

Estimated Tax Void has Unintended Consequences

Check wills to make sure that there are no surprises; consider accelerating gifts in 2010

By Robert N. Gordon

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There is good news and bad news having no estate tax this year. The good news is obvious: no estate tax.

But the bad news is that there is no longer a step-up in basis for property with unrealized capital gains. This means that some heirs could pay more tax this year than if the estate tax were still in force.

The previous step-up in basis on inherited property meant that heirs used as their cost basis the market value of the property at the time they received it.

Without the step-up and without the estate tax, unrealized gains on property aren't taxed on the death of the person making the bequest but instead at the time when inheritors — who assume the original owner's cost basis — sell the property. In other words, only when heirs sell the property are capital gains triggered.

This change could cause enormous nightmares as heirs try to reconstruct and document the cost basis of inherited property. There is some comfort that in 2010, the government allows a \$1.3 million step-up of unrealized appreciation to heirs and an additional \$3 million if the inheritor is the spouse.

Who can be hurt?

Although wealth has always transferred from spouse to spouse without being subject to estate tax, the same won't be true for property that is inherited in 2010, which will be subject to capital gains taxes if it has high amounts of unrealized gain. Children receiving property with unrealized gains exceeding the allowance will face a new calculus on what to do with inherited shares.

Inherited real estate with a negative basis and limited value will create a taxable gain this year — more than would have been imposed last year, or when new rules kick in next year.

To reflect the temporary elimination of the federal estate tax and the risk that money won't be distributed as intended, most wills need to be amended. Wills for most sizable estates are set to distribute property among heirs with reference to amounts allowed under estate laws or generation-skipping tax provisions that (for this year, at least) don't exist.

As an example, to maximize wealth transfer under the old rules, many wills are constructed to leave the maximum allowable amounts to the next generation without triggering the estate tax. After that, everything else goes to the spouse free of estate tax.

Using that methodology in 2010 could cause all the wealth to go to the next generation, with nothing for the spouse — certainly not what was intended. That is why anyone with a sizable estate should check with his or her attorney to make sure that the necessary provisions are in place.

Aside from trying to die between now and Dec. 31, are there ways to take advantage of this unique year?

First, considering that the old law may be put back in place retroactively, don't do anything you would not have done under the old law, or make sure whatever you do is reversible. One thing your clients might consider is giving a gift.

This year, the tax rate on gifts stands at 35%, down significantly from last year's 45% and sharply below the 55% rate that is scheduled to kick in next year.

Additionally, there is no generation-skipping transfer tax in 2010.

When that tax comes back in 2011, money gifted to grandchildren or descendants further down the line is scheduled to be taxed at a rate that is a tad below 80%. By that standard, 2010's 35% gift tax looks like a bargain.

In a December report, the Congressional Budget Office predicted that gifts will rise to \$42 billion this year, from \$3 billion last year. It bases that assumption, in part, on past experience.

When the Tax Reform Act of 1976 raised the maximum gift tax rate to 70%, from 57.75%, gift tax receipts quadrupled in the months between the law's enactment and its effective date, according to the CBO.

A few strategies for gift giving that have been suggested can be undone if the laws change retroactively. There is some talk that even if a retroactive law were put in place, it would give taxpayers the option of filing under the current "no-tax" regime or whatever new one replaced it.

Since finding a middle ground where both political parties can hammer out a compromise has proven difficult, there is no reason to believe that we will see a bipartisan solution this year, especially considering the coming elections.

Given the political climate, the possibility exists that we won't have an estate tax in 2010.

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