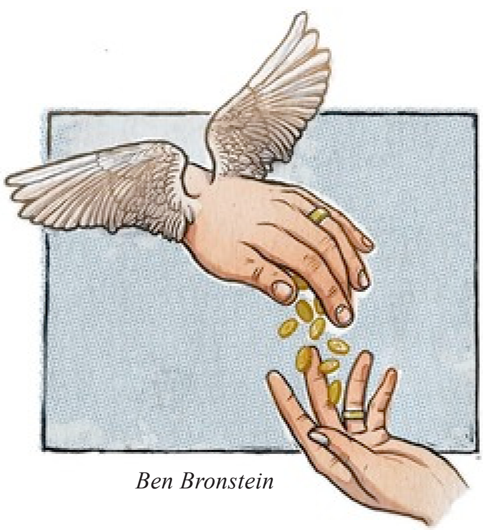
Avoiding Estate-Tax Traps

By Laura Saunders – August 10, 2012

Are you married? Then put a copy of this column with the "valuable documents file" you are leaving—or ought to be—for your heirs.

Here's why: The Internal Revenue Service in June issued guidance for an estate-tax law Congress passed late in 2010. As a result, many couples will now find it easier to maximize federal estate-tax savings without costly predeath planning.


Ben Bronstein

There is an important hitch, however. An estate-tax return must be filed soon after the first partner's death—usually within nine months—in order for a couple to get this new benefit.

If the estate's executor misses that crucial filing, the couple will likely lose the value of one partner's estate-tax exemption. That's currently $5.12 million per individual, so the loss would mean sheltering only about $5 million versus $10 million of assets per couple from federal estate tax.

"A small mistake makes a big difference here," says Carol Harrington, an attorney at McDermott, Will & Emery in Chicago. She and other experts are especially worried about oversights by executors of smaller estates. Many of them, unaware of the changes, may think no estate-tax return needs to be filed if the assets fall below the exemption amount.

"This could easily happen to the owners of a farm or small business whose advisers aren't estate-tax specialists," says Tom Ochsenschlager of American University's Kogod Tax Center.

The recent changes are the latest effort to address a long-standing estate-tax issue for married couples. Since 1981, each spouse has been allowed to leave property to the other spouse, free of tax at death—which seems only fair.

But this fairness spawned another problem. If, as is common, one partner left all assets to the other, then this tax-free transfer in effect cost the couple one of their two estate-tax exemptions. At the second death, only one exemption was available to shelter assets.

Planners devised trusts to get around this issue, but they were clumsy and costly—and taxpayers had to be willing to plan ahead. The new rules instead make each partner's estate-tax exemption "portable," so extensive predeath planning isn't required.

Here is a simplified example, under both regimes: A husband and wife together have $7.5 million of assets, $6 million of it in a business owned by him and the rest owned by her. Under prior law, if they died and each partner left everything to the other (with no trusts), the estate of the second-to-die partner would owe federal tax on $2.5 million—even though the law gave each spouse a $5 million exemption.

Under the new rules, when the first partner dies—say it's the wife—the executor files an estate-tax return preserving the value of her $5 million exemption. The result: At the husband's death, the wife's exemption is added to his, and the entire $7.5 million passes to heirs tax-free.

At current rates, that's a federal estate-tax saving of $833,000, says Linda Hirschson, an attorney at Greenberg Traurig in New York.

What if a couple has total assets far below the exemption—say, $2 million? Experts advise filing an estate-tax return to preserve the dead partner's exemption, in case the survivor receives a windfall.

The new rules, however, don't allow taxpayers to pile up exemptions from "serial marriages."

For example, if a rich widower remarries a wealthy woman, the first wife's unused exemption is available only as long as the second wife is still alive, although it can be used to make gifts until her death. This is a complex area with great benefits; if you are one of the few affected, get expert help.

The IRS has tried to simplify estate-tax filing. As long as assets go to a spouse or a charity, there is no need for expensive appraisals—the executor files a list with reasonable estimates. A house, for example, might be valued according to comparables in the neighborhood.

Why worry about these new rules when the estate tax is in flux? After all, the exemption is scheduled to drop to $1 million, with a top 55% rate, next Jan. 1. If that occurs, the new portability rules wouldn't apply either.

The answer: Experts say these rules will be incorporated into any new regime, because they tackle a long-standing issue.

"The IRS spent a lot of time preparing these generous rules," Ms. Hirschson says. "We hope they're here to stay."