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Key death tax exclusion hinges on speedy filing

'Portability' of unused exclusions only guaranteed if surviving spouse files estate tax return swiftly

By Liz Skinner
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Timing is everything, even in death.

The Internal Revenue Service last month clarified that executors of estates wishing to take advantage of a new provision allowing a spouse to pass unused estate tax exclusions to a surviving spouse must file an estate tax return within nine months of the death of the husband or wife.

That means the estate of someone who died Jan. 1, 2011, should have filed the estate tax return Form 706 by Oct. 3. Another form can be filed for an automatic six-month extension, the IRS said in its notice late last month.

Clients need to be informed of this hitch. The reason? Many don't file an estate tax return if they don't owe any taxes (thanks to the exemption on the estate tax), said John McManus, a tax attorney and founder of McManus & Associates. The value of the surviving spouse's estate could surge before their death, however, and then it would be too late to claim the unused portion of the first spouse's exemption.

“We just think it is prudent to file the return and seek portability for the surviving spouse,” Mr. McManus said.

The new “portability” provision was part of the tax deal that President Barack Obama and Congress struck in the waning days of December. In that agreement, the estate tax, which expired for 2010, was reinstated for 2011 and 2012. The limits that can be passed on to heirs tax-free for the 2011 and 2012 were set at $5 million per person or $10 million for a married couple. The exemption was also made portable to allow a spouse to make use of the unused portion of the dead spouse's exemption upon their death.

For example, if a husband dies leaving $1.5 million in his estate, the wife's estate upon her death can claim the remaining $3.5 million of his exemption plus her full $5 million exemption, as long as his estate filed a tax return within nine months of his death.

“Portability is an advantage to someone who has underplanned, though we think still think trusts are eminently better,” Mr. McManus said.

Sophisticated estate planning techniques, including setting up credit shelter trusts, allow a spouse to avoid estate taxes when passing on assets to heirs. The trust is structured so that when the first spouse dies, the assets in the trust can go to the children as named beneficiaries, but still provide income to the surviving spouse.

Credit shelter trusts also protect estates from taxes on the growth of assets over the period between the deaths of the two spouses, Mr. McManus said.