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## Estate Tax Repeal May Cut Some Benefits Too



**MONEY TALK**  
LIZ PULLIAM WESTON

The idea of repealing estate taxes is increasingly popular among politicians and their baby boomer constituents, who are set to receive trillions of dollars in inheritances during the next 30 years.

But some heirs may find they would be trading one complicated, expensive taxation system for another—and giving up at least one and possibly two valuable tax breaks in the bargain.

The estate tax repeal bill that passed the House of Representatives earlier this month would phase out the so-called death tax over 10 years. Currently, estates worth more than \$675,000 face federal estate tax rates that start at 37%.

The legislation, however, also would eliminate what's known as the step-up in tax basis for estates over a certain size. That could make selling inherited assets an expensive proposition, not to mention creating a nightmare of tax paperwork, because heirs would have to pay capital gains taxes based on what the original owner paid for the property rather than what it was worth at the time the owner died.

This is a big deal for some inheritors, but it has been largely ignored in the mainstream media—perhaps because estate taxes are complicated and often difficult to understand, and perhaps because only the richest Americans are likely to be affected.

Given the stakes involved, however, it's worth spending a little time to educate yourself; should the bill become law, your estate plans could be affected radically.

"Any estate planning that occurs right now has to consider the possibility of repeal," said Michael B. Allmon, a certified public accountant in Marina del Rey and chairman of the California Society of CPA's estate planning commission.

First, a few definitions. "Basis," for tax purposes, is generally the amount you pay for an asset; when you sell the asset, the basis is what is subtracted from the sale price to determine your taxable gain.

Currently, most property that is inherited is given a new cost basis for tax purposes. If you paid \$20,000 for a home in the 1950s that grows to \$250,000 in value by the time you die, for example, the home would be revalued for tax purposes—or "stepped up"—to reflect the value at the time of death. If your heirs then sell the house for \$250,000, they would owe no capital gains tax.

Under the House bill, however, some assets would no longer receive that favorable step-up in basis. Your heirs would be required to pay capital gains taxes on the difference be-

### Who's Paying

Internal Revenue Service figures show 42,901 estates paid estate taxes in 1997—the latest year for which figures are available. That represents about 2% of the taxpayers who died that year. Nearly half of the \$16.7 billion in estate taxes paid came from the 5% of estates worth more than \$5 million.

Estate size	Taxes paid in 1997	No. of tax returns
Up to \$1 million	\$834 million	19,006
\$1 million to \$2.5 million	\$4.3 billion	17,606
\$2.5 million to \$5 million	\$3.4 billion	3,954
\$5 million to \$10 million	\$2.7 billion	1,414
\$10 million to \$20 million	\$2 billion	592
More than \$20 million	\$3.5 billion	329

Source: Internal Revenue Service

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tween what you paid for the asset—\$20,000 in our simplified example—and the eventual sale price. In the example, what would have been a tax-free sale under current rules could generate a capital gains tax bill of \$63,000 for Californians in the top income tax brackets.

And just imagine how fun it would be to try to keep track of basis over many years, and possibly many generations if the property is inherited more than once. It's hard enough keeping track of basis during one lifetime, said Robert L. Sommers, a San Francisco tax attorney and publisher of the Tax Prophet Web site.

"Just try to figure out what the basis is in a mutual fund after investing for a few years," Sommers said.

The House bill does include two exemptions that preserve step-up in basis for most people. The first \$1.3 million of any estate could receive a step-up in basis at death, and a married person could leave an additional \$3 million to a spouse with a stepped-up basis. So up to \$4.3 million could be passed to heirs without estate tax and with a step-up in basis—a very good deal for most inheritors because most estates are worth far less than \$4.3 million.

However, at the surviving spouse's death, only \$1.3 million could be passed on with a step-up in basis; the \$3 million passed on by the first spouse would retain the basis given at the first spouse's death.

It's unclear how the bill, which proposes to eliminate estate taxes by 2010, would affect the double step-up in basis that Californians and other residents of community property states now enjoy. The double step-up revalues both halves of property owned by a married couple when one of the spouses dies. (In non-community property states, only half of the property is revalued at a spouse's death.) It appears the House bill would eliminate that double step-up, said Doug Badger, deputy chief of staff for Rep. Jennifer Dunn (R-Wash.), who sponsored the House bill.

The bill still must be considered by the Senate and in current form faces a likely veto by President Clinton, although strong bipartisan support could sustain an override.

Should a repeal in some form eventually become law, the ramifications could be far-reaching for those with substantial assets and those expecting to be on the receiving end.

For example, attorneys and accountants speculate that baby boomers' parents could become more tightfisted.

Current estate tax law encourages wealthier people to reduce the size of their estates by making gifts while they're alive, because estates worth more than \$675,000 now face estate tax rates that start at 37% and climb to 55% for estates worth more than \$3 million. (The size of estates that escape tax is scheduled to rise under current law to \$1 million by 2006.)

That's why many people take advantage of provisions that allow anyone to give away \$10,000 per recipient per year without triggering gift taxes.

A repeal of the estate tax would reduce the perceived necessity of such giving.

With repeal, charities might see fewer huge bequests, as well. Currently, any money given to charity at death escapes all estate taxes. With no estate taxes, the motivation for big bequests may decline. Taxpayers could still receive an income tax break for assets given away during life, of course, but estate planners say many people are reluctant to let go of money or property because they're concerned they will need it before they die.

"We get a lot of clients to consider it [charitable giving at death], because they see the tax benefit they get," said Jeffrey Zabner, an estate planning attorney in Westlake Village. "If that's taken away, they won't do it."

Finally, retirement accounts could begin to play an even greater role in estate planning. Without estate taxes, more money could potentially be passed to heirs, particularly via Roth IRAs, which offer the distinct advantage of withdrawals that are free from income taxes.

What estate-tax changes aren't likely to do is reduce most people's need for estate planning. Californians would still need living trusts to avoid probate costs, and nearly everyone should have plans for dealing with illness and incapacity.

In addition, wealthier people would continue to want trusts to control the flow of money to heirs. And many people would simply need help making the tough decisions about whether and when to give away assets during life.

"I don't think estate planning attorneys will be out of a job," Zabner said. "In fact, we may be busier than ever."

Liz Pulliam Weston is a personal finance writer for The Times and a graduate of the personal financial planning certificate program at UC Irvine. She can be reached at [liz.pulliam@latimes.com](mailto:liz.pulliam@latimes.com).