Death Without the Estate Tax?

By HYMAN G. DARLING, Esq.

Although Congress has often discussed the elimination of an estate tax, it has yet to do so.

When George W. Bush was first elected president, part of his campaign was based on his promise to eliminate the estate tax. At the time of this writing, the law currently stands that the exemption through 2008 will be $2 million per person for federal estate taxes. In 2009, the exemption becomes $3.5 million. In 2010, an unlimited deduction is available for any United States citizen, so anyone who dies then will pay no estate tax.

In fact, many practitioners have suggested that in 2010, wealthy clients who are not physically well should consider chartering a plane to the Netherlands or some similar country that permits assisted suicide. Although this may be a harsh statement, this would completely eliminate federal estate tax as the law now stands. The government's plan is to return the limitation back to the amount of $1 million in 2011.

With the current economic and budget crisis in the United States and with the need for additional funds to be raised, it is unlikely that a full, unlimited estate deduction will be available for every individual. Many proposals have surfaced providing that each decedent will have an exemption credit of between $2 million to $5 million, and this would certainly eliminate estate tax for most individuals. Therefore, with proper planning, a married couple would have the benefit of up to $10 million in assets that could pass to family members or friends without any estate tax.

With estate taxes making up less than 1% of the income received by the federal government from all sources, it is hard to imagine why the government would not consider eliminating this tax. It has been suggested that there be should be a tax on the very wealthy. Certainly, they can either afford to pay the taxes or leave a significant portion of their wealth to charity, which eliminates estate taxes.

Many charities are concerned that without an estate tax the charitable intention will be lessened, and wealthy individuals will plan fewer gifts without the incentive to reduce their tax liabilities. However, in light of Hurricane Katrina and other recent natural disasters, it appears that many companies and individuals may make significant gifts without regard to the value of a tax deduction, even though recent legislation has allowed increased gifts with fewer limitations for deductibility on income tax returns.

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There are two other reasons for maintaining at least some form of estate tax. The Internal Revenue Service needs to justify many of its employees in the estate and gift tax area. There are thousands of individuals who process estate tax returns, audit them, and process payments. They could possibly lose their jobs, and may not be able to reclassify their positions within the government if the estate tax was totally eliminated.

Another group lobbying for a persistent estate tax includes insurance companies. Life insurance is often sold in order to replenish wealth as a result of payment of estate taxes. In order to alleviate the requirement to sell property, force a closing and sale of businesses, or liquidate other stocks or personal assets, life insurance is often used as the means to obtain 'fast cash' for payment of estate taxes, which are due nine months from date of death.

Another frequently sold option is the so-called joint and survivorship policy, or second-to-die policy, which is marketed as one policy on two lives, normally a husband and wife. Since all estate taxes may be deferred until the second death, the second-to-die policy is available as a resource that provides for liquidity upon the second death, when the significant tax liability is due.

If there were no estate taxes, there would be less of a need for life insurance in the role of estate tax liability. However, there may still be a need for life insurance if a person has a spouse and children, and also wishes to ensure that funds are available to pay mortgages, provide liquidity for college education or otherwise supplement the surviving spouse or children in order to meet their future needs.

The government has also suggested that in the event that estate taxes are eliminated, there may be an adjustment to the basis of assets that are passed on to heirs upon death. This will result in significant income tax issues for heirs to review in lieu of estate tax issues.

Under the current rule, in most situations, assets passing to children receive a date-of-death basis if as the asset is includable in the estate for estate tax purposes, even if there is no estate tax due. Under suggested rules, there may be a threshold of between $1 million and $1.5 million for basis adjustment, but assets in excess of this amount will be taxable at the basis of the person who died.

Since assets included in the exempted amount are flexible, this could cause significant problems within families who may argue about one sibling's inheritance being included as a step up asset and another sibling's inheritance being taxed at the lower basis.

Therefore, it will be essential to do prior estate planning around the allocation of the basis adjustment and make decisions about which assets will be sold and which assets will be maintained upon death.❖

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