

THE ESTATE TAX: WHERE WILL IT GO FROM HERE?

By Kevin Lanigan, Carlson Estate Planning

As most people know, the federal estate tax disappeared entirely beginning this year - but for just one year, after which it will go back to a top tax rate of 55% on amounts over the \$1 million exemption, which is what the tax was before 2001. This curious situation came about because the estate tax phase-out and the other Bush tax cuts were passed via the reconciliation process in order to avoid a filibuster by the Democrats' then-minority in the Senate, and budget measures passed this way were required to sunset after 10 years.

Back then, nobody expected we would end up in this situation. It was generally assumed that sometime before the end of 2009, Congress would either reinstate the estate tax- probably with a higher exemption and a lower top rate- or make the repeal permanent. It did neither.

So if you die before midnight December 31, 2010, your heirs will make out like bandits, right? Well, maybe - but maybe not. Although the heirs of billionaire Yankees' owner George Steinbrenner, who passed away last month, may benefit from the timing of his exit, others who are heirs to moderately but not extremely large estates may actually be worse off.

That's because when the death tax died (pardon the pun), limits were placed on a feature permitting a step-up in the tax basis of the estate's assets to whatever their value was on the date of death. This feature can result in huge savings of capital gains taxes for the heirs when the assets are later sold. For assets inherited from those who die this year, the decedent's tax basis will be carried over to the heirs, with only limited step up, thus potentially triggering a large capital gains tax liability when the heirs go to sell them.

While there is still some relief, it is limited. Up to \$1.3 million (plus an additional \$3 million for surviving spouses) can now be added to the tax basis by the step up as long as the adjusted basis does not exceed the estate's actual value. Still, heirs of many modestly large estates likely will end up paying capital gains taxes they wouldn't have had to pay under last year's rules.

Hardly anyone believes this situation will continue. Either the draconian pre-2001 estate tax will return automatically on January 1, 2011, or Congress will put something else in its place. Republicans and small business groups would like to kill the beast forever, but they don't have the votes to do it. President Barack Obama has proposed resurrecting the 2009 estate tax- a 45 percent top rate with a \$3.5 million exemption.

Meanwhile, Senators Blanch Lincoln of Arkansas, a Democrat and Jon Kyl of Arizona, a Republican, have proposed a compromise that would set a top rate of 35 percent with a phased-in \$5 million exemption, but so far the Senate's Democratic leadership has shown scant interest.

Proponents of the estate tax point to the need for revenue to reduce the budget deficit and to its role in redistributing wealth. However, both of these arguments run up against the “2 percent barrier.” Even before 2001, estate and gift taxes rarely amounted to more than 2 percent of total federal revenue from all sources. Stated another way, this unpopular tax doesn’t really generate much revenue.

It is also believed that much of what the estate tax collects comes at the expense of revenue that otherwise would be raised by the income tax. Any projected revenue “gain” from the return of the estate tax has to be reduced by the lost income tax effects.

In addition, collecting taxes from dead people is not socially efficient. Compliance costs, by some accounts, amount to \$1 for every dollar collected - five times the cost per dollar for income taxes - and strategies used to minimize death taxes results in misallocation of resources.

But, one way or another, the estate tax is almost certain to come back. If so, perhaps the Lincoln-Kyl compromise is the best we can hope for.