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How To Protect Your Family From Estate Tax Uncertainty

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With Washington gridlocked, you should take steps now to protect your heirs and assets.

An Illinois woman inherited not quite $100 million this year. Estate taxes could consume 53%, 45%, 16% or none of it, depending on whether the federal and/or Illinois estate taxes--which both lapsed on Jan. 1, 2010--are reinstated retroactively. "It's wacky to have so many scenarios and not know what the tax is," complains Richard A. Lang, a Chicago partner of McDermott, Will & Emery representing the estate.

You're not crying for the heiress or her lawyer? Then consider another Lang client, a widow trying to divide her late husband's modest estate with the children from his first marriage without incurring ill feelings or big lawyers' bills. The husband's will was tied to the defunct federal estate tax. Now, by one legal reading the widow gets everything outright. By another, all the assets go into a trust that ultimately goes to the children, with the widow having access to the trust's earnings (and, if need be, principal) while she's alive. "This is going to be worked out," Lang vows.

Lots of families are living in similar estate limbo. Under the crazy terms of the 2001 Bush tax cuts, the federal estate tax expired on Jan. 1, 2010 and then springs back to life on Jan. 1, 2011, with only $1 million in assets exempt from a stiff 55% levy on all assets not left to a spouse or charity. Meanwhile, a long-standing provision, which "steps up" the basis of someone's assets to their market value at his or her death (allowing them to be sold immediately with no capital gains taxes due), has also lapsed for 2010.

President Obama and most Democrats want to restore the estate tax retroactively to its 2009 state--meaning $3.5 million per estate would be exempt, the tax rate would be 45% and all assets would get a step-up in basis. Republicans want a higher exemption and lower rate. When and how this gridlock will end is anyone's guess. After all, rational folks (including most estate planners) had assumed the pols would cut a deal before the tax expired. Complicating matters: Any retroactive tax is likely to face an epic court fight from rich heirs, perhaps including those of Texas pipeline tycoon Dan L. Duncan, who died in March with (we estimate) $9.8 billion.

You need to be careful even if you don't have as much as Duncan. Here are some tips.

Have contingency plans. Make sure your estate plan accounts for a year with no estate tax, as well as a minimal $1 million exemption next year. Typically, a couple's wills are designed to use each spouse's estate tax exemption, without leaving a surviving spouse short of funds. When the first spouse dies, the exemption amount goes into a "bypass" trust for the children and the rest goes outright to the surviving spouse. The survivor has access to trust income and, if needed, principal, but the amount in the trust bypasses his or her estate.

With no estate tax such formula-driven plans don't work as intended, with too little, too much or even nothing left to certain heirs. So far ten states have passed laws saying that an estate's executor can fund the trust as if the 2009 estate law is in place; Florida has decided to require heirs to go to court to sort it out.

If you have a bypass trust, consult a lawyer now. You may be able to do a cheap fix with a codicil that clarifies how your assets should be allocated if there is no estate tax when you die. Or, if your plan is old and you live in a state with an estate tax, consider a will rewrite that might help your family minimize the combined federal and state tax bite. (Nineteen states and the District of Columbia have their own estate taxes, and these laws are also constantly in flux.)

Get the basis. Track down your cost basis for securities, collectibles, real estate and other appreciated assets. For 2010 deaths the law allows a $1.3 million step-up in basis for property left to anyone, plus an additional $3 million step-up for property left to a spouse. (So a spousal heir can get $4.3 million in total step-ups.) If your property has more than $1.3 million in unrealized gain, your executor will need to allocate the allowed step-up to different assets and heirs--meaning he'll need to know the basis of each item.

If you don't die this year, your research won't go to waste; it will help you avoid the temptation to hold on to a bad investment because you don't know its basis and to manage your capital gains as tax rates rise

Reconsider your executor. Maybe the son, daughter or sibling you named as executor because he or she lives close by and "gets along" with everyone is still up to the task. Maybe not. The executor may have to make complicated and delicate decisions--for example, which assets, going to which heirs, get stepped up in basis. "Beneficiaries will start sniping after the fact," warns Kenneth Brier, a Needham, Mass. estate lawyer. You may want to name a nonheir as executor to reduce potential conflicts of interest. Once you settle on an executor, related or not, consider granting him or her the latitude to make decisions without fear of being sued, suggests Norman Benford, chairman of the trusts and estates practice at Greenberg Traurig.

Give a little. The estate tax uncertainty reinforces the wisdom of giving away some assets while you're alive--so long as you're sure you won't need them. Anyone can give anyone else up to $13,000 a year in cash or assets without having to worry about gift taxes. So you and your spouse could transfer $26,000 a year to each child or grandchild. You can also pay anyone's education or medical bills, without dipping into the $13,000 exclusion, if the payment is made directly to the school or medical provider.

In addition, each person gets a lifetime gift tax exemption of $1 million. (Once the estate tax comes back, gifts made under this provision will reduce your estate tax exemption dollar for dollar.) Above that $1 million the gift tax rate this year is just 35%. Yes, there's a risk that Congress could retroactively reinstate 2009's 45% gift tax rate. But wealthy families are making taxable gifts now, in part because they worry that Congress might crack down later on techniques such as grantor-retained annuity trusts and family limited partnerships. (Both are used to hold down the taxable value of gifts.)

Give a lot. If your spouse is in failing health (and a U.S. citizen) consider giving him or her most of your assets, suggests New York City estate lawyer Jonathan Blattmachr.

Why? Gifts to citizen spouses aren't taxed, and if your spouse dies this year while there is no estate tax, you can pass down more to your kids and grandkids, free of estate tax. Note: Except where state taxes are relevant, there's nothing to be gained from giving away the last $1 million.