# KATZ BASKIES LLC

# Highlights of the new 2010 Tax Relief Act

On December 17, the President signed the "The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010" ("The Tax Relief Act"). Some of the highlights of the Tax Relief Act are summarized below; however, one key feature of the Tax Relief Act is its duration – the Tax Relief Act only lasts for two years. So all of these changes are fluid and subject to further Congressional debate and future changes.

Changes Impacting Estate Planning

Among other things, the Tax Relief Act includes the following important changes impacting estate planning:

- First, the **estate tax** has been retroactively re-enacted for those who died in 2010; however, the estate tax has a $5.0 million exemption (indexed for inflation from 2010 beginning in 2012) and a 35% rate. Estates of persons dying in 2010 can instead elect to be subject to "carryover basis" instead of the estate tax. The election must be made on a return filed within 9 months of the effective date of the Tax Relief Act. This essentially means that Personal Representatives can elect for the estate/trusts to: (a) be subject to the estate tax and receive a full step-up in basis, or (b) not be subject to an estate tax, but apply a carry-over basis for the decedent's assets (subject to a limited amount of step-up), whichever the Personal Representatives deem most beneficial.

  Planning Notes: This change in the estate tax law highlights two planning notes:

  1. All Personal Representatives and all Trustees who have administered or are administering estates and trusts of decedents who died in 2010 must consult with their tax advisors/attorneys to review this new reporting requirement and their tax planning option.
  2. With the estate tax exemption going up so significantly, all estate planning clients should review their estate plans, as soon as possible. While many estate plans will work perfectly under these new rules, the $5 million exemption may frustrate certain clients' planning intentions, particularly for clients with plans that include gifts to spouses or others (e.g. children from a prior marriage or grandchildren) based on formulas tied to the estate tax exemption – and virtually all plans for married clients do.

- Second, the **gift tax** exemption remains at $1.0 million for 2010, but starting January 1, 2011, the gift tax exemption is re-unified with the estate exemption (i.e., the gift tax exemption increases to $5.0 million). In addition, the gift tax rate for 2010, 2011 and 2012 is 35%. This major increase in the gift tax exemption (coupled with the increase in the GST exemption – below) is extremely valuable to high net worth clients.

<u>Planning Note</u>: After January 1, 2011, clients should consider the benefits of making substantial gifts to multigenerational trusts (“dynasty” trusts) to lock in the gift tax exemption opportunity and shift assets, as well as the income and appreciation on those assets, out of their taxable estates.

- Third, the **Generation-Skipping Transfer Tax (“GST”)** has been retroactively re-enacted for 2010. While that sounds bad, the good news is the GST tax rate for 2010 is zero. This provision of the Tax Relief Act is actually helpful as it clarifies the GST consequences of transfers made by gift or from estates in 2010, and confirms those transfers are subject to all the rules that previously existed, but the rate in 2010 is zero. For example, for any clients who made taxable gifts to grandchildren or younger generations (or to trusts for them) during 2010, they now have the GST tax impact clarified – there will be no retroactive GST tax to pay. In addition, the Tax Relief Act clarifies that direct skip gifts in trust or "taxable distributions" in further trust for grandchildren in 2010 will incur no current GST tax and would not have the potential problem of having the GST tax apply to later distributions from the trust to the grandchild. If clients have GST non-exempt trusts and are making distributions in 2010 or if clients are considering GST transfers in 2010, this clarification is helpful. Starting in 2011, the GST exemption will equal the gift and estate tax exemptions - $5 million. This increased GST exemption can be allocated to 2010 transfers or to 2011 or 2012 transfers.

  <u>Planning Notes</u>:

  1. The GST provisions of the Tax Relief Act provide valuable support for Personal Representatives and Trustees of 2010 decedents, who will have to file estate tax returns. Absent this clarification, there was great confusion on how transfers from estates would be treated and reported for tax purposes.
  2. The $5 million (increased) gift and GST tax exemptions available after January 1, 2011 offer many clients the opportunity to make substantial gifts to dynasty trusts for their families, and to make even more substantial loans or sales of assets to such dynasty trusts. For clients who have already made gifts or sales to dynasty trusts, the new exemptions offer opportunities to either add additional “seed” money to the trusts or to reduce the promissory notes they are holding.

- Fourth, the Tax Relief Act offers **portability** of the estate tax exemption between spouses if the first spouse to die does not use all of his or her exemption. However, the portability provisions offer several pitfalls. First, clients can only avail themselves of the exemption of their last spouse to die – i.e. they cannot “stockpile” exemptions from more than one spouse. Second, as a result of this “last spouse” limitation, it is possible that remarriage by a surviving spouse could cause the loss of the portability if the new spouse predeceases the client but uses his or her full estate tax exemption. For reasons explained in detail in the linked article below, estate tax portability might help some couples who have not planned their estates, and it offers a full “step up in basis” on the assets at the 2nd death, but many clients who plan ahead will be better served by continuing to use Credit Shelter Trusts (“CST”), which have a number of advantages over portability. Relying on portability does not leverage the estate tax exemption of the first to die; if assets appreciate and there is no CST, the appreciation is fully taxable in the surviving spouse's estate. If the assets appreciate after the first death in a CST, the appreciation passes tax free to the family. Also, portability does not preserve the GST exemption of the first spouse to die as the GST exemption isn't portable. This means that unless used during their lifetimes, a couple relying on portability can only exempt $5 million on death from the GST. On the other hand, by applying GST exemption to a CST after the first death, clients can ensure use of both spouses' GST exemption, and exempt $10 million instead of $5 million for their families. Finally, without a CST, the assets the surviving spouse inherits will not be protected from creditors or future spouses of the surviving spouse.

Planning Note: Based upon the reasons highlighted above, many clients will still benefit by using CSTs in their estate plans, and CSTs will still be recommended. For more on this subject, please see an article featured in Trusts & Estates magazine – Click here.

- Fifth, to provide some leniency in recognition of the estate tax rollercoaster ride, the Tax Relief Act provides **additional time** for Personal Representatives and Trustees of estates of persons dying in 2010 to make certain elections and file certain returns. In general the deadlines for actions such as disclaimers and/or filing an estate tax return are extended until 9 months from the effective date of the Tax Relief Act.

- Sixth, as noted previously, all of the amendments in the Tax Relief Act will **sunset** in two years (so expect another political battle – especially with a Presidential election in 2012).

Other Changes for Individual Taxpayers

Among other things, the Tax Relief Act includes the following other important tax changes for taxpayers:

- The **income tax rates** for individuals will stay at 10%, 15%, 25%, 28%, 33% and 35% (instead of moving to 15%, 28%, 31%, 36% and 39.6%).

- The Tax Relief Act held the **standard deduction** for married taxpayers filing jointly (and qualified surviving spouses) at 200% (rather than 167%) of the standard deduction for single taxpayers for 2011. The standard deduction for married persons filing separately is half of the joint filer amount.

- **Itemized deductions and personal exemptions** of higher-income taxpayers will not be reduced. Without the Tax Relief Act, after 2010 itemized deductions would have been reduced by 3% of AGI above an inflation-adjusted figure up to 80%, and personal exemptions were subject to complete phase out.

- The Tax Relief Act continues – at least through 12/31/2012 - the **15% long term capital gains rate** (which would have gone up to 20%) and continues to tax **qualified dividends** at the long term capital gains rate (instead of the top income tax rate – 35%).

- The tax act offers some **Alternative Minimum Tax** ("AMT") relief. The act increases the 2010 and 2011 AMT thresholds for all filers and avoids the approximately 33% decrease in the filing threshold that would have applied in 2011.

Plus, many tax breaks for individuals that expired at the end of 2009 were retroactively reinstated and extended through 2011, including:

- The election to take an **itemized deduction for state and local general sales taxes** in lieu of the itemized deduction permitted for state and local income taxes (generally a large benefit for Floridians).

- Increased contribution limits and carry-forward period for **contributions** of appreciated real property (including partial interests in real property) **for conservation purposes** (conservation easements).

- The provision that permits taxpayers age 70 1/2 or older to make **tax-free distributions to charity from an Individual Retirement Account** (IRA) of up to $100,000 per taxpayer, per tax year. Additionally, individuals will be allowed to treat IRA transfers to charities during January of 2011 as if made during 2010.

<u>Tax Changes Aimed at Stimulating the Economy</u>

In addition to the foregoing personal tax changes, there are a number of changes in the Tax Relief Act offering incentives to bolster the economy including:

- Business write-offs for equipment (sec 168);
- Bonus depreciation (sec 168);
- Increases to the expensing limitations (sec 179); and
- A temporary 2% payroll social security tax cut in 2011.

Plus the Tax Relief Act extends a host of business tax breaks that expired at the end of 2009. These provisions were retroactively reinstated and extended through 2011, including: a research credit, new markets tax credit, and other deductions and credits.

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# Summary Chart of Estate, Gift and GST Tax Law

| **2010** | | **2011-2012** | |
|---|---|---|---|
| Estate Tax | | Estate Tax | |
| Exemption amount: | $5,000,000 | Exclusion amount: | $5,000,000 |
| Tax rate: | 35% | Tax rate: | 35% |
| Carryover basis: | Option to elect carryover basis | Carryover basis: | Not applicable |
| Gift Tax | | Gift Tax | |
| Exemption amount: | $1,000,000 | Exclusion amount: | $5,000,000 |
| Tax rate: | 35% | Tax rate: | 35% |
| GST Tax | | GST Tax | |
| Exemption amount: | $5,000,000 | Exemption amount: | $5,000,000 |
| Tax rate: | 0% | Tax rate: | 35% |