

## Estate Tax Is Dead, but Confusion Lives On

### Law's expiration can create unpleasant surprises for heirs

By: [Linda Stern](#) | Source: AARP Bulletin Today | April 14, 2010



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Congress has done what seemed impossible: injected uncertainty into death and taxes. On Dec. 31, the federal estate tax lapsed after having been in effect since 1916. However, without new legislation, it will roar back with a vengeance in 2011.

That gives both pro- and anti-estate tax legislators an incentive to revive the tax this year in a form they can agree on. Meanwhile, the unusual hiatus has left older wealthy people up in the air. Some will have to rewrite their wills, possibly more than once. Some investors might actually find their estates liable for even bigger taxes, due to a capital gains tax break that died with the estate tax.

“What a mess!” says Lee Farris, the estate tax policy coordinator with United for a Fair Economy, a group in favor of taxing estates. “It’s a chaotic situation and advisers are telling people to plan both ways,” as if the tax both did and didn’t exist.

How did the confusion come about? A major tax reform law signed by President George W. Bush in 2001 reduced estate taxes over eight years, until by 2009 legacies worth more than \$3.5 million (\$7

million for married couples) were taxed at 45 percent. Then in 2010, the law repealed the tax entirely. But the legislation expires in 2011, sending estate taxes back to their 2001 levels—a top rate of 55 percent on estates over \$1 million. An estate tax has been in effect continuously since 1916, although limits and rates have varied over the years.

### **An uncertain future**

At the moment, little about the tax is clear. Will Congress pass a new law setting new rates for 2011 and beyond? Would the law apply retroactively to bequests made this year? Or is it possible that partisan gridlock will prevent any new law from passing this year? Late last year, the House passed a bill that would have made the 2009 levels permanent, and Senate Finance Committee Chairman Max Baucus, D-Mont., predicted that Congress would restore the tax retroactively as soon as it returned in late January. But the Senate was unsuccessful even at passing a temporary three-month extension of the estate tax.

“They had eight years to do this, and were unable to pull 60 votes in the Senate last year, when it would have been easier,” says Dick Patten of the American Family Business Foundation, which believes that estates should not be taxed. “I’m scratching my head to see how they could do it this year.”

Patten’s group and others say that any future bill that would make the new tax retroactive likely would not pass.

Other observers such as Bruno Graziano, a senior estate tax analyst with the Riverwoods, Ill., tax research firm CCH, say it’s very likely that some estate tax legislation will be passed this year. “Don’t get into a mindset where you think the estate tax is going away, because I don’t think that it is,” says Graziano.

Even setting the question of retroactivity aside, it’s not at all clear what kind of new law might emerge this year as Congress works against a backdrop of rising deficits and election-year pressures.

Farris and others in favor of an estate tax prefer a bill like the one proposed by Rep. Jim McDermott, D-Wash., that would levy a 45 percent tax on estates over \$2 million, a 50 percent tax on estates over \$5 million, and a 55 percent tax on estates of \$10 million or more. The bill would allow a \$2 million exemption to pass from one spouse to another, so a surviving spouse could leave as much as \$4 million to heirs before the estate reached a taxable level.

Groups on the other side have indicated they would be willing to accept a 35 percent rate for estates over \$5 million, so as to allow a new bill to pass and keep the costlier 2001 rates from coming back as current law dictates.

### **Pitfalls ahead**

While Congress is hashing it out, people with substantial assets should take another look at their estate plans.

The biggest problem for many older Americans isn’t the estate tax itself—it’s a related provision that would have protected their heirs from big capital gains taxes.

When the estate tax was in effect, it included a provision called “step up in basis.” That means that when stocks or other valuables are inherited, the heirs are considered to have acquired the shares at their price at the time of the inheritance.

Say, for example, that Mom has owned General Electric stock for 40 years, and originally paid \$1,000 for it, but it’s now worth \$30,000. If she sold the stock, she would owe capital gains taxes on \$29,000. If she left it in her estate to an heir, and the “step up in basis” rule were in effect, the heir’s “purchase price” would be set at \$30,000, and he or she could sell it at that price without paying capital gains taxes.

But in 2010, the rule applies only to the first \$1.3 million for most heirs and \$4.3 million for spouses. Many older parents who intend to leave a family home and accumulated investments to their children could bump up against that \$1.3-million level. Any excess could be subject to capital gains taxes.

A second problem can arise for people who originally had their wills written with language that would leave to their children and grandchildren “the maximum amount which can pass free of estate taxes,” and the remainder to their spouses.

With no estate tax in effect, says Barry Small, an estate planning attorney for Philadelphia law firm Duane Morris, an entire estate may pass to subsequent generations under terms of a will, and spouses may be left with no inheritance.

So, while the absence of legislation may create tax-free windfalls for the heirs of the handful of uber-wealthy people who may die before this issue is resolved, it creates problems for most people, and few opportunities.

As Small noted, “the only way to really take advantage of the repeal of the estate tax this year is to die, which is not that appealing to most people.”