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Federal estate tax remains in flux

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The federal estate tax is on course to be repealed for one year beginning in January, allowing heirs of large inheritances to temporarily escape the so-called death tax although a little-noted provision in the law would expose many smaller estates to higher tax liabilities. Senate Republicans blocked a Democratic attempt to temporarily extend the estate tax earlier this week, meaning that barring any unforeseen action the levy will disappear on Jan. 1. The move was hailed by conservatives who have long opposed the estate tax as a form of double taxation, hitting income once when it is earned and then when it is passed on.

"There's nothing that outrages the American people more than the thought that they will have to visit the IRS and the undertaker on the same day," said Senate Minority leader [Mitch McConnell](#) (R-Ky.).

The celebration, however, is likely to be short-lived as Senate Democrats have promised to pass a temporary measure early next year that would apply retroactively to Jan. 1. Even without a fix, the estate tax is slated to go back into force in 2011, with higher tax rates and lower exemptions than are in the law now.

The complicated situation is the result of a series of Bush-era tax cuts enacted in 2001. Backers of the estate tax cut wanted to outright kill the tax -- which is estimated to raise \$25 billion this year -- but they settled for a plan that slowly increased the tax exemptions for estates while lowering the estate tax rate.

Democrats have long regarded any repeal of the estate tax as helping only the most wealthy Americans at a significant cost in federal revenue. And now that they are in power in Congress, Democrats have worked to keep the tax in place, albeit at modified rates.

Two weeks ago, the House passed an extension of the estate tax at the 2009 rates. The Senate, under the pressure of dealing with a health-care reform proposal, has not agreed on any extension proposals, setting up the current situation.

All of the flux and uncertainty have left tax lawyers and estate planners at a loss. "We don't know what to tell our clients," said Carol A. Harrington, a partner at law firm McDermott Will &

Emery. "Nobody who was in the know thought Congress would be this irresponsible in dealing with a situation that they had on the horizon for nine years."

Currently, the value of inheritances above \$3.5 million for individuals and \$7 million for couples are taxed at a 45 percent rate by the federal government. Smaller estates are exempt from the tax, leaving less than 1 percent of all inheritances subject to the tax. Because of the lack of action by Congress, the estate tax now goes away only to reappear in 2011 with a higher, 55 percent rate.

During the interlude, many estates will be subject to a capital gains tax that they are now exempted from. The capital gains levy would tax the difference between the original price a decedent paid for an asset and the price it fetches when it is sold.

For example, stocks, land or other assets purchased for \$200,000 a half century ago and sold for \$2 million now, would be subject to 15 percent capital gains taxes on the \$1.8 million in appreciation. The first \$3 million is exempted for spouses, and the first \$1.3 million is protected for other heirs. Still, analysts say the capital gains tax will hit many more inheritances than the current estate tax.

"There are going to be a lot of people who are going to be surprised in 2010 who never paid the estate tax and all of a sudden have a capital gains tax burden," said Chuck Marr, a tax expert at the Center on Budget and Policy Priorities.

The uncertainty has split business groups, who generally dislike the estate tax but are even more leery of the confusing situation around the levy.

"This is not a new issue that requires a great deal of deliberation, rather it is an issue that requires leadership and the will to enact what many traditionally opposing parties view as a reasonable compromise," said Todd McCracken, president and chief executive of the National Small Business Association, an advocacy group. "Yet another patchwork, limited fix to the estate tax does very little to truly help small businesses."

Brenda Schafer, a tax expert at H&R Block's Tax Institute, called the entire scenario a nightmare for tax planners. "It's chaos," she said. "It is just crazy because you don't know what to do. The only thing we know for sure about the situation is that it is all going to get undone."