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Estate Taxes: How to Beat The Levy That Won't Die

- By LAURA SAUNDERS

An elderly client recently asked Bruce Bettigole, an attorney with Gilmore, Rees & Carlson in Wellesley Hills, Mass., whether her children would inherit her considerable estate if she committed suicide this year.

His response: "I took a long, hard look at her, and said, 'I'm going to make believe I didn't hear that question.'"

Welcome to the macabre world of estate planning 2010, where such questions are relevant. They stem from the fact that this year there is no estate tax, but on Jan. 1, 2011, it snaps back with a low $1 million exemption per individual, down from $3.5 million in 2009, and a 55% top rate, up from 45%. (By the way, the answer to the question is "yes": A suicide won't affect federal estate taxes and inheritances, though it can affect insurance payouts.)

The return of the estate tax in 2011 presents dilemmas even more gruesome than those of a year ago, when taxpayers clung to life past Jan. 1, 2010, to escape death duties their estates would have owed in 2009. This year, by contrast, the tax code is giving taxpayers an incentive not to live but to die—saving heirs as much as 55 cents of tax on a dollar of assets.

Resolution is nowhere in sight, although Congress is expected to raise the 2011 exemption at some point. The Bush tax-cut extension has lawmakers so tied up that they have pushed the estate tax to a back burner. According to BNA's Daily Tax Report, Senate Finance Committee Chairman Max Baucus (D., Mont.) said on Nov. 16, "We're barely talking about it, let alone ready to make a decision."

More on Taxes

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The current mess began late in 2009, when the Senate dropped the ball by failing to pass the House of Representatives' extension of the $3.5 million individual exemption and 45% top rate. That caused the estate tax to lapse for 2010. (The one-year lapse was hastily enacted in 2001 and never expected to take effect, but lawmakers failed to fix it.)

Advisers already are dreading the end of the year. One anguished attorney heard this week from a client newly diagnosed with pancreatic cancer, which is often swiftly fatal: "I just couldn't talk about the difference between dying this year and next," the attorney said, "but I'll have to."

Although some have joked about "throwing Momma from the train" before 2011, attorney Joshua Rubenstein of Katten Muchin Rosenman in New York believes a greater danger is tax-motivated suicides: "Most people don't kill their relatives, but I'm afraid that moms and dads who are already sick will quietly kill themselves."

How to handle this terrible limbo? There are no clear answers and individual situations vary. Howard Zaritsky, an estate attorney in Rapidan, Va., who acts exclusively as an adviser to other estate attorneys on tough issues, offers the following counsel. He stresses that this advice comes with no guarantees:

• Assume that at some point the estate tax for 2011 and beyond is changed so there is at least a $3.5 million exemption per individual and 45% top rate, retroactive to Jan. 1, 2011. It is plausible that the exemption could go as high as $5 million per individual and the rate as low 35%, but less likely the tax will be repealed—as some are pushing for—in a time of budget crisis.

The no-estate-tax regime of 2010 will probably not be retroactively repealed, but there is sentiment in Congress for allowing estates of those who die this year to choose between the current regime and final law for 2011. That is because some heirs—mostly those of estates between $1.3 and $4 million—fare worse under current law due to a change in capital gains tax for heirs.

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There are ways to elude the estate tax. Above, Canarsie Cemetery in the Brooklyn, New York.

• If death is on the horizon, take advantage of every simple legal loophole to reduce the size of an estate. Each taxpayer can make annual gifts of $13,000 in cash (best), securities or property, tax-free to anyone else with no limit on the number of recipients. Medical-care payments, including health insurance also is tax-free, and tuition can be prepaid.

"When there are several children and grandchildren, it's often possible to move surprisingly large amounts, especially if you straddle a year and relatives are in private school or college," says Mr. Zaritsky. If some heirs receive unequal portions (say, because one has children in college and another doesn't) it's possible to equalize through a simple will codicil.

• If assets are still vulnerable despite such planning, look to taxable gifts and generation-skipping and other trusts. This often involves writing a check to Uncle Sam, but gift tax rates this year will probably be the lowest ever: 35%.

Going this route requires good legal help—and planning. Because it still isn't clear what Congress will do, it's best to make arrangements now and act on them late this year.

"Don't think you can start this process after Christmas and get it done," Mr. Zaritsky says. "If you want to transfer securities on Dec. 28, it could take two weeks unless the recipient already has an account at your firm. Get your ducks in a row."