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Estate Tax Will Return Next Year, but Few Will Pay It

By PAUL SULLIVAN

Almost no one will have to worry about paying the estate tax under the tax legislation just approved by Congress. By one estimate, from Alan Rothschild, the chairman of the American Bar Association's real property, trust and estate law section, less than one-half of 1 percent of people who die in 2011 will be hit by the estate tax. In contrast, 10.5 percent paid the estate tax in 1977.

And even for the very few who will be subject to the tax, the increase in the gift tax exemption will allow them to give their heirs tens of millions of dollars before the estate tax even comes into play. "I think people will be seizing the opportunity for next year," said Carol Kroch, head of wealth and financial planning at Wilmington Trust.

The only caveat for the wealthy is that the tax compromise reached by Republican leaders and President Obama is set to expire in two years and revert to much lower exemption levels and a higher tax rate.

"It seems like to me we're just setting ourselves up to repeat 2009 and 2010 all over again," Mr. Rothschild said. "That's the most frustrating part to me."

Still, it has been something of a roller coaster of a year for the estate tax, which expired at the end of 2009 and, despite predictions, was never reinstated in 2010. So billionaires like Dan L. Duncan and George Steinbrenner died, and their wealth was not subject to an estate tax. And the not-so-wealthy fretted that the tax was going to hit more modest estates next year.

But that does not mean that wealthy people should ignore a host of short-term issues. Here are a few of the most important.

OPTIONS FOR 2010 Under the estate tax wording in the bill, the heirs of people who died this year will have two options for a tax bill. If they chose to treat the estate by the tax laws in place in 2010, they will have to calculate the capital gains on all assets in the estate to determine if the value is above a level the Internal Revenue Service is allowing. This "artificial step-up in basis" is $1.3 million to any heir and $3 million to a surviving spouse.

The other option is to apply the 2011 law, which would exempt the first $5 million of the estate and impose a rate of 35 percent on anything above that. This is far more generous than the 2009 law — a $3.5 million exemption and a 45 percent tax rate — which many people thought would be reinstated.

Ed Koren, a lawyer at Holland & Knight who represented Mr. Steinbrenner until his death in July, said that for estates larger than $10 million, it makes sense to calculate the capital gains since the tax rate is only 15 percent.

The estates that benefit the most from applying the 2011 law retroactively are those that would not have been subject to the estate tax under the 2009 regime but could have been forced to pay capital gains taxes this year.

Applying the 2011 law to estates in 2010 is also a gift to an individual estate that is worth more than $3.5 million but less than $5 million. That $1.5 million would have been taxed last year.

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Mr. Koren declined to comment on the specifics of Mr. Steinbrenner's estate, but he said the family was never at risk of losing control of the New York Yankees to pay a tax bill. "I can assuredly say that the Yankees wouldn't have been on the block this year if there was an estate tax," he said.

The reason was years of diligent planning. "It has to be an aggressive and ongoing approach," he said. "I represented George for 22 years."

Yet without the specter of an estate tax, lawyers and accountants worry that people will not plan at all. They will leave what is known in the industry as "I Love You" wills, giving everything to the surviving spouse.

In taking this path, though, the wealthy lose control of how their estates will be distributed. "Estate attorneys have hidden behind the estate tax to discuss leaving assets in trust to spouses," Mr. Rothschild said. "There are other less pleasant reasons to leave assets in trust, such as remarriage and competency."

GIFT BONANZA Much is being made of how low the estate tax rate is above the $5 million exemption. Dan Kesten, a lawyer at Davis & Gilbert in New York, pointed out that a $100 million estate would pay $20 million less in taxes in 2011 than it would have if Congress had not acted and the estate tax had reverted to its 2001 level — a 55 percent tax rate for individual estates larger than $1 million.

But the problem is the law is set to revert to that 2001 level in 2013 if nothing is done to make the current numbers permanent.

The real benefit to the extremely rich is the increase in the gift tax exemption to $5 million from $1 million. To a couple who have given money away to the limit of the old exemption, this means they can pass an extra $8 million to their heirs free of tax.

"That's changing an awful lot of plans," said Kacy Gott, chief planning officer at Aspiriant, a wealth management firm. "Now, with a two-year window, we're expecting a lot of gifts."

But most very wealthy people would never write a check outright for $8 million when they could give assets to their heirs through complicated structures that can multiply the size of their gifts.

Lance Hall, president of FMV Opinions, which provides business valuation services, said he expected his business to boom for the next two years. For one, his firm determines the discount applied to shares in a privately held business. (This happens because such shares are presumed to be harder to sell than marketable securities.) And two, the values of those businesses themselves are still lower than they were before the recession.

If a couple were to give their heirs an $8 million stake in a company that had lost 30 percent in value and was discounted a further 35 percent because it was family-owned, the transfer could be worth two or three times the $8 million.

The other advantage comes from using sophisticated trusts that pass money on to heirs.

Setting up one of these vehicles, a grantor-retained annuity trust, for the two-year minimum has become an even more effective way to move tens of millions of dollars out of an estate tax-free. The reason is that the trusts are structured to use very little of the gift tax exemption.

Jere Doyle, wealth strategist at the Bank of New York Mellon, said he could envision using another strategy, called a sale to an intentionally defective grantor trust, to turn that $5 million gift tax exemption into a $50 million transfer tax-free.

He concedes, though, that it is going to be tougher to get people to think about these trusts, however beneficial they are to their heirs. “The problem is you can’t scare them into your office anymore by saying you’ve got a big tax you’re going to pay,” he said. “You’ve got to come up with a different way to get them in.”