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Wealthy Lock In Low Gift Levy as Time Runs Out on 0% Estate Tax

By Ryan J. Donmoyer - Oct 7, 2010 12:01 AM ET

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The 84-year-old widow gathered her children at the Chicago offices of the law firm McDermott Will & Emery LLP and told them they were going to get a special Christmas gift this year: half of her $20 million fortune.

The decision to pass on her money while still alive was prompted by the deadlock in Congress over renewing Bush-era tax cuts that could make providing for her heirs much more costly if she dies after Dec. 31.

"She said, 'I don't want anyone wishing I was dead,'" said her lawyer, Domingo Such, who declined to identify the client.

Estates are exempt from all taxes for 2010, and the rate shoots up to 55 percent next year unless lawmakers act in a post-election session. That means the best tax-reduction strategy, short of dying in 2010, may be to transfer assets to family members this year and lock in a historically low gift-tax rate of 35 percent.

At first, the 84-year-old woman's heirs thought she was joking about her fear of a death wish, Such said. The repeal of the estate tax this year -- which the economist Paul Krugman has called the "Throw Momma from the Train" law in his New York Times column -- has generated much black humor about unfortunate accidents befalling wealthy parents as Dec. 31 approaches.

Such says his client made a bet that she would reduce her tax bill by as much as 40 percent by rewarding her heirs immediately, compared with what she would pay if she dies in 2011 or beyond. The gift tax also is scheduled to rise to 55 percent Jan. 1 without congressional intervention.

'Lowest Rate'

"This is the lowest rate that the gift tax has ever been at; it's only going to get higher," Such says.

Gift taxes have long been matched with estate taxes to prevent the wealthiest from ducking the Internal Revenue Service after death. Americans can give away a total of $13,000 this year without any tax consequence, up to a $1 million lifetime maximum. When the allowance is spent, gifts are taxed at the same rate as estates. The exception: the 0 percent estate-tax rate prevailing in 2010, which is accompanied by a 35 percent gift tax, equal to the top marginal rate on ordinary income.

All of those rates were set in 2001 as part of an effort by then-PresidentGeorge W. Bush and his Republican allies to abolish the estate tax permanently. After encountering opposition from congressional Democrats, they had to settle for a gradual reduction over a decade culminating in a one-year repeal for 2010.

Bush Tax Cuts

Now, Congress is sparring over what to do with the estate tax as part of a larger debate over Bush's tax cuts, which all expire at the end of the year. Democrats last month postponed any discussion on extending the cuts until at least mid- November, after the congressional elections and before most of the newly elected lawmakers are seated.

President Barack Obama and House Democrats still want to restore 2009 rules that exempted the first $7 million of a couple's estate from any tax and applied a top 45 percent rate to the remainder. Most Republicans still back extending the repeal. In the Senate, Arizona Republican Jon Kyl and Arkansas Democrat Blanche Lincoln have attracted support from both parties with a 35 percent rate and a $10 million exemption.

While five billionaires, including New York Yankees owner George Steinbrenner, have died this year leaving behind fortunes that were exempt from taxation, lawmakers have made little progress on fixing the estate tax next year and beyond.

Retroactive for 2010

Senate Finance Committee Chairman Max Baucus, a Montana Democrat, vowed in December to reinstate the estate tax retroactively for this year. Tax experts said they don't expect him to be able to make good on that promise.

That is prompting more people to look at the low gift tax in their estate planning, said attorney Linda Hirschson, a shareholder at the firm Greenberg Traurig.

"People are doing planning and operating on the assumption we're really not going to have an estate tax" this year, she said.

Older people are more likely to make taxable gifts than younger people, she said. “It’s a case-by-case basis,” she said. “I find younger clients are less inclined to do it. If it’s a hedge fund guy in his 40s, he might be willing to make some gifting, but not a lot to incur the upfront tax cost.”

Wealthy people in poor health also have to consider whether they’re likely to die within three years of making the gift, in which case special tax rules would cut any savings in half, Such said.

Joshua Rubenstein, head of the estate and trust practice at the New York Law firm Katten Muchin Rosenman LLP, said clients are all hedging their bets by waiting until late December to transfer wealth as gifts to children and grandchildren. That’s to ensure the giver doesn’t die before year’s end, in which case the gift tax would have been needlessly paid.

“This is going to be the craziest year-end ever,” Rubenstein said.

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