

# 2010 Estate Tax Update: Can Congress Find a Solution?

By Paula Calimafde

The federal estate tax system is in a state of chaos. Despite some discussion among lawmakers in the past year, there has been no progress or change to report. The outlook for a good resolution is somewhere between bleak (*some believe the best possible result will be having the 2009 estate tax law reinstated for two years only*) to murky (*a compromise may be in the works which will provide a permanent solution*) More details on these and other possible outcomes below.

What's the problem? In a numbers nutshell, last year's (2009) estate tax exemption (*amount not subject to estate taxes*) was \$3.5 million. Assets in an estate above this amount were subject to a 45% tax rate. Basis in property received a step-up in basis up to date-of-death values. This means that heirs had a tax value (or basis) in the property equal to its value as of the date of the decedent's death.

Fast forward to 2010; the estate tax is repealed. Repeal is advantageous for the very wealthy, but heirs may end up paying substantial capital gains tax on assets inherited in 2010 when they sell those assets. A significant number of small taxable estates are actually worse off under repeal than they would be under the 2009 estate tax law due to the loss of the step-up in basis.

Absent Congressional action, in 2011 estate taxes will return with a vengeance. The estate tax exemption is scheduled to be cut back to \$1 million and the top estate tax rate will increase from 45% to 55%.

## What Congress Has Been Saying This Year

Some members of Congress want the 2009 estate tax law to be reinstated this year retroactive to January 1, 2010. Many agree except they don't want the reinstatement to be retroactive - and others want to give 2010 estates the option of choosing to come under the 2009 estate tax law or the 2010 no estate tax system (*sometimes referred to as the election approach*).

The "progressive" members of Congress think that nothing should be done so that next year the estate tax exemption is \$1 million and the top estate tax rate increases to 55%. They do not want to give any "tax breaks" to what they perceive to be the "wealthy." Others, particularly in the Senate, who come from big ranching and farm states, want to have a \$5 million exemption with a 35% tax rate. Some suggest starting at \$3.5 million with a 45% rate and over a 10-year period phase in the \$5 million exemption with a single 35% rate. One school of thought is that a \$3.5 million exemption with a cost of living adjustment is good enough and that the rate should remain at 45%. Still other members suggest a multiple rate system, calling for an estate tax rate of say 35-45% on the first \$10 million of assets over the exemption amount and a higher rate on assets in excess of that amount. And many members believe they can only allow the 2009 estate tax law to be reinstated for two years due to pay-go considerations (*defined below*).

After all this time, the only thing you can say for sure is that members of Congress seem to be having an extraordinarily difficult time coming up with a compromise (*requires 60 votes in the Senate*). Yet just as I finished writing this, a potential plan to pay for permanent estate tax relief at the \$3.5 million exemption level may have been found....

A group of liberal Senators (*Sanders, Whitehouse, Harkin and Brown, the latter from Ohio*) recently introduced a new estate tax bill, the **Responsible Estate Tax Act**, (S.3533) which would, among other things:

- Establish the estate tax exemption at 3.5 million permanently (no indexing for cost of living adjustments) and reinstate the estate tax law as it existed in 2009

- Impose the following tax rates on estates in excess of 3.5 million:
  - 45% on assets over \$3.5 million up to \$10 million
  - 50% on assets over \$10 million up to \$50 million
  - 55% on assets over \$50 million
- Impose a 10% surtax on assets in excess of \$500 million
- Retroactively reinstate the estate tax back to January 1, 2010 so that the step up in basis to date of death values is put back in place
- Disallow minority discounts for “nonbusiness” assets
- Provide additional relief for farmers, allowing them to reduce the value of their farmland by \$3 million
- Require GRATs (Grantor Retained Annuity Trusts) to have at least a 10-year term

In essence, this bill would remove the vast majority of small businesses, family farms, and ranches from the federal estate tax, since these groups generally have estates below \$5 million and the vast majority have estates at or below \$3.5 million. This permanent exemption would be paid for by charging the super-wealthy estates with higher rates, including the 10% surcharge on assets above \$500 million, and making the estate tax retroactive to the beginning of this year.

We mentioned “pay-go” a little earlier and promised you a definition. In an effort to be fiscally responsible, both the House and the Senate have decided they will not pass tax legislation that loses revenue unless there are offsetting provisions that “pay” (i.e., raise revenue) for those provisions. Certain items were exempt from pay-go; in the Senate, but not in the House, for instance, pay-go is not needed to reinstate the 2009 estate tax law retroactively for 2010 and to keep it in place for 2011 (i.e., a two-year fix). Of course, either or both Houses could decide to waive pay-go on a particular bill if they so chose, but in the Senate such action with respect to the estate tax would require a 60-person vote.

The “cost” of making the 2009 estate tax law permanent over a 10-year period has been scored at about \$250 billion. Increasing the exemption amount to \$5 million and reducing the estate tax rate to 35% adds another \$50 to \$60 billion. Thus, the bill introduced by this small group of liberal Senators meets pay-go by increasing the tax rates on the “mega estates.”

As mentioned above, most of the Republicans and some Democrats would prefer to increase the exemption amount to \$5 million (*even if phased in over 10 years*) and reduce the top tax rate to 35% (*again even if phased in*). Yet up to this point, nobody has figured out how to raise the revenue to pay for it and there do not appear to be 60 votes in the Senate for either the proposal or for waiving pay-go for the proposal.

In the estate tax relief debate, the super-wealthy and small businesses have been tied together, even though if the exemption amount were large enough, small business and most farmers and ranchers would be “out of the game.” For the super-wealthy, the name of the game has always been rate reduction, which is why increasing the dollar amount of the exemption holds little interest for them. A one percent decrease off the top rate means a whole lot more to someone with a \$500 million potential estate than a \$10 million exemption off the bottom. It is important to understand that a great many small business owners, farmers and ranchers have estates in excess of \$1 million, in part due to insurance and the value of their land. The scheduled 2011 estate tax law would cause many of these family businesses to be sold (*or some or all of the assets sold*) to pay the extremely high estate tax bills that will be generated in 2011 if Congress does not act. This is why the estate tax issue is one of the most critical issues facing this vital sector of our economy, a sector that is responsible for most of the new jobs, growth and innovation.

Most small business owners, ranchers and farmers want at least a \$3.5 million exemption that would be adjusted for inflation. Many members of those groups are concerned that the provision dealing with family limited partnerships and LLCs could cause a number of problems. Nevertheless, at this juncture, many small business groups are favorably inclined towards S.3533 because it would bring some sorely needed certainty to the estate tax area. So, if this bill gets traction, by taking the vast majority of family and privately owned businesses out of the equation, the more wealthy will be left alone to fight this issue. To gain some momentum, however, this proposal or one similar to it will have to be “adopted” by some of the more mainstream Senators, particularly those on the Finance Committee, which at this point, does not seem to be happening.

A majority of Hill observers believe that some sort of solution for the estate tax mess must be arrived at before August recess because after that, all members of the House and one third of the members of the Senate will be devoting their attention to the upcoming November elections. In most election years, the Hill’s ability to focus on significant legislation ebbs after the August recess. Given that this issue is such a political hot potato, however, and since mid-term elections tend toward some realignment of political

forces, this year it just may be possible to get an estate tax bill after August if the issue has not been resolved before then.

Finally, have you noticed that a number of rich, famous billionaires have been dying recently? Some of the Democrats in Congress have. One might think this would cause a renewed push to come up with some way to reinstate estate taxes retroactively or at a minimum to try to stop the hemorrhaging of lost estate taxes by coming up with a bill sooner than later. Yet as we head toward the dog days of summer, all is still quiet, which is very disconcerting for those viewing the 2011 \$1 million exemption as a ticking time bomb.