

Uncertainty Swirls Around Estate Tax

MORE IN [MARKETS MAIN](#) »

By [LAURA SAUNDERS](#)

The possible expiration of the federal-estate tax has sent the normally staid world of estate planning into a frenzy of activity, as taxpayers try to cope with uncertainty.

Without the old estate tax in place, some new rules will come into play, potentially forcing families to dig up decades-old records or face big tax penalties. Some other onerous taxes will lapse, potentially cutting bills by two-thirds on transfers to grandchildren. And a debate is raging about whether Congress can pass a bill next year that would be retroactive to Jan. 1.

"These changes bring planning opportunities but also dilemmas, because we don't know what will happen," said Carol Harrington, head of estate planning at law firm McDermott, Will & Emery.

The problem dates back to 2001, when Congress passed an estate-tax law that cut rates and increased the size of estates that would be hit by the tax. Right now, there is a federal tax of up to 45% on estates valued at more than \$3.5 million, which applies to only about 5,500 estates a year. The law mandates that the estate tax disappear entirely in 2010, but then reinstated in 2011 at a 55% rate, with an exemption of slightly more than \$1 million.

Democrats said they will resurrect the law retroactively, in January. Some Republicans likely will oppose making any new law retroactive. But questions swirl around the constitutionality of making the tax retroactive.

The House of Representatives voted this month to make the current law permanent, but Senate Democratic leaders have failed to push through an extension. Some lawmakers are supporting a higher exclusion of \$5 million and a lower tax rate, 35%.

Estate-tax lawyers and planners are shocked and livid. "We never dreamed Congress would be this irresponsible," Ms. Harrington said. "It is the stupidest policy imaginable. People will die, and executors need to move quickly. But no one knows what the law will be."

To get any agreement before Jan. 1, a "phoenix would have to rise from the ashes," said Clint Stretch, a principal with Deloitte Tax LLP, a tax-consulting firm. The House has recessed for the year and would need to be called back. The Senate, still sitting, is enmeshed in the health-care debate.

The question of whether a retroactive fix is constitutional is roiling the blogosphere. Michael Graetz, a professor at Columbia University and a tax expert, believes it is unlikely to be a problem.

Many in Washington believe Democratic congressional leaders will issue a statement saying they intend to make any extension of the tax retroactive to Jan. 1, once Congress reconvenes. Based on history, such a statement would weaken any claim that a retroactive tax is unconstitutional, Mr. Graetz said.

Even if leaders don't make a statement, a retroactive tax still is likely to be upheld. In 1993, the Supreme Court rejected a case challenging a retroactive tax increase that cost the estate of Ellen Clayton Garwood \$1.3 million. Another case with a similar claim on the same law was rejected by a lower court.

A retroactive bill probably will trigger legal challenges. Mr. Graetz and others agree that the longer the estate tax remains unresolved, the easier it becomes to make a constitutional argument, especially if a wealthy person dies when the law is in limbo.

"The failure to act quickly commits the government to years of litigation at best and at worst a substantial loss of revenue," Deloitte's Mr. Stretch said.

Heirs also could take a hit from the fallout of the current estate tax's demise, which does away with a favorable tax provision.

Current law lets heirs figure taxes based on the value of the assets at the time of the donors' death. So if a father dies holding a piece of land acquired for \$4,000 in 1970 that is valued at \$50,000 today, no capital gains tax is due at death, and his heir inherits the land. In preparing taxes, the heir can use that \$50,000 as a start point, called a "cost basis." If the heir sells the land for \$55,000, he pays tax only on a \$5,000 gain.

As of the new year, however, the cost basis of an asset would be the original 1970 purchase price of \$4,000. So the heir could owe tax on a gain of \$51,000 instead of \$5,000.

There is some wiggle room. Each estate would be allowed to use current values for up to \$1.3 million of assets. With proper planning a couple could protect up to \$4.3 million.

But the provision opens the door to multigenerational record-keeping nightmares on assets ranging from real estate to stocks to family heirlooms. Heirs would have to scramble to find out what things cost decades before when preparing tax returns.

A similar imbroglio ensued after a tax-law change in 1976, but it caused such an uproar that it was suspended and later repealed. "It was an absolute horror," said Stuart Kessler, a former head of the American Institute of Certified Public Accountants.

Other little-noticed provisions of the January repeal present quandaries for planners.

On Jan. 1, the generation-skipping tax lapses entirely. This levy prevents grandparents from escaping a layer of tax by giving directly to grandchildren. The top gift tax rate also drops to 35% from 45%. This means that wealthy grandparents would pay far less tax on large transfers to grandchildren.

Under current law, if a grandparent wants to give \$10 million to a grandchild, the donor will be \$21 million out of pocket because \$11 million in taxes will be due. As of Jan. 1, with the estate tax repealed and the same \$10 million gift, the grandparent need only put up \$13.5 million because the tax is only \$3.5 million.

Write to Laura Saunders at laura.saunders@wsj.com