Estate Tax Tips for Married Couples

By BILL BISCHOFF MARCH 18, 2011, 12:47 P.M. ET ESTATE PLANNING for Wall Street Journal

Thanks to the generous $5 million exemption for individuals who pass away in 2011 or 2012, the assets of relatively few people in the United States will be exposed to the federal estate tax over the next few years. To see if you and/or your spouse's estate might bump up against the exemption, try our estate tax calculator and read on for estate-tax-saving tips.

Take Advantage of the Unlimited Marital Deduction

If your spouse is a U.S. citizen, you can leave any amount to him or her with no federal estate tax hit. If you are a U.S. citizen, your spouse can do the same. This is the so-called unlimited marital deduction privilege. For married couples, the $5 million federal estate tax exemption and the unlimited marital deduction privilege provide significant federal estate tax shelter for those who die in 2011 or 2012.

If either you or your spouse has a large estate, however, leaving everything to your spouse can result in your spouse having an estate that exceeds the federal estate tax exemption when he or she dies. In that case, you need to look at the other estate-tax-saving tips.

Take Advantage of Portable Estate Tax Exemption

For 2011 and 2012, you can direct the executor of your estate to leave any unused federal estate tax exemption to your surviving spouse. For example, if you die in 2011, you can leave everything to your spouse, including your unused $5 million exemption. Your spouse would then have a $10 million exemption if he or she dies in 2011 or 2012 (his or her $5 million exemption plus your unused $5 million exemption). Unless Congress takes action, however, portable estate tax exemption will expire at the end of 2012.

Make Bequests to IRS-Approved Charities

If you had died in 2010, you could have left everything to relatives and loved ones and no federal estate tax would have been due (even for billionaires). For 2011 and 2012, that's not the case.

You might want to change your estate planning documents to direct the executor to give away more to IRS-approved charities in order to get your taxable estate down to the current $5 million estate-tax-free ceiling, or $10 million if you leave everything to your surviving spouse (including your unused $5 million federal estate tax exemption).

Put another way, you and your spouse can together leave up to $10 million to relatives and loved ones without any federal estate tax hit if you (both) die in 2011 or 2012. If you leave more, there will be a federal estate tax bill to pay. But the taxable value of your estate is reduced by donations that the executor of your estate is directed to make to IRS-approved charities. Of course, increasing charitable donations to avoid the estate tax means leaving less to relatives and loved ones.

Make Annual Gifts to Relatives and Loved Ones

Thanks to the annual federal gift tax exclusion ($13,000 for 2011 and probably the same for 2012), making annual gifts up to the exclusion amount will reduce the taxable value of your estate without

reducing your lifetime $5 million federal gift tax exemption or your $5 million federal estate tax exemption. The same holds true for gifts by your spouse.

With two adult children and four grandchildren, for example, you and your spouse could give them each $13,000 in 2011 for a total of $156,000 (6 x $13,000 x 2). Then, do the same thing in 2012. Over the two years, your taxable estates would be reduced by $312,000 (2 x $156,000) with no adverse federal gift or estate tax effects.

Pay School Expenses (Not Room and Board) or Medical Bills for Relatives and Loved Ones

You can give away unlimited amounts for these purposes without reducing your $5 million federal gift tax exemption or your $5 million federal estate tax exemption--as long as you make the payments directly to the school or medical service provider. The same holds true for gifts by your spouse.

Give Away Appreciating Assets to Relatives and Loved Ones While You Are Still Alive

Thanks to the federal gift tax exemption for 2011 and 2012, you can give away up to $5 million worth of appreciating assets (stocks, real estate, etc.) without triggering any federal gift tax hit. So can your spouse. This can be on top of cash gifts to relatives and loved ones that take advantage of the annual exclusion and on top of cash gifts to directly pay college tuition or medical expenses for relatives and loved ones.

Key Point: Gifts in excess of the annual exclusion amount ($13,000 for 2011) reduce your $5 million federal gift tax exemption and your $5 million federal estate tax exemption dollar-for-dollar. But that is OK if you are giving away appreciating assets--because the future appreciation will be kept out of your taxable estate.

If you and your spouse each give stock worth $100,000 to your favorite relative in 2011, for example, the gift uses up $87,000 of both of your $5 million federal gift tax exemption ($100,000 $13,000 annual exclusion) and $87,000 of both of your $5 million federal estate tax exemption. Utilizing your exemptions like this makes sense if you are giving away appreciating assets--because the future appreciation will be kept out of your taxable estate.

Set Up Irrevocable Life Insurance Trust

As you may know, life insurance death benefit proceeds are usually federal-income-tax-free. However, the proceeds from any policy on your own life are included in your estate for federal estate tax purposes if you have any incidents of ownership in the policy. It makes no difference if all the insurance money goes straight to your beloved Aunt Myrtle.

It does not take much to have incidents of ownership. If you have the power to change beneficiaries, borrow against the policy, cancel it, or select payment options, you have incidents of ownership. (The preceding is not a complete list of things that count as incidents of ownership.)

This unfavorable life insurance ownership rule can cause federal estate tax exposure for people who believe they have none.

Key Point: The life insurance ownership rule is more likely to adversely affect unmarried people. Why? Because death benefit proceeds from a policy on the life of a married person can be left to the surviving spouse without any immediate federal estate tax hit, thanks to the unlimited martial deduction privilege (assuming the surviving spouse is a U.S citizen). However, all the insurance money going into your surviving spouse's coffers could cause his or her estate to eventually exceed the federal estate tax exemption.

The estate-tax-saving solution is to set up an irrevocable life insurance trust to own the policies on your life. Since the trust, rather than you, owns the policies, the death benefit proceeds are not counted as part of your estate (unless the estate is named as the policy beneficiary which would defeat the purpose). You are still able to direct who gets the insurance money because you get to name the beneficiaries of the irrevocable life insurance trust (typically your children and/or grandchildren).

There may be some complications. When you move existing policies into the trust, you must live for at least three years. Otherwise, the death benefit proceeds will be included in your estate, just as if you still owned the policies at the time of death. Also, when existing whole life policies are transferred into the trust, their cash values are treated as gifts to the trust beneficiaries. Finally, you may have to jump through some hoops to get the cash needed to pay the annual insurance premiums into the trust without adverse gift tax consequences. All these issues can usually be finessed with the help of an estate planning professional.

When you have a large estate that will inevitably owe some federal estate tax, you can set up an irrevocable life insurance trust to buy coverage on your life. The death benefit proceeds can then be used to cover all or part of the estate tax bill after you die. This is accomplished by authorizing the trustee of the life insurance trust to purchase assets from your estate or make loans to the estate. The extra liquidity is then used to cover the estate tax bill. When the irrevocable life insurance trust is eventually liquidated by distributing its assets to the trust beneficiaries (usually your children and/or grandchildren), the beneficiaries will wind up with the assets purchased from your estate or with liabilities owed to themselves. Bottom line: the federal estate tax bill gets paid with dollars that are not themselves subject to the federal estate tax.