Bloomberg.com

Death Tax Lives in Estate Repeal for Heir Who Must Sell Assets

2010-05-07 04:01:00.17 GMT

By Ryan J. Donmoyer and Margaret Collins

May 7 (Bloomberg) -- Blanche Christerson, an executive in Deutsche Bank AG's private wealth management division, loves her 85-year-old ailing mother, Hedda Lark, of Manhattan Beach, California, and isn't ready for her to die. Still, Christerson says, she and her mother are bothered that in discussing Lark's estate, they wrestle with tax complications that didn't exist just a year ago.

Christerson, 54, is responsible for managing her mother's estate. The wealth adviser says she fears she may be one of about 60,000 Americans who the U.S. Congress's Joint Committee on Taxation projects will be caught in a novel tax trap. Those who inherit estates worth more than $1.3 million this year face an expensive quandary caused by the repeal on Jan. 1 of the 94-year-old federal estate tax, Bloomberg Markets magazine reports in its June issue.

Under a little-noticed twist, these people will owe capital-gains taxes if they sell assets they inherit. And if their loved ones die in 2011, the levies are scheduled to be even higher. Under 2009 rules, which Congress may reinstate, many of them would have paid nothing.

"It's really a mess for a lot of people," says Christerson, who has spent much of this year so far counseling clients facing similar situations. "As heirs, we would have been better off under the old regime."

Five months into a year that marks one of former President George W. Bush's biggest tax-policy changes -- the end of what he called the death tax -- confusion reigns.

Client Purgatory

Estate planners and their wealthy clients are in purgatory, struggling with whether to spend tens of thousands of dollars to restructure wills, only to have to spend even more if the law is changed again.

Estate planning under ordinary circumstances is expensive and complex. The new environment poses unforeseen risks, such as potential heirs finding themselves unintentionally disinherited if wills aren't properly rewritten, Christerson says. Others face new tax and accounting complications.

"It's a total, complete nightmare," says Carol Harrington, head of the private client practice group at Chicago law firm McDermott Will & Emery. "Clients are frustrated."

It all happened because nine years ago, U.S. lawmakers approved a little-publicized footnote as part of phasing out the estate tax. To hold down the cost to government, Bush's
2001 tax legislation replaced the estate tax in 2010 with capital-gains levies on inherited items that are sold.

Gradual Change

That decision also satisfied Democrats who argued that large amounts of wealth appreciation would escape tax altogether in the absence of both estate and capital-gains taxes.

The Bush administration crafted the policy not in Congress but in the U.S. Treasury Department's Office of Tax Policy, as part of a broader $1.6 trillion tax cut. The law whittled away the estate tax gradually over nine years, raising the tax-free level of an estate to $3.5 million per person in 2009 from $675,000 in 2001.

It also reduced the tax rate for bequests above those amounts to 45 percent in 2009 from 55 percent in 2001. Unless Congress acts, the estate tax will be resurrected on Jan. 1, 2011, as if Bush's tax cuts had never happened. The tax rate will be 55 percent on every dollar in excess of $1 million per individual.

For most of the decade since the law was enacted, legislators moved on to other matters.

'Clogging Channels'

By the time Democratic Representative Earl Pomeroy of North Dakota sounded a warning about the potential new tax quagmire in late 2009, the Democratic leadership in Congress was so focused on adopting President Barack Obama's health- care overhaul that efforts to avoid the tax mess died.

Pomeroy introduced a bill to keep the estate tax as it was in 2009. It passed in the House but not in the Senate.

"It does reflect the clogging of the channels here," says Michigan Representative Sander Levin, a Democrat who's acting chairman of the House Ways and Means Committee. He says the stalemate between Democrats and Republicans that bogged down legislators in health-care debates for all of 2009 carried over to almost all bills.

"With the estate tax, people need to plan," Levin says. "We need some give and take in the Senate."

Obama's proposed 2011 budget poses an ironic challenge for Republicans and Democrats. Obama wants to bring back the estate tax as it existed in 2009. That would stop the rules from reverting back to 2001 levels and represent a tax cut to 45 percent from the 55 percent it would be if Congress makes no change.

Calculating Gains

And it would increase the tax-free allowance to $3.5 million from the $1 million now slated to take effect in 2011.

A sole heir who sells inherited assets valued at more than $1.3 million must account for their original cost. So if Grandpa bequeaths 100 shares of Google Inc. he bought in 2004's initial public offering at $85 a share to a granddaughter and those shares were worth $600 each in January when he died, the granddaughter would pay a 15 percent capital-gains tax on $51,500 if she sells the stock, or $7,725.

Last year, the granddaughter might have paid nothing because the old estate-tax law effectively reset the securities' worth to fair market value on the day they were inherited.

It gets more complicated. People who inherit stock have to reconcile the original price paid for each share with decades of splits and reinvested dividends. Heirs also must account for the initial price of coins or stamps in a collection.

Art and Jewelry

The recipient of Grandma's Renoir or Monet has to determine how much the grandmother paid for the painting -- or its value at the time she may have inherited it. For collectibles such as art and jewelry, the capital-gains tax rate is 28 percent.

These taxes have been on the books since 1997, when Congress reduced capital-gains rates for securities, businesses and homes -- but not for collectibles. They were irrelevant to heirs under the estate-tax law.

"The tax itself is only the tip of the iceberg," says Earl Blumenauer, a Democratic representative from Oregon, who voted against the bill in 2001. Some people will spend weeks researching and working with accountants for what could turn out to be a small tax burden, he says.

Home Pricing

As an estate planner, Deutsche Bank's Christerson knew about the capital-gains tax. She just never expected it to take effect because Congress had repealed a similar tax law in the 1980s after business groups protested the legislation.

A home purchased in the early 1970s for $65,000 is her mother's biggest asset. It's now worth about $2.5 million. Had Lark died in 2009, her entire estate would have passed to her heirs tax-free.

If Lark dies this year, Christerson and her two siblings could have to pay a 15 percent capital-gains tax if they inherit her home and sell it. They'd have to use their mother's original purchase price and make adjustments for depreciation and at least five major renovations during the past 40 years to calculate the profit.

Laurence Keiser, an estate-tax lawyer and certified public accountant at Stern Keiser & Panken LLP in White Plains, New York, is already wrestling with a similar situation. A client of the firm died in February, with a $2.3 million estate, most of it in securities.

'Time and Money'

It will take months to plow through brokerage records to determine what she paid for the stocks, Keiser says. That means delays for her heirs who are waiting to receive their money.

"In 2009, this would have been a very easy estate," Keiser says. "Now, it's going to take time and money to do everything right."

For the past two decades, the National Association of Manufacturers, the U.S. Chamber of Commerce and anti-tax organizations lobbied Congress to get the estate tax eliminated. They were funded in part by the owners of Koch Industries Inc., Mars Inc. and Wal-Mart Stores Inc., according to Public Citizen and United for a Fair Economy, two nonprofit research groups.

The anti-tax organizations clashed with Berkshire Hathaway Inc. Chairman and Chief Executive Officer Warren Buffett and Bill Gates, founder of Microsoft Corp. The two wealthiest Americans have testified before Congress in favor of retaining the estate tax.

'Progressive and Meaningful'

They say the government can't afford to lose the revenue, which would total $669.8 billion from 2010 to 2018, according to the taxation committee. Buffett also told senators that tax cuts for the most affluent families are bad for the nation.

"A progressive and meaningful estate tax is needed," Buffett told the Senate Finance Committee in 2007. "In a country that prides itself on equality of opportunity, it's becoming anything but that as the gap between the superrich and the middle class widens."

Today, the NAM and the USCC say the current law is bad for business, and they're asking Congress to bring back the estate tax. They support a proposal by Republican Senator Jon Kyl of Arizona and Democratic Senator Blanche Lincoln of Arkansas to adopt a levy that would set a 35 percent rate on estates exceeding $5 million.

That plan would decrease federal revenue by $342.4 billion from 2010 to 2018, compared with the 2009 rates, the taxation committee estimates.

'Our Mantra'

"Our mantra was full repeal just to keep everyone on the same page," says Dena Battle, director of tax policy at the NAM. Battle worked as a lobbyist on the issue for a decade, starting before the law was passed.

By 2006, Battle says, the NAM changed its goal to find a compromise solution. The group supports the Kyl-Lincoln proposal. To win, it will have to overcome legislators who have vowed to try to reinstate the 2009 estate tax retroactively.

With no resolution yet reached, estate lawyers can only guess about what to do.

Estate-tax attorney Harrington says one of her wealthy clients, a small-business owner, died suddenly this year. Harrington says she's not sure how to file the estate's tax return -- which she has nine months from the day her client died to do -- because the repeal may be reversed and the tax could be brought back retroactively.

'No Idea'

"We would normally be looking at what we were going to do to raise money to pay the taxes and what all of our options are," she says. "We have no idea whether we'll even owe the estate tax or not, but it would be hundreds of millions of dollars."

Estate planners' No. 1 hope is that Congress will clean up the tax morass this year. Levin says one temporary solution under consideration would allow heirs in 2010 to choose between the 2009 rates and the new ones to see which treats them the most beneficially.

Estate attorney Keiser says there's no simple answer for clients. Some people may need to adjust formulas in trusts, he says. Others might have to add contingencies in wills anticipating a variety of tax situations.

Keiser, whose firm has vaults filled with wills that may need updating, says the mess keeps him up at night. He doesn't know what to tell clients.

Impractical Solution

The simplest way to avoid the capital-gains tax is to not sell inherited assets, says Linda Hirschson, an estate-tax lawyer at Greenberg Traurig LLP in New York. But that's impractical in many cases because heirs don't want to keep a parent's home or family business.

Ultimately, every stratagem involves risk, uncertainty and cost, so many clients are reluctant to make expensive changes to their wills.

"What I'm finding is that people don't want to do the planning right now," Keiser says. "They don't want to spend the fees. They're saying, 'Let's see what happens.'"

Hirschson says waiting for Congress to act may be fruitless. “It’s sort of a moving target,” she says.
“There’s a very real possibility they’ll do nothing this year.”For Related News and Information: