There are no limits on how much of a marital deduction your estate can qualify for. Thus, if your entire estate goes to your surviving spouse, your estate will owe no federal estate tax. Many taxpayers take this simple approach. In the long run, however, it can cost your family hundreds of thousands of dollars in extra estate taxes. Here's what's involved.

Every individual is entitled to a “unified” credit entitling him to transfer $3.5 million in cash or property free of federal estate tax. (The estate tax is scheduled to be repealed on January 1, 2010, and to be reinstated, with a $1 million exemption, on January 1, 2011.) Property doesn't have to be transferred to the individual's spouse to qualify for this credit. A husband and wife, therefore, can transfer a total of $7 million ($3.5 million each) to their children (or other beneficiaries) in 2009, free of estate tax. If the first of them to die leaves everything to the surviving spouse, however, he will have failed to take advantage of his unified credit. At the later death of the spouse, assets with a value of $3.5 million passing to the children will be “sheltered” by her credit, but the rest of the “parental” estate will be taxed.

Example (1). Harry dies in 2009 with an estate of $7 million, which he leaves in its entirety to his surviving spouse, Wilma. Harry's estate has no estate tax liability due to the marital deduction. Wilma dies later in 2009 with the $7 million comprising her estate. (For the sake of simplicity, assume that there will be no appreciation in the value of the property after Harry's death.) After applying the unified credit that applies in 2009, the estate tax bill for Wilma's estate will be $1,575,000.

Example (2). The facts are the same as above except that Harry leaves only $3.5 million to Wilma and leaves the balance of his estate ($3.5 million) to their children. In this case, Harry's estate will still owe no estate tax due to the combined effect of the marital deduction and unified credit. At Wilma's later death, her estate will be $3.5 million, instead of the $7 million in the first example. Now, after applying the unified credit that Wilma's estate will be entitled to, the estate tax bill will be zero. By keeping $3.5 million of Harry's estate from qualifying for the marital deduction, $1,575,000 in estate taxes are avoided.

Property passing to the spouse. One reason an estate may overqualify for the marital deduction is that property may go to the surviving spouse automatically—that is, not under the taxpayer's will. Two common examples are jointly owned property and life insurance.

If a married couple owns property jointly with survivorship rights, the surviving spouse obtains complete ownership by operation of law outside the estate. Under the estate tax rules, half the value of the property is included in the gross estate but qualifies for the marital deduction since it goes to the surviving spouse. Similarly, if the surviving spouse is the beneficiary of life insurance which is included in the estate, the marital deduction applies.

Accordingly, to avoid “overqualifying” for the marital deduction, it is important to know what property is already targeted to go to the surviving spouse. Then steps can be taken within your estate plan to make sure enough assets are set aside to take advantage of the unified credit.

If you are hesitant to remove $3.5 million or more of your assets from your spousal bequest for fear of leaving your spouse with insufficient property to meet her needs after your death, special arrangements can be made to achieve your goals. One way is to place assets in trust with your spouse receiving the income interest for life and with your children receiving the assets at the spouse's death. The trust can be set up to avoid

qualifying for the marital deduction at your death, thus avoiding inclusion in your surviving spouse's estate at her death.