

Continued Elimination of the Estate and Gift Tax?

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“...the estate tax has no redeeming qualities...[t]here is no theoretical or empirical basis to suggest that the estate tax promotes fairness or reduces inequality.”

The Senior Economist for Congress' Joint Economic Committee, December 1998

President Bush's Presidential campaign proposed the elimination of the estate tax. Congress somewhat dutifully took up the legislation in earlier this year. However, somewhere along the way the concept was warped by the political necessity of keeping the total revenue reduction below the \$1.35 trillion previously approved by the Senate. As a consequence, the bill eliminated the estate tax for one only year, 2010. On January 1, 2011, the entire bill, including the estate tax elimination, is automatically revoked in its entirety - taking us back to the laws as they existed in 2001. It should also be noted that although the bill eliminates the estate tax in 2010, it never eliminates the gift tax.

While the bill raises the maccabe spectacle of family members exercising medical powers of attorneys in 2010 for tax reasons, it also provides significant uncertainty for estate planners and those selling life insurance to cover the cost of a diminishing estate tax. Will the Congress vote to continue the elimination of the estate tax after 2010? It is highly doubtful, for a number of reasons, including:

X The politics of wealth will allow opponents of elimination to easily attack those who want to eliminate the tax. Although the revenue reduction is estimated to only be \$236 billion over 10 years, political expediency, not economics will assure that the transfer tax system remains. Moreover, all opponents of the elimination have to do is control one organ of the political process (i.e., the House, Senate or White House) and the continued elimination is dead.

Even if the Republicans control all three political arenas, in order to eliminate the tax, the Republicans would have to have filibuster-proof control of the Senate. Few expect the Republicans to have enough votes to break a filibuster and pass such a tax bill over Democratic objections, especially while losing those Republican legislators who want to reform, but not eliminate the estate tax. Those Democrats who voted for repeal during the Clinton presidency do not have the comfort of knowing they have a President who will veto any repeal.

X Polls indicate most Americans want to eliminate the estate tax. But, according to a number of studies, only 2% of decedents are subject to the estate tax. The estate tax has a limited impact on the population and its elimination will probably be traded away for broader-based tax reform, like the reform of the Alternative Minimum Tax. When the 2001 tax bill is fully phased in, the number of middle class Americans subject to AMT will explode and reform of the system will become a political necessity.

X The surplus is already diminishing rapidly and if reform of other tax areas (e.g., AMT) occurs, there will probably not be enough money left in the surplus to eliminate the estate tax. Because the AMT system impacts more Americans, its reform will have broader support than the elimination of the estate tax.

X Although estate taxes have made up only 1.1% to 1.3% of the federal revenue during the 1990s, this percentage is expected to grow rapidly as the single wealthiest generation that has ever lived dies and passes trillions of dollars to its heirs. A study by Boston College estimates that between \$41 and 136 trillion will pass by the year 2050. Given the concerns that many elderly Americans

have taken more out of the social security and medicare than they put into the systems, some in Congress may view the estate tax as a repayment of these distributions.

- X Thirty-eight states have adopted an inheritance tax which is equal to the maximum credit given against the federal estate tax for payment of state taxes. The 2001 tax bill eliminates this credit over 4 years and replaces it with a deduction. As a consequence, states will either have to lose significant revenue (by some estimates as much as \$70 million over 10 years) or adopt new inheritance taxes which are no longer tied to the federal estate tax. There is no assurance that the states will adopt the large tax exemptions granted by the federal government -which could result in higher state inheritance taxes on estates which are not subject to any federal estate tax. This dichotomy will further complicate estate planning and reduce the benefit of the higher unified credits provided for in the 2001 tax bill.
- X There is widespread concern that the elimination of the estate tax will reduce the level of charitable bequests in the country. Opponents are using this concern to press for a reduction of the estate tax, but not an elimination. But see the contrary article by Hilton Kramer in the February 21, 2001-edition of the Wall Street Journal.
- X In February of this year, Warren Buffett and over 300 hundred of America's wealthiest citizens publically opposed the elimination of the estate tax. They pointed out that the purpose of the tax was not to raise revenue, but to avoid creating a class of perpetually wealthy in America. Increasingly, the debate may shift to the taxation of the super-wealthy as a social issue. See the article in the New York Times February 14, 2001. A column by William H. Gates, Sr. describing why the estate tax is a societal necessity can be found in the February 16, 2001-edition of the Washington Post. It makes interesting reading.
- X If the estate tax is eliminated, the law also calls for the elimination of the step-up in basis that occurs at death. The new carry-over basis rules will be complex to administer and will place the burden on heirs of showing the decedent's basis in an asset - an often difficult process when assets have been held for decades (e.g., what is grandfather's basis in the railroad stock he acquired in 1940 - after all the splits, mergers and stock dividends which have occurred?). The complexity and burden of the new basis rules will lend support to the reduction, not the elimination of the estate tax.

The 2001 tax bill notwithstanding, the estate tax is not going to be eliminated anytime soon. For an excellent series of articles on the debate, see the Money and Investing Section of the Wall Street Journal for Monday, February 26, 2001.

This does not mean that tax reform is not possible. It should be anticipated that one or more of the following may occur:

- X An increase in the Unified Tax Credit. Best guess is an increase to as much as \$2-4 million per taxpayer.
- X Allowing a cost of living adjustments to the new Unified Credit, once it fully phases-in.
- X Adoption of a federal estate tax business deduction which is not so complex as to be unusable. Moreover, the business deduction will probably no longer be reduced as the Unified Credit increases.
- X New transfer tax and income tax incentives for charitable contributions.
- X Reduction in the top estate tax bracket in the range of the reductions in the 2001 tax bill.
- X A lengthening of the current lower transfer tax brackets (e.g., increasing the point where the 45% rate kicks in to \$5.0 million).

X Increasing the annual exclusion from \$10,000 per donee to perhaps \$15-20,000 per donee.

When will any changes occur? Most likely around the next Presidential election - in 3 to 5 years. While reform of the transfer tax system is overdue, continued elimination is borders on being a fantasy. Unfortunately, we are going to face 3-5 years of uncertainty while we wait on Washington.

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