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In Agreement on Estate Taxes, Even More Complications

By PAUL SULLIVAN

FROM a tax perspective, dying last year seemed a simple proposition for the wealthiest people in America: their assets would pass to their heirs free of federal estate tax because the tax had lapsed.

But for some of these estates, the tax issue has turned out to be incredibly complex.

The reason is the terms of the agreement reached last December by President Obama and Congressional Republicans. The two sides agreed that the estate tax for 2011 and 2012 would exempt the first $5 million in assets per person and that any assets above that would be subject to a 35 percent tax rate. (Had they not reached that agreement, the exemption this year was set to be $1 million and a 55 percent tax rate.)

But instead of trying to impose the tax retroactively on the assets of people who died in 2010, the agreement allowed executors to make a choice: they could file an estate tax return under the new law or they could opt out. But in opting out, the people who received the assets would have to pay a different set of taxes when they sold those assets.

And the deadline for making that choice is coming up soon — Nov. 15.

(For most estates from 2010, the decision will be easy. Andrew Katzenstein, a partner at the law firm Proskauer in Los Angeles, said he calculated that any estate worth up to $6.25 million should file under the current estate tax regime.)

Here’s why the decision is complicated for other estates: If the heirs opt out of the estate tax, the assets in the estate will not be valued as of the date of death but at their original value. The beneficiaries are eligible for what amounts to a tax credit against the appreciated value of the assets — $3 million for the spouse and another $1.3 million for any other heir.

The problem is how the executor will determine who benefits from that $1.3 million credit.

“I have seen spiteful circumstances,” said Mitchell Gaswirth, a tax partner at Proskauer. “While there’s this amazing opportunity to avoid the wealth transfer taxes of people who died in 2010, there is tremendous family complexity and tremendous downside to this boondoggle.”

And that doesn’t even count the second problem. With only 10 weeks left to decide what to do, the one tax form needed to opt out of the estate tax, No. 8939, has not been issued yet by the Internal Revenue Service.

Still, however frustrating the delay in the I.R.S. form may be, there may be good reason to wait before just going ahead and filing an estate tax return. Joanne E. Johnson, United States head of the wealth advisory practice at J. P. Morgan Private Bank, said the firm was handling a $15 million estate that, by its calculations, would pass to the couple’s children free not only of estate tax but also of any other federal taxes. Had the surviving spouse died in 2011, and not 2010, the estate would have had to pay at least $3.5 million in estate taxes.

“That’s a great result for the beneficiaries,” Ms. Johnson said. “This is a win-win for everyone but the I.R.S.”

With that in mind, here is a look at how this issue is having a direct impact on the United States Treasury and a certain group of tax filers.

GUIDANCE With the deadline approaching, the I.R.S. is being tight-lipped on when a final form 8939 will be released. On Aug. 8, the American Institute of Certified Professional Accountants wrote to the I.R.S. commissioner demanding both clarity on the issue and an extension of the filing deadline.

But their letter yielded little. The I.R.S. released a draft of form 8939 in March, with a disclaimer that it could change. It released additional guidance in August to help answer some questions. But Eric L. Smith, a spokesman for the I.R.S., said he could not give an exact date for the final form, beyond “sometime this fall.”

This is problematic for heirs who are still weighing which way to go, since the estate tax return will have to be filed by late September. Mr. Smith suggested that executors could file for a six-month extension on the estate tax return.

But that could raise other issues. If an executor filed an extension, would the estate have to pay taxes at that time or file a separate extension to delay them? If the person filed the extension and had to pay the taxes, would the estate then have to file for a return of the estate tax if it opted out and filed form No. 8939 instead?

Mr. Smith would only say this: “All are possible.” And he referred me to the instructions page for the extension form.

Some accountants dismissed the concern over the I.R.S.’s delay as beside the point. Tamir Dardashtian, a senior tax manager at Anchin, an accounting firm, said executors should be prepared. “By now, they should have one column saying one thing, and another saying another,” he said.

DECISIONS Once the I.R.S. form is released, how an executor allocates the artificial basis may be akin to playing favorites.

The executor can apportion the $1.3 million however he wants. What makes this potentially problematic is that different assets have different tax rates when sold: securities are at the 15 percent capital gains rate, collectibles like art are at 28 percent, real estate is 25 to 35 percent depending on how it has been depreciated. So how that $1.3 million is distributed is significant: one child might get a painting worth $5 million that she will never sell and another $5 million in stock that he will sell the next day.

But what if the executor is a spouse and the children are from a different marriage? The decision on what to do rises above family issues. It risks approaching self-dealing and could be ripe for litigation over fiduciary responsibility.

“It’s hard to say you’re not going to make this decision as an executor and take yourself out of it,” said Paige K. Ben-Yaacov, partner at the law firm Baker Botts in Houston. “In some situations, an executor may need to go to court, if the surviving spouse is serving as executor.”

Her advice in any contentious estate is that each heir have proper representation and that the executor get everyone involved to sign off on the final decision.

WINDFALLS Ms. Johnson’s example of the $15 million estate being passed tax-free is as much about luck as changing tax policy. In 2006, she said, the husband died and left everything to his wife, including a family business. Under normal circumstances, this would have meant the loss of his estate tax exemption, and the whole estate would have been subject to estate taxes.

But those assets, including a family business, received a step-up in valuation to the date of his death. That, combined with the $1.3 million in artificial basis plus capital losses, zeroed out the gains.

Few cases will be this simple. Advisers are concerned with how aggressively their clients value closely held businesses. If they discount the values too greatly, the heirs could run into trouble down the road if the I.R.S. challenges what they did.

"Is it a real possibility that valuations now could cause real issues later on?" asked Stuart Kessler, a partner at J. H. Cohn. "The fact of the matter is if it does happen 10, 15 years down the line, the agents themselves may not know what happened that year, or they may not want to fight it."

Add the fear of being audited to tense family debates, and what seemed to be such a giveaway for the wealthiest families in America could turn out to be a major headache.