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Some Experts Questioning Bush Plan on Estate Taxes

By DAVID CAY JOHNSTON

President Bush has made repealing gift and estate taxes a centerpiece of his tax cut plan. Proponents and opponents of the repeal agree that, as proposed, it would save the wealthiest 2 percent of Americans about $236 billion over the next decade.

But unless Congress writes conditions into the legislation, estate tax lawyers and other experts say, the real savings to those taxpayers — and the consequent drain on government treasuries — could be vastly greater. They cited several ways in which wealthier taxpayers could maneuver to reduce or eliminate other taxes.

Not just the federal Treasury, but also the District of Columbia and the 43 states with their own income taxes, would lose far more revenue than they might anticipate, these experts said. They also said charities could feel the effects, since one important incentive for creating private foundations would be eliminated.

Jonathan G. Blattmachr, an estate tax lawyer at Milbank, Tweed, Hadley & McCloy in New York, who counsels some of the nation's wealthiest families on how to minimize their taxes, said he was troubled by the lack of debate about the broader effect of repeal on government finances and charities.

Mr. Blattmachr, who called himself a "card-carrying Republican," said arranging new ways for the wealthy to capitalize on the changes would become a major business for lawyers like him, who now concentrate on estate tax planning. "This will shift the tax burden from the wealthy to everyone else," he said.

Gift and estate taxes are not assessed on the first $675,000 of net worth an individual has at death. Amounts above this threshold are taxed at rates that begin at 37 percent and rise to 55 percent on amounts greater than $3 million.

Nearly 48,000 Americans, or 2 percent of all the Americans who die each year — who range from small business owners and professionals to multibillionaire executives — pay estate taxes. Nearly half the estate tax is paid by just 4,000 people who die each year leaving more than $5 million dollars or more.

Legislation that passed Congress last year and was vetoed by President Bill Clinton also would have repealed the estate tax, but it would have limited the income-tax avoidance strategies that are possible under the Bush proposal.

The Bush plan, which would phase out gift and estate taxes by 2009, was introduced in the Senate last Monday by Phil Gramm, Republican of Texas, and Zell Miller, Democrat of Georgia. How Congress will proceed is unclear, since neither of the committees with jurisdiction over taxes — the House Ways and Means Committee and the Senate Finance Committee — has begun to draft a bill.

Some in Washington are aware of the loopholes opened by the Bush plan, and are debating whether and how to close them. So it is possible that any legislation that emerges this year could vary significantly from what Mr. Bush has proposed.

If it goes through unchanged, tax experts and others offer several examples of how the Bush proposal could be manipulated.

Consider, for one, the case of an individual with stock that has grown in value by $100 million.

Currently, if the stockholder sold, she would owe $20 million in capital gains taxes. If she gave the stock to a relative, she would have to pay $55 million in gift taxes, and if the relative sold the stock, he would owe $9 million in capital gains taxes.

But if the gift and estate taxes were repealed without conditions, a family maneuver could permit the stock to be sold and the full $100 million in profit realized without payment of any capital gains tax. Here is how: The owner would give the stock to an older relative — say, an uncle — who is expected to live at least a year. The uncle would leave the stock to his niece, the original owner, in his will. When the uncle died, the stock would be returned to the niece at its new value, tax free.

President Bush's press secretary, Ari Fleischer, said the Bush bill would be "reviewed so that interaction among provisions will not lend itself to creation of new loopholes." But he said that the possibility that a few wealthy Americans might exploit new loopholes should not prevent "the many being relieved of the unfair burden of a tax that should not exist."

He said President Bush was adamant that the gift and estate taxes should be repealed for everyone and that the president would not support raising the current exemption so that the tax would continue to be applied to the wealthiest.

Douglas Freeman, of Freeman, Freeman & Smiley, an estate tax law firm in California, said, "The analysis done by the tax-writing committee staff of the cost of repeal has been very poor and shows they have not given much thought, if any, to how repeal will affect the income tax" or to "creative ways that will be found" to cut the income tax bills of the wealthy.

One such way would be to give stock to one of the million or so Americans who report negative incomes on their tax returns and thus do not pay federal income taxes, even though they may be quite wealthy. Many of these people who live tax free are real estate developers and landlords, whom Congress allows to use deductions, like that for depreciation of their buildings, to offset their incomes.

The individual with the $100 million-dollar gain could arrange to give her stock to such a person, who would sell it tax free, then return the proceeds, presumably keeping a part of the proceeds for his trouble.

Alan Halperin, an estate tax specialist at Stroock & Stroock & Lavan in New York, said such transfers would be inhibited only by the degree to which one trusted the recipient of the gift to honor the deal. Mr. Halperin emphasized that, in describing new tax avoidance techniques, he was talking only about the technical issues and not taking a position on taxing gifts and estates.

Even if one has neither an aged relative nor a wealthy friend in real estate, the capital gains tax can be reduced by as much as 63 percent.

To accomplish this, the stock would be given to several lower-income relatives, who are among the 70 percent of Americans whose capital gains tax rate is 10 percent (which Mr. Bush wants to reduce to 8 percent).

Assuming the individual owed taxes at the nominal top rate of 20 percent on capital gains, using this technique, he would cut the tax bill on each million dollars of gain to $100,000 from $200,000.

The tax savings using this technique would be even larger for taxpayers who make roughly $150,000 to $330,000 a year because tax rules and the alternative minimum tax force such individuals to pay up to 27 percent of their capital gains in taxes. By working with relatives in the 10 percent capital gains tax bracket, these people could save 63 percent.

Residents of New York and many other states could also stop paying state taxes on their investment income. Here's how:

The investments would be given to a relative, say a brother, in a trust. Under current law, such a gift would face a 55 percent gift tax, but with repeal, no tax would be owed.

The trust would be organized in Florida, Texas or one of five other states with no state income tax. Each year, the trust would pay federal income taxes on its capital gains, dividends and interest, but not state income taxes.

When the individual wanted to spend the money in the trust, he would have his brother approve the return of the money. If this was done early in the year, none of the money would be taxed by New York or many other states. That is because investment income from previous years would be treated as untaxable capital, not income.

Mr. Blattmachr used himself as an example, saying he could put his investment assets into a trust in Alaska, where his brother Douglas lives. Alaska does not have a state income tax.

"For the states, the losses from this kind of activity would be gargantuan," he said. "I don't understand why the governors are not calling President Bush to tell him that this would be a disaster for the states."

Mr. Halperin concurred. "In terms of who loses," he said, "I would say the states first and foremost, then charity and then spouses. The states will really get hammered."

Charities would be hurt because repeal of the estate tax would remove an important rationale for private foundations, which are created because the gifts to them reduce estate taxes.

With the estate tax gone, these experts say, the wealthy would be encouraged instead to create trusts on which little or no tax would be owed. Unlike private foundations, these trusts could, for example, own the entire family business. The trusts would be obligated to make much smaller gifts to charity than private foundations, which must pay out 5 percent of their assets each year. And if such trusts were created in any of the 10 states that allow trusts to exist in perpetuity, a family could avoid large amounts of taxes on its wealth indefinitely.

Mr. Blattmachr and Mitchell Gans, a professor of tax law at Hofstra University, wrote an article for the journal Tax Notes in which they outlined some ways to avoid the income tax that would be created by repeal of the gift and estate tax laws.

Mr. Blattmachr predicted a 90 percent drop in charitable giving at death. Mr. Halperin, however, said many bequests were motivated not by taxes but by issues of status and of concern for a charity, and so any decline might be much less.

Repeal of the gift and estate tax laws would also effectively undo state laws that protect against a wealthy person's leaving nothing to a spouse at death, these experts say.

Most states have laws entitling a spouse to at least one-third of an estate, but with repeal of the gift tax laws, these experts say, an angry spouse could give everything tax free to the children, or even a mistress, before dying.

"If Congress repeals the gift tax, then it doesn't matter if you give an asset away while you are alive or after you die," Mr. Halperin said. He said an individual who wanted to make life miserable for a spouse could arrange to give away assets before death to children, friends or even a lover and leave the surviving spouse with little or nothing.

"Congress," he said, "needs to consider this."