

Estate tax repeal could mean a bigger headache

By Amy K. Kanyuk

The federal estate tax affects less than 1 percent of all Americans and generates a comparatively modest amount of revenue for the federal government. Nonetheless, the tax has become a centerpiece of the tax reform firestorm. Republicans, demanding nothing short of full repeal, and Democrats, willing to concede only modest decreases to the levy, are equally passionate about the fate of the estate tax.



The estate tax was enacted in 1916, and, until 2001, remained relatively unchanged, except for occasional rate adjustments and increases in the exemption amount. The 2001 Tax Act – which included the largest tax cut in 20 years – reduced the federal estate tax from 2002 through 2009, and eliminates it completely in 2010. In 2011, the estate tax is scheduled to be reinstated with a top rate of 55 percent and a \$1 million exemption.

Currently, the top estate tax rate is 47 percent and the exemption amount is \$1.5 million. This means that if you die in 2005 and the value of your property is less than \$1.5 million, your estate will not owe any federal estate tax. A married couple with less than \$3 million in assets can completely shelter their estates from the tax.

Since 2001, President Bush and congressional Republicans have been fighting to make permanent the repeal of the estate tax. On April 13, for the fourth time in four years, the U.S. House approved legislation to permanently repeal the tax. So far, Senate Republicans have been unable to find the 60 votes they need to push the bill through the Senate and onto the president's desk. Republican and Democratic senators currently are negotiating a compromise to complete repeal that may clear the Senate this summer and end the controversy.

'Capital gains headache?'

Why is the estate tax such a hot button? Opponents argue that the tax is inherently unfair, forces families to sell farms and small businesses to pay the tax, discourages savings and taxes money already taxed during a person's working life.

Proponents of the tax counter that full repeal will shield the estates of the super-rich, who already are benefiting from recent tax breaks for dividends and capital gains, and discourage charitable giving. They also dismiss the argument that the estate tax burdens small farms and businesses. Non-partisan studies show that these entities comprise very few taxable estates, and those estates receive especially generous estate tax treatment.

If fully repealed, the estate tax will be partially replaced by a capital gains tax

The anti-tax lobbies often point to the "confiscatory" nature of the tax as an example of its inherent unfairness. Before the 2001 Tax Act, the top marginal estate tax rate was 55 percent. However, the proportion of an estate that goes to pay the tax – called the "effective tax rate" – is actually much lower than the top rate. The difference between the top marginal rate and the effective rate is due to the estate tax exemption, deductions, the effect of estate planning strategies and the progressive nature of the rates.

According to the Internal Revenue Service, in 2003 the average estate subject to the tax paid an effective rate of 18.8 percent, and estates worth between \$5 million and \$10 million paid an effective tax rate of 29 percent.

Defenders of the estate tax say that the relatively low effective tax rates undermine the "confiscatory tax" argument.

However, 29 percent of \$10 million is a big check to write to the government, and the effective tax rate data may not take much wind out of the Republicans' sails. What may prove fatal to

full repeal is the country's growing financial crisis. There simply may not be enough money to repeal the tax.

The Joint Committee on Taxation has estimated that complete repeal would decrease federal revenues by \$290 billion through 2015, and \$881 billion in the decade thereafter. On the other hand, reforming the tax by instituting a \$3.5 million exemption and 45 percent top rate could raise enough revenue to cover one-quarter to one-half of the Social Security trust fund over the next 75 years, while at the same time subjecting three out of every 1,000 estates to the tax.

Finally, there is the dirty little secret of estate tax repeal – if fully repealed, the estate tax will be partially replaced by a capital gains tax. Currently, any property you inherit comes with a "stepped-up basis."

This means that if you sell an asset after you inherit it, you pay capital gains tax only on the difference between the asset's sale price and its date-of-death value. You do not pay capital gains tax on appreciation that occurred during the deceased owner's lifetime. Upon full repeal of the estate tax, most of the benefits of the basis step-up will disappear.

A deceased owner's basis in property will be carried over to the heirs, so if you sell inherited property, you will pay tax on appreciation that occurred during the decedent's lifetime. As with the estate tax, there are some exceptions to the new "carryover" basis rules, but for many estates the exceptions will not be sufficient to cover all of a decedent's property.

Your estate tax headache will be replaced with a capital gains headache, which you will share with your financial adviser, since the burden will be on you to track basis – a difficult (and in some cases nearly impossible) task.

The estate tax debate is far from over, and the senators on both sides of the debate are working hard to find a solution that will make their constituents equally unhappy. Stay tuned. **NBR**

Amy K. Kanyuk of the Concord law firm of McDonald & Kanyuk concentrates her practice in the areas of estate, gift and generation-skipping planning for high net worth individuals.