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The Future of the Federal Estate Tax

The Bush Administration sought to eliminate the federal estate tax altogether in the 2001 Economic Growth and Tax Relief Reconciliation Act—and almost succeeded. But there weren't quite enough votes in the Senate for outright repeal.

So the Bush Administration struck a Faustian bargain, which provided for the phase-out of the estate tax over 2001-2010, with the tax in 2011 to spring back to life at the 2001 top rate of 55 percent and a $1 million exemption if Congress does nothing.

Why did the Bush Administration agree to this? Apparently, they believed everyone would be so relieved to see the hated "death tax" die that not even the most liberal of liberal Democrats would dare to try to resurrect it. Well, as Michael Corleone said to his mother in *The Godfather II,* times change.

In the years following 2001, a number of Republican Senators, most notably former Senator Don Nickles (OK) and Senator John Kyl (MS), exhorted their colleagues to compromise with moderate Democrats to agree on the largest possible permanent exemption. It was reported that a deal almost was made on a permanent $10 million exemption. But hardliners unwisely held out for total repeal of the "death" tax.

The result is the Obama Administration soon has to propose what to do with the federal estate tax—and no one is betting on an exemption remotely close to the $10 million exemption that was "doable" during the Bush Administration. To borrow a phrase from the late, great Vince Lombardi, the future is now.

What happens next year if Congress does nothing? For one "brief shining year," which may be thought of as the Camelot of estate planning, *there will be no estate tax*. If you meet the Grim Reaper in 2010, you die tax-free—the epitome of a good news/bad news situation.

What does this mean in practical terms? Big Daddy has an estate of $12 million. If he dies on December 31, 2010, the estate tax is zero. This means his two children, Bro and Sis, each get $5 million. But what if Big Daddy dies *after* the stroke of midnight? If he dies in 2011, the top estate tax rate will be 55 percent and the exemption will be only $1 million. This means Bro and Sis wind up with approximately half of what they would have gotten if Big Daddy had died before the stroke of midnight.

Pity the poor physician required to certify the time of death when $6 million in taxes are at stake, depending on which side of midnight Big Daddy died. A little pressure to fudge the time of death…? The irony is the 2001 Economic Growth and Tax Relief Reconciliation Act may end up spurring economic growth for an unintended class: writers of crime novels.

So What's Likely to Happen to the Estate Tax in the Short Run?

During the 2008 campaign, candidate Obama said he favored making permanent the $3.5 million exemption and a top rate of 45 percent. These just happen to be the exemption and top rate in effect for 2009.

If this becomes the "permanent" law, not many estates will be taxable—a fact some left-leaning Democrats find unpalatable. According to IRS statistics, fixing the exemption at $3.5 million will result in only about 8,000 estates per year owing tax (or fewer than two percent of annual deaths).

Through careful estate planning, e.g., using testamentary trusts to make sure that each spouse maximizes the full extent of the credit available to each individual, a married couple can "shelter" $7 million. And, of course, there is the testamentary charitable contribution, which results in an estate tax reduction. Still, we have come a long way from a near deal on an exemption of $10 million.

On May 11, 2009, the Treasury Department published *General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals,* the so-called "Green Book." The Administration is proposing that for 2011 and thereafter, the 2009 federal estate tax rates (45 percent top tax rate) and exemptions ($3.5 million) will apply. But "thereafter" is open to doubt.

The Green Book also revealed the plan to end the "free pass" for 2010, the magical year free of estate tax. The Administration proposes instead to apply the 2009 rates and exemptions in 2010, resulting in a projected $3 billion in tax revenues.

How Does the Long-Term Future Look?

The extension of the 2009 federal estate tax rates and exemptions may *only* be for 2010. Federal budgets for fiscal years 2011 and thereafter are premised on the assumption of a "roll back" of the estate tax rate and exemption to 2001 levels, i.e., 55 percent top tax rate and a $1 million exemption. The rollback is projected to bring in more than $13 billion annually for the near term. This is not an impressive number by federal standards. For comparison purposes, consider that in 2007, Americans donated in excess of $306 billion in charitable contributions, according to the Giving Institute. Nonetheless, in a fiscally challenged environment when the Treasury is "priming the pump" by lavish spending, $13 billion in tax revenues may be too enticing to pass up.

If you meet the Grim Reaper in 2010, you die tax-free—the epitome of a good news/bad news situation.

Federal fiscal year 2010 begins on October 1, 2009. There is, to say the least, a lot on the President's plate. Thus, it is probable that in 2009, Congress will only take up the federal estate tax rate and exemption for 2010. The long-term future of the estate tax will be deferred until 2010 or maybe even later. Congress in 2010 may enact another one-year extension, "kicking the can down the road," as the expression goes.