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Estate Tax Repeal--Update

The Economic Growth and Tax Relief Reconciliation Act of 2001 gradually phases out the federal estate tax until its complete repeal in 2010. Without additional legislation, however, the federal estate tax will return in 2011.

Since 2001, there have been a number of failed attempts to make the estate tax repeal permanent. However, there are still several bills in Congress that include provisions to eliminate this tax, and should one of these bills pass, it will go to President Bush who has said he will sign it into law.

The question is: Will permanent repeal become law, and if so, what are the potential ramifications?

Goodbye estate tax, hello capital gains tax

Repeal does not mean that tax on wealth transfers from one generation to the next will disappear. While currently a tax is imposed on estates, after repeal, a tax will be imposed indirectly on inheritances in the form of capital gains tax. Here's a simplified explanation.

Under the current tax system, property that is transferred to heirs at the owner's death typically gets a "step up" in tax basis. Generally, tax basis refers to the cost the owner paid to acquire the property, and is used to compute capital gains tax when the property is sold. For example, let's say Mr. Smith buys property for $50,000, which becomes his tax basis, and sometime later sells the property for $60,000. Mr. Smith's computed capital gain for tax purposes is $10,000.

When property is transferred by gift, the recipient receives a "carry over" basis; the tax basis in the hands of the person making the gift generally becomes the recipient's tax basis. So, let's say that Mr. Smith gives the property in the above example to his son, John. Mr. Smith's $50,000 tax basis carries over to John, and when John subsequently sells the property for $60,000, John recognizes the $10,000 capital gain.

However, when property is transferred because of the owner's death, the tax basis is stepped up to its current fair market value. Again using the first example, let's say that John receives the property through his father's will. John's tax basis is stepped up to $60,000, the property's fair market value. When John subsequently sells the property for $60,000, John recognizes no capital gain on the transaction.

One of the consequences of estate tax repeal will be that the step up in tax basis will be lost. Heirs will receive a carry over basis on inherited property, and will recognize the capital gain (or loss) when the property is sold at some point in the future.

The question is: Will permanent repeal become law, and if so, what are the potential ramifications?

What will this change in the tax system mean for American families? The current estate tax affects 2% of the most wealthy Americans. Capital gains tax, on the other hand, can affect anyone who owns capital assets. Therefore, unless the step up in basis remains, estate tax repeal is likely to result in creating a higher tax bill for a greater percentage of less wealthy Americans. Further, repeal will create a paperwork headache for heirs who will have to determine the decedent's tax basis in the property they've inherited.

Impact on charitable contributions

The estate tax encourages charitable giving by providing a full deduction for gifts and bequests to qualified charities. Eliminating the estate tax will eliminate this incentive. Some experts theorize that estate tax repeal will result in a decline in charitable contributions.

Studies predict annual giving could be reduced by at least 12% and as much as 40%. These studies, however, assume that donors are motivated to give exclusively or primarily for tax reasons. A key variable, that Americans give to charity for philanthropic reasons, will likely offset the estimated negative affect on charitable giving. In fact, another study posits that without the estate tax, Americans will have more wealth available to both satisfy heirs and make donations, causing donations to increase. If the estate tax is repealed, only time will tell whether charities will suffer, gain, or feel no significant impact from its absence.

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Other pros and cons of permanent repeal

Proponents of permanent repeal regard the estate tax as morally unfair and an obstacle to family business continuity and growth. Critics call permanent repeal a boon to the mega-rich and fiscal suicide in a time of budget deficits, a Social Security and Medicare crisis, and war. The confusing reality is that there is statistical evidence both for and against the arguments presented by each side.

One thing is certain, however; dealing with the uncertainties of the current state of the estate tax is a burden on Americans and their financial planning professionals who must re-evaluate estate planning options every year. For many on both sides of the issue, sensible reform is a preferable alternative to the success or failure of permanent repeal.

Dealing with the uncertainties of the current state of the estate tax

The uncertainty about the long-term prospects of the estate tax is a conundrum. Whether you're willing to bet the estate tax will be permanently repealed or you believe the estate tax is here to stay, planning in advance is as essential as ever. Here are some important facts to keep in mind:

- Even without a federal estate tax, your state may impose a death tax of its own which you need to plan for.
- Though estate tax may be repealed, gift tax will remain. Gift tax planning is still critical to your overall estate plan.
- The estate tax phases out through 2010 by increasing exemptions and decreasing rates. Make sure your will and trusts include formula provisions that take care of these changes automatically.
- Your estate will incur other costs besides estate tax. Be sure your estate will have the cash available to pay expenses such as outstanding debts and liabilities, final medical bills, burial and funeral costs, and executor and attorney fees.

- Estate planning meets other goals besides tax avoidance. You still need to plan to take care of your surviving family members, avoid probate, distribute your estate according to your wishes, make charitable gifts, plan for incapacity, and meet many other objectives.

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