Death and taxes

They stay entwined even if the estate tax goes

by Charles A. Lowenhaupt

In 2001, Congress "repealed" the estate tax, which had been taxing estates since 1916. The repeal is scheduled to be effective in 2010, and private wealth is asking how to plan around it.

The 2001 legislation actually repeals the estate tax for only one year, 2010, leading many to conclude they should encourage parents and rich uncles to live until New Year's Day that year and then die no later than Dec. 31, 2010.

The "sunsetting" of the estate tax repeal—that is, the provision reinstituting the estate tax in 2011—is a topic in Congress as President Bush encourages tax reform. Many believe the provision itself will be repealed so that the 2010 scheme of no estate tax will survive indefinitely. Others, more skeptical, expect Congress will enact new forms of estate-tax relief, even for 2010, without allowing repeal to take place.

Celebration of the repeal is somewhat overenthusiastic in any event. Perhaps most ominous is the provision of carry-over basis. Under the traditional estate tax, assets included in a decedent's estate receive a cost basis equal to fair market value at date of death, meaning the built-in gain on an appreciated asset disappears as soon as that asset passes through an estate. The result is a tax benefit, particularly when the estate itself is small enough that estate tax is not imposed (generally today $1 million but scheduled to increase gradually to $3.5 million in 2009). Another result of the step-up in basis is simplification of record-keeping, a benefit that had led to repeal of a carry-over basis provision enacted in 1976 but determined to be unworkable even before it seriously took effect.

The 2001 repeal of the estate tax, however, returns carry-over basis, meaning that a decedent's death will not eliminate built-in gains. In effect, the estate tax is replaced with a capital-gains tax, possibly at lower rates but with rates subject to increase.

Under the repeal legislation certain step-up is to be allowed. It is complicated enough that estate-tax repeal will never be confused with simplification. Your lawyer and accountant will have plenty of advice beginning in 2009 about how to build your estate plan around the carry-over basis rules.

Then there is the gift tax. In 1924 Congress enacted it to supplement the estate tax by ensuring that wealth could not be transmitted during the donor's lifetime free of tax.

This time around Congress has decided to continue the gift tax even after repeal of the estate tax. The expressed reason is to ensure parents will not use gifts to assign income-producing assets to low income-tax paying children who can return those gifts as needed by parents. Yet any parent likely to make that assignment is likely to have children who already have substantial income. A more probable motive is to avoid the kind of rush that occurred from 1926-1932, when the tax was repealed and there was a spike in gift giving.

Even as the amounts that pass free of estate tax (even if passing other than to a spouse) and generation-skipping transfer taxes are increased from $1 million this year to $3.5 million in 2009, the comparable amount that might be given away free of the gift tax during a lifetime stays at only $1 million.

Congress wanted to guarantee that the only passage to tax-free wealth transmission was through death's jaws.

Similarly, Congress continues the generation-skipping transfer tax, the 1986 grandchild of the estate and gift tax structure, taxing trusts passing from generation to generation. The repeal legislation continues to tax any trust created before repeal as it passes from generation to generation.

All of this means that even after repeal of the estate tax, the "transfer taxes" will continue to target gifts and generation-skipping transfers.

So how should you plan around the repeal of the death tax? Start by analyzing your goals and objectives; that is, decide what you want to do with your wealth as if there were no tax. Then consider the tax issues.

Recognize that the repeal may never shelter you. You might die before or after 2010, and Congress may change its mind. So continue to plan your estate as you might have before the repeal.

Make your annual gifts of $11,000 per donee and try to use property without substantial appreciation. Pay for educational and medical expenses of others directly to the providers. Utilize the full amount available of your $1 million exemption on giving without a gift tax; leverage those gifts, as desirable and possible, using limited partnerships and limited liability companies, charitable trusts, grantor-retained annuity trusts, stock options and other traditional planning devices—all as if there were no repeal on the horizon.

In making those gifts, once again generally use assets that are without substantial appreciation. Consider the desirability of making the gifts ultimately for future generations and utilizing your generation-skipping tax-exempt amounts.

If charity is an object of your bounty, observe that the repeal of the estate tax will reduce the tax efficiency of gifts at death to charity, while the continuation of the income and gift taxes will continue to allow you to have the government help pay for charitable gifts. So such gifts might be accelerated and made during your lifetime (when, in any event, you have the satisfaction of tracking the success of the gift).

Should you pay gift taxes? We have told clients for 70 years that the surest way to save estate tax is to pay gift tax, but today we are not so confident. If repeal takes and stays in place, gift tax will generally be wasted except to increase somewhat the cost basis of assets transferred.

On the other hand, if repeal does not take place, well-made gifts will as always help reduce ultimate taxes. If there is an opportunity not to be missed—such as an asset that looks as if it will appreciate dramatically over the coming years—consider the transfer of that asset even if gift tax is incurred.

If your estate is large enough that you are willing to diversify your planning structure, determine an amount you are willing to pay to keep Uncle Sam in britches and make as tax-effective a gift as you can design. As always, the ultra-high-net-worth among us have opportunities not to be missed.

Will we see the death of death taxes? We may see the repeal of the estate tax, but death and taxes remain as intricately entwined—and as certain—as ever. Estate plans require as much if not more attention now than they did before we learned of the "repeal."

Plan your estate actively—unless, like one of our clients, you can declare that your estate tax is one levy for which you will never write a check. When presented with volumes of techniques to save taxes for the benefit of his children and grandchildren, the client asked "What has posterity ever done for me?" ■

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