# Estate tax to return in 2011, and it could hurt ordinary folks

By Sandra Block, USA TODAY, July 21, 2010

In life, George Steinbrenner beat the Red Sox. In death, he beat the IRS.

Steinbrenner's death on July 13 occurred six months after the federal estate tax expired. *Forbes* magazine estimates the Yankees owner's net worth was $1.15 billion, so the timing of Steinbrenner's death could save his heirs up to $500 million in federal estate taxes.

But future heirs may not be so lucky. The federal estate tax is scheduled to return with a vengeance on Jan. 1, 2011, imposing a levy of up to 55% on estates valued at more than $1 million. And the same congressional paralysis that allowed the tax to expire in 2010 could thwart efforts to pare it back, estate planning attorneys say.

A $1 million exemption would affect a lot of families that are well out of Steinbrenner's league. "You take a home, an IRA or 401(k) retirement account, some other savings and you get to $1 million pretty easily," says Richard Behrendt, senior estate planner for Robert W. Baird and a former IRS attorney.

Families who live in areas with high property values are particularly vulnerable, says Clint Stretch, tax principal for Deloitte Tax who lives outside Washington, D.C. "People in my neighborhood bought a house for $32,000 in the '60s, and now it's worth $1 million," he says. "If they've got anything else, they would be paying an estate tax."

*"If you could do nothing and get more money, it's better than voting to raise taxes to get more money," says Jason Smolen of SmolenPlevy.*

And for truly wealthy families, estate taxes could influence life-or-death decisions. But more on that later.

**Congressional inaction**

The roots of the estate tax disarray date back to 2001, when Congress voted to gradually raise the estate tax exemption while cutting income tax rates. The phase-out ended in repeal of the tax in 2010. But like the Bush administration's income tax cuts, the reduction in the estate tax is scheduled to expire at the end of this year.

Right up until the end of 2009, most estate tax attorneys expected Congress to step in and reinstate the tax. That didn't happen — raising doubts about whether Congress can agree on a fix that will prevent a more punitive tax from rising from the grave in 2011.

"Nine years ago I would have told you there was no chance we would have a year of repeal and no chance we would go back to the $1 million exemption," says Beth Kaufman, a partner with Caplin & Drysdale in Washington, D.C., and former associate tax legislative counsel for Treasury's Office of Tax Policy. "Now that we've gotten to the year of repeal, it's hard to say that something is impossible anymore."

Historically, wealthy individuals have used a variety of strategies to mitigate estate taxes, including giving away a large portion of their wealth while they're still alive. Individuals can give their children, relatives and others up to $1 million during their lifetimes without incurring federal gift taxes, Kaufman says. In addition, individuals can give away an annual amount without reducing their exemption for gift or estate taxes. In 2010, the annual gift tax exclusion is $13,000 per recipient and individuals can give away that amount to as many people as they want. Many wealthy families also reduce the size of their taxable estates by giving money and other assets to charity.

But those strategies aren't practical for families who have most of their wealth tied up in their primary residences and retirement savings, Kaufman says. "You're not going to give away your house, because you're living in it," she says. Taking withdrawals from retirement plans will trigger income taxes, plus a 10% penalty if the plan owner is under 59½.

**Proposed fixes**

The Obama administration has proposed returning the estate tax to its 2009 level, with a $3.5 million exemption and a 45% rate on assets that exceed that amount. The House approved the administration's proposal last year, but Republican opponents blocked action in the Senate.

Last week Sens. Jon Kyl, R-Ariz., and Blanche Lincoln, D-Ark., re-introduced legislation that would exempt up to $5 million from estate taxes and impose a 35% tax rate on assets that exceed that amount.

"In just six short months, American taxpayers will face the largest tax hike in history unless Congress acts," Lincoln said in a statement. "It is estimated that more than a half-million American families will pay the estate tax over the next decade, and the lack of congressional action creates a tremendous amount of uncertainty for these families, small-business owners and farmers."

But political partisanship has made compromise increasingly difficult, says Melissa Montgomery-Fitzsimmons, director of wealth planning for First Western Trust Bank in Denver. "Given the fact that we're in an election year, the most likely thing to happen is that the laws will not change, and we will go back to $1 million of exemption and a 55% rate," she says.

Plus, reinstating the estate tax with a lower exemption would provide lawmakers with a back-door way to raise revenue, says Jason Smolen, an estate tax attorney at SmolenPlevy of Vienna, Va. "If you could do nothing and get more money, it's better than voting to raise taxes to get more money," he says.

Stretch is more optimistic that Congress will resolve the issue before the end of the year. He believes an estate tax with a higher threshold than $1 million — possibly somewhere between the one in the House-passed bill and the one proposed by Kyl and Lincoln — will be included in legislation preventing the middle-class tax cuts from expiring.

That legislation has real urgency, because without it, millions of middle-class Americans will see their taxes go up on Jan. 1, Stretch says. The higher taxes "would come out of people's paychecks almost immediately," he says. "If there's any sanity left in our political system, it will take care of middle-class tax cuts before January and at that moment in time they'll take care of estate tax."

Stretch says there's a good chance the House will extend the middle-class tax cuts and address the estate tax before the midterm elections, possibly as early as this month. But the Senate probably won't take up the issue until after the elections, he says.

**Retroactive tax unlikely**

In the meantime, the list of wealthy estates that will escape federal estate taxes will no doubt continue to grow. In addition to Steinbrenner, families of real estate magnate Walter Shorenstein, Texas pipeline tycoon Dan Duncan and Taco Bell founder Glen Bell will not have to worry about federal estate taxes. J.D. Salinger's heirs will also get a tax break, although establishing the value of the reclusive author's estate could take years.

"If there's ever a good time to die, 2010 is certainly it for the wealthy individual," Kaufman says.

Shortly after the estate tax expired, there was widespread speculation that Congress would reinstate it and make the tax retroactive to the beginning of 2010. But even if Congress agrees on an estate tax fix, it's unlikely lawmakers will be able to make it retroactive, Behrendt says. Families of billionaires who have died this year have the money and wherewithal to fight the tax all the way to the Supreme Court, he says.

"At some point, it becomes impractical to bring it (estate tax) back," Behrendt says. "George Steinbrenner's death in mid-July really underscores that reality."

**Life-or-death tax implications**

As repeal of the estate tax loomed at the end of 2009, wealthy families had an incentive to keep ailing parents or grandparents alive until Jan. 1. This year, in what sounds like an episode of *Law & Order*, heirs stand to benefit if wealthy benefactors die before midnight on Dec. 31. While outright homicide seems unlikely, estate-planning attorneys say they can envision situations in which the prospect of onerous estate taxes influences family members' decision to discontinue a relative's life support.

It could also cause some wealthy people with terminal illnesses to hasten their own demise, Behrendt says. "The fact is that our tax laws are influencing people's decision to live or die."