



BY ALLAN SLOAN

## Doing a Big Favor For the 'Small Rich'

**W**HEN THE Senate turned down President Bush's bid to repeal the estate tax permanently last week, it actually did a favor for tens of thousands of moderately well-off households—the “small rich,” if you prefer. That's because such households would be worse off under the full repeal scheduled for 2010 (which Bush wants to make permanent) than they would be under the 2009 rules, which are more favorable for estates than today's rules. According to a study by Congress's non-partisan Joint Committee on Taxation, 7,500 estates would be better off under full repeal in 2010 than under the 2009 rules—but more than 60,000 would be worse off.

This isn't exactly what you heard during last week's debate, is it? How on earth could the beneficiary of any estate be better off under the 2009 rules than under the 2010 version of

permanent repeal? The answer gets a little complicated—but please bear with me.

It has to do with the difference between so-called stepped-up tax basis and carry-over tax basis. Under current law, when you die your heirs get stepped-up tax basis. That means the assets you bequeath are valued for income-tax purposes at what they were worth the day you died—not what you originally paid for them. Say you paid \$50,000 for stock that's worth \$500,000 when you die. Your heirs can sell it for \$500,000 and owe no tax on the \$450,000 gain. As long as your total estate doesn't exceed the exemption limits, there's no estate tax, either.

Now watch. Under the 2009 rules, estates of up to \$3.5 million (\$7 million for a married couple) would be exempt from federal estate tax. The tax rate on assets above that level would be 45 percent. Inheritors would

be able to step up the basis of \$3.5 million (or \$7 million) of inherited assets to their value the day they inherit them. Flash forward to 2010, when the estate tax is repealed. Yes, the estate tax would be gone. But heirs would be able to step up only \$1.3 million in assets to their value on the day of death. (Don't ask why; that's just how it is.) Assets above \$1.3 million would be valued for tax purposes at carry-over basis—their cost (for income-tax purposes) for the person who died. So any estate with \$1.3 million to \$3.5 million in assets (\$2.6 million to \$7 million for a married couple) is worse off under full repeal in 2010 than it would be in 2009. Inheritors in the \$1.3 million-to-\$3.5 million range would face higher taxes if they sold inherited assets than they would under the 2009 rules. At the very least, they would have complicated paperwork to deal with. They'd be much better off inheriting in 2009 than in 2010. But if you're dealing with an estate of \$3.5 billion rather than \$3.5 million, you'd be far better off inheriting in 2010.

How many estates are we talking about? To answer that, let's consult the aforementioned study by the Joint Committee on Taxation. The study, requested by John Buckley, chief Democratic tax counsel for the House Ways and Means Committee, projects that 7,500 people who die in 2009 will have an estate-tax liability—remember, that's estates of more than \$3.5 million. The study also projects that 71,400 people will leave estates of \$1.3 million or more. This means that 63,900 people—71,400 less 7,500—will leave estates of

\$1.3 million to \$3.5 million. As I've shown, such estates are better off in 2009 than in 2010. “There are lots more losers than winners under full repeal compared to the 2009 rules,” says Buckley, who used the study for a 2005 paper in *Tax Notes*, a professional journal. Yes, Buckley's a partisan. But it doesn't make him wrong—the numbers are the numbers.

Under current law, the estate-tax exemption drops to \$1 million in 2011. (The Bushies built that into their 2001 tax cut to make its total cost seem more reasonable.) This would subject broad swaths of the middle and upper-middle classes to the estate tax—which is one reason the “eliminate the death tax” crowd got so much political traction in the first place. The original idea of an estate tax was to assess a handful of very rich people to avoid excessive concentrations of wealth while helping to finance the system that made that wealth possible.

It seems to me that adopting the 2009 rules, indexing the exemption for inflation and allowing a full step-up in basis would get us back to the original intent of the estate tax. Taxing 7,500 estates a year doesn't seem unfair. And it

would generate significant revenue.

What we shouldn't do is eliminate the estate tax to the benefit of a few, very large estates and to the detriment of the small rich and everyone else. We've already done that with the alternative minimum tax, which hits the middle and upper-middle classes but not the truly wealthy. Let's try not to make the same mistake again.

### BY THE NUMBERS

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SOURCES: JOINT COMMITTEE ON TAXATION, NEWSWEEK CALCULATIONS