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Mind the Estate Tax Gap

Sure, heirs of the ultra-rich who die this year will get a break on estate taxes, but they could wind up paying even more in taxes on capital gains

By Amy Feldman

For some time, people have been making morbid jokes about bumping off their rich relatives in 2010, a year that has no federal estate tax. The George W. Bush-era law that lowered the tax contained a one-year gap that Congress has never gotten around to fixing. The tax is set to return, at a 55% rate, on Jan. 1, 2011.

Few are laughing about it now. While heirs of the ultra-rich who die this year may enjoy an estate tax break (17,172 taxable estate tax returns were filed in 2008, according to IRS data), this gap year is having an unintended consequence. Far larger numbers of affluent families who suffer deaths this year could wind up paying stiff capital-gains taxes on inheritances. That's because of the disappearance of what's known as the "step-up" in basis, which allowed assets to be revalued for tax purposes at the time of death. "Many people are going to be worse off than before," says Clay R. Stevens, director of strategic planning at Aspiriant, a Los Angeles wealth-management firm. "If you've only read the sound bites, you've been misled."

Under last year's rules, estates below $3.5 million (or $7 million for a couple) were exempt from the estate tax; people above those limits were hit with rates as high as 45%. Crucially, assets were revalued at the time of death—"stepped up" to their full current value and not subject to capital-gains tax on past appreciation. When the estate tax went on hiatus, the "step-up in basis" rule for valuing assets went, too, so heirs are suddenly liable for capital gains on the past appreciation of assets they inherit and sell. For those who are bequeathed homes that have grown in value, family businesses that have expanded, or stocks that have risen in price, the old "step-up" rule let them start with a clean slate, owing no capital-gains taxes when they sold the assets. Not anymore.

An executor can now assign a "step-up" basis of up to $1.3 million to assets in the estate, and an additional $3 million for assets left to a surviving spouse. Many affluent families that have held assets for decades will bump up against those limits. Consider someone who inherits from their widowed father a home purchased for $100,000 decades ago that is now worth $2.5 million. Under last year's rules, assuming that was the only asset in the estate, there would have been no tax due because the estate would have been below the exemption amount. This year there would be no estate tax due either, but there would be capital-gains tax due on the $1.1 million in gain above the allocated step-up —$165,000 at the current 15% federal rate.

Things get more complex when family dynamics come into play. If there are multiple assets going to multiple heirs, the executor must choose how to allocate that $1.3 million in tax basis among the assets, a Solomonic task. "It may be applied so that it doesn't equally benefit all beneficiaries," Aspiriant's Stevens says. "You have to say, 'I'm giving you this asset and you get the step-up in basis, but I won't give it to that asset.' So two beneficiaries could receive the same fair market value of assets, but different amounts of aftertax value."

Take that example a step further. Assume that in addition to the $2.5 million house, there's $2.5 million in IBM (IBM) stock, bought for $500,000. If the house goes to the deceased's daughter and the stock to the son, the two would seem to get equal amounts. But because the daughter will owe more capital gains when she sells the house, she has actually received less—unless the executor allocates a larger portion of the step-up in basis to offset it.

Brent R. Brodeski, managing director at Rockford (Ill.) wealth-management firm Savant Capital Management, outlines a scenario where one adult child inherits a family business worth $5 million, with a tax basis of $1 million, and the other inherits $5 million in cash. Last year those bequests were equivalent in value. But without the step-up, the family business has an embedded capital gain that would be due at the time of the sale. Even if the executor allocated all of the $1.3 million to the business, that would still be the case, since there's $4 million in appreciation. "Does that mean that you have to look at the family business net of tax, and the kid with the cash has to ante up to the kid with the business?" Brodeski asks. "The kid with the cash says, 'My brother doesn't want to sell it, so I don't want to give him a bonus.' And the kid with the business says, 'I don't know if I want to pass it down to my kids, I might want to sell it.' How do you resolve that debate?"

These questions fall to executors, who face potential lawsuits from disgruntled heirs. There's also a record-keeping nightmare: tracking capital improvements parents made to a home or determining all the stock splits that occurred in a stock over 50 years. Estate attorneys are urging children of elderly parents who expect to inherit property that has substantially appreciated to ask parents to gather records now.

Last year the conventional wisdom was that Congress would fix the estate tax problem before yearend. More than three months into 2010, it's clear that even if Congress fixes the rules, it won't happen fast enough to forestall some families' estate tax hell. "I imagine we'll have decades-long court battles over it," says Brodeski. "It's a big, fat mess."

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