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PERSONAL FINANCE

IRS Gives Wealthy Families More Time to Shelter Assets from Estate Tax

A surviving spouse will now have up to five years to claim larger estate-tax exemption

By Ashlea Ebeling

July 14, 2022 12:01 am ET

The federal government is giving widows and widowers more time to deal with the intricacies of the estate tax after a spouse dies.

When one spouse dies, their partner often inherits all or part of the deceased person's estate. The surviving spouse receives those funds tax-free. They can also carry over the deceased's unused estate tax exclusion if they file an estate tax return and choose what the Internal Revenue Service calls portability.

Under prior rules, a surviving spouse had up to 15 months to file the return. The application window was extended to two years in 2017 and then to five years last week because so many families were missing the deadline.

This change means less hassle for widows and widowers, and their adult children helping to settle their estates, and it sets the families up for potentially big estate tax savings.

The reason portability exists is because the federal estate tax is levied per person and has a floor before it kicks in. Without portability, in theory, a tax designed per person would charge the assets of both spouses given one partner usually dies first. For 2022, the exclusion amount is set at $12.06 million per person.

Here's how it works: Say a husband dies and leaves $2 million to his children and $10 million to his wife.

With portability, the wife gets to tack his $10 million unused exclusion amount onto her estate, meaning more can be sheltered from estate taxes at her death. So she would be able to shield $22 million from federal estate tax, which is levied at 40%.

If the executor of the first spouse to die doesn't elect portability on an estate tax return, and then the surviving spouse dies with $2 million over the estate tax exclusion amount, it would cost the estate $800,000 in unnecessary federal estate taxes, for example.

"You think it [portability] doesn't affect you until you need it, and that may be years later. The estate tax exclusion may go down and your assets may go up. Why not lock it in?" says Ed Slott, a certified public accountant in Rockville Centre, New York.

Even those with estates much smaller than $12 million should consider filing an intent to use portability, since the thresholds for the tax may be reduced in coming years.

On Jan. 1, 2026, the Trump tax cuts expire. At that time, the exclusion amount that an individual can shelter from estate taxes is scheduled to drop back to the mid $6 million range, though inflation will determine the exact number. Separately, the Biden administration has proposed lowering the exclusion amount back to the 2009 level of $3.5 million per person. So families with smaller estates, below the $12 million threshold, should still consider filing an estate tax return on the first spouse's death and choose the portability option.

Surviving spouses often miss the deadline since dealing with death is hard enough without dealing with the estate tax, says Bruce Steiner, a trusts and estates lawyer in New York City.

Mr. Steiner says that his firm does portability returns routinely for existing clients, and he has a handful of new clients who have filed special requests to let them do so after the deadline. He is currently helping a son and a widow whose husband died in September 2020 file a return, and says the new five-year window takes off the time pressure.

In the September 2020 case, the dad left his spouse $3 million in investments and assets. Now, her estate is worth $6 million. If she lives another 20 years, she could easily be in estate tax territory, Mr. Steiner figures.

For a younger widow like Mr. Steiner's client, who has $6 million in assets in her mid-60s, it is an easy call to file for portability, tax professionals say. For an older widow who has $1 million in assets and is in spend-down mode, it probably won't make a difference—unless she wins the lottery.

The reason so many people fail to file the correct forms is largely a procedural issue. If everything is passed directly from one spouse to the other when the first one dies, there is no estate administration, says Mr. Steiner. So there is nobody to spot the issue.

"It falls between the cracks," Mr. Steiner says.

The new IRS five-year rule applies to estates not required to file an estate tax return for any reason other than to choose portability, in other words, a nontaxable estate. The deceased must have been a U.S. citizen or resident, be survived by a spouse, and have died after 2010.

The IRS will no longer issue special rulings for families on or before the fifth anniversary of a death. If you have a pending private letter ruling request, the IRS will close the file and refund the user fee. Then you can file an estate tax return, Form 706, electing portability. Write on top of the form: filed pursuant to Revenue Procedure 2022-32 to elect portability.

"The risk-reward of the cost of doing the return is something but modest compared to the cost if you're wrong and the surviving spouse's estate is otherwise above the exclusion amount when she dies," says Mr. Steiner.

Those missing the five-year deadline will be stuck back in line, meaning they will have to ask for a private letter ruling. That can take six months or longer and it is too early to know whether the IRS will continue to rule in favor of taxpayers on this issue, says Mr. Steiner.

Appeared in the July 14, 2022, print edition as 'Estate-Tax Savings Made Easier'.