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Dear Bernie And Hillary, Your 'Sensible' Estate Tax Actually Isn't

Under current law, estates worth $5.45 million or less are exempt from federal estate tax. Beyond that, you pay. Call it an estate tax, a death tax, or a tax on accumulated wealth. Whatever you call it, it is controversial. It is entirely distinct from income tax. You pay income tax as you earn, but whatever you have left might be taxed on death, again. Theoretically, it stops real fat cats from getting fatter generation after generation. The idea is to stop dynasties that operate with a kind of royal attitude and bankbook. But does it work, and *should* it work on top of income taxes?

Most estate planning lawyers will say that the really big estates can find plenty of ways around most of the rules to at least materially reduce their impact. Planning to avoid the estate tax is expensive, and requires years of pre-planning. However, the notion that the federal estate tax is going to stop, or even significantly curtail, the accumulation of wealth may be a little naive. What the estate tax succeeds at doing, though, is catching many people unawares after they have worked and paid income tax their whole life. It can force sales of family companies, and sales of family farms and ranches. This can be a bitter pill to swallow.

Democratic presidential candidates Sen. Bernie Sanders, I-Vt, and Hillary Clinton react as they speak during the CNN Democratic Presidential Primary Debate at the Brooklyn Navy Yard Thursday, April 14, 2016, New York. (AP Photo/Seth Wenig)

The problem has simmered for decades. But Americans finally got some certainty in 2013 with a $5 million per person exemption. It is indexed for inflation, now standing at $5.45 million, $10.9 million for a married couple. Republicans hope for more, with some still touting repeal altogether. Conversely, House Democrats want to raise the estate tax materially. Rep. Sander Levin, D-Mich. is the ranking member of the House Ways and Means Committee. Incredibly, he and other House Democrats want to restore the estate tax and gift tax rate and exemption level to the same amounts as in 2009.

So do Hillary and Bernie. Hillary has finally passed Bernie in all the ways that count, even if she had to get more liberal to do it. The Sensible Estate Tax Act of 2016 would slash the estate tax exemption to $3.5 million and raise the tax rate to 45% as detailed here. Less than a year ago, Sen. Bernie Sanders pitched his Responsible Estate Tax Act. He has made it about moral imperatives and fixing growing economic inequality. His rival Hillary Clinton also pushes this change, so is not a rival on this. Yet even if Sanders' lawyers can't get rid of those "Bernie is my comrade" T-shirts, it is unlikely that Hillary will wear one.

And the Democrats could go even farther in their wealth redistribution efforts. Not long ago, President Obama argued that allowing a basis step up on death—for income tax purposes—was a huge loophole. He proposed no basis step up, hoping to raise approximately $200 billion over the next decade. When combined with state estate taxes, the President's proposal would yield the highest estate tax rate in the world. Small and family businesses could be particularly hard hit. Already, it is hard for many family-owned businesses to stay afloat after the death of a key figure. Not all of the reasons are managerial. Many are financial, and taxes can force a sale.

Stephen Moore of the Heritage Foundation calculated that by eliminating basis step up, we would end up with the world's highest estate tax rate. Dick Patten, chairman of the Family Business Defense Council calculated an effective death tax rate of 57%. If you add in state inheritance taxes, the combined tax rate could go as high as 68%. The President's putative simpler and fairer tax code is detailed here.

Of course, President Obama is making his farewell tours, and his views may be of waning importance. Bernie and Hillary are both hoping for big wins and big tax increases. Get ready America.

For alerts to future tax articles, email me at Wood@WoodLLP.com. This article is not legal advice.