

Carol G. Kroch, Esq.
Managing Director, Charitable Trusts
Head of Wealth and Financial Planning

Congress Passes Tax Relief Act: No Tax Increases for 2011 and 2012

On December 16, 2010, Congress enacted the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the Act), which President Obama signed on December 17, 2010. The Act gives taxpayers at all income levels significant tax relief for the next few years. The Act extends the so-called “Bush-era tax cuts” enacted in 2001 and 2003 for virtually all taxes, so that significant income, capital gains, and estate tax increases scheduled to go into effect on January 1, 2011 will NOT take effect. Perhaps the biggest gift to high-net-worth taxpayers, however, is the new generous estate, gift, and generation-skipping transfer (GST) tax exemptions of \$5 million and maximum rate of 35% effective through 2012. In addition, a variety of expiring provisions, impacting personal and business income tax deductions and credits, were extended, effective in most cases for 2010 and 2011. And the alternative minimum tax (AMT) exemption was temporarily increased, saving roughly 21 million taxpayers from that increased burden. None of the actions Congress took is permanent, however, so long-term income and estate tax planning will still be challenging. But for the short-term, there is much good news for taxpayers.

Because of the last-minute changes Congress made to the gift and GST taxes, individuals who have been contemplating year-end taxable gifts and GST gifts will need to act quickly to review their plans in light of the changes. Individuals need to consider whether gifts in 2010 or 2011 will be more advantageous for their particular circumstances. The Act establishes a rate of 0% for GST gifts in 2010, but reinstates the GST regime, thus eliminating many of the uncertainties that had surrounded GST gifts in trust and offering unique planning opportunities to make GST transfers in 2010 without a GST cost. But the Act does not increase the gift tax exemption until 2011, so for some families it may make sense to defer taxable gifts until 2011, when a \$5 million gift tax exemption will take effect. If you are considering year-end transfers, we urge you to contact your outside advisors and your Wilmington Trust relationship manager as soon as possible.

With that brief summary, let’s take a look at the details most important to high-net-worth taxpayers.

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 has created extraordinary gifting opportunities for high-net-worth individuals over the next two years, as well as unique last-minute, year-end opportunities for GST gifts. It also saves taxpayers at all levels from tax increases on income and capital gains.

ESTATE, GIFT, AND GENERATION-SKIPPING TRANSFER TAXES

The Act makes significant changes to the estate, gift, and GST taxes, but note that all changes will expire on December 31, 2012. At that time, if Congress does not act, the exemptions will drop to \$1 million (indexed for inflation in the case of the GST tax only), and the highest rate will increase to 55% for all three taxes.

The Act's most significant changes are summarized below:

Estate Tax

- The estate tax is reinstated for 2010, with a \$5 million exemption, indexed beginning in 2012. **(But see option to elect out of estate tax for 2010 below).**
- The highest estate tax rate is 35%.
- The estate tax exemption is made “portable” for deaths after 2010, meaning that the unused exemption amount of a deceased spouse may be used by the surviving spouse. The rules governing portability are extremely complex.
- The basis rules for inherited property revert to the pre-2010 rule, under which the basis of inherited property is its full, fair market value on date of death.
 - The “carryover” basis rule is eliminated, except for those decedent’s estates electing it for 2010 only.
 - Under the carryover basis rules, the basis of inherited assets is limited to the lesser of the fair market value on date of death or the decedent’s basis (typically the cost of the property), increased by a limited basis step up of up to \$1.3 million of appreciation, and an additional \$3 million for qualified spousal property.
- For estates of decedents who die in 2010, the estate tax will apply, unless an executor elects to subject the estate to the repeal regime, with carryover basis rules applied to inherited assets.
 - Typically, smaller estates of less than \$5 million will be better off under the estate tax, allowing the estate to take full advantage of the \$5 million exemption, and giving the heirs a full fair market value basis in the inherited assets.
 - Larger estates, however, may find it advantageous to opt out of the estate tax and to take the lower carryover basis required for inherited assets. The heirs would be subject to future capital gains tax on appreciation earned during the decedent’s lifetime in excess of their

carryover basis as adjusted, but the capital gains tax rate of 15% is substantially less than the estate tax rate of 35%.

- Determining which estate tax regime to elect will be dependent on the facts and circumstances of each estate, particularly the size of the taxable estate and the amount of appreciation potentially subject to capital gains tax.

GST Tax

- The GST tax is also reinstated for 2010, with a \$5 million exemption, indexed beginning in 2012.
- **Effective for 2010 only, the GST tax rate is 0%.** While this provision may seem odd, the framework for the GST tax is reinstated for 2010, thus eliminating many uncertainties about making GST transfers in trust in 2010.
- For 2011 and 2012, the GST tax rate is 35%.

Gift Tax

- **The gift tax exemption of \$1 million and rate of 35% stays in place for 2010 only.**
- For 2011 and 2012, the gift tax exemption increases to \$5 million, and all three taxes are “reunified.”

PLANNING NOTES

2010 Year-End Gifts

Time is of the essence: As noted above, anyone contemplating making a year-end gift needs to act extremely quickly. It can take time to review and accept gift instructions, establish accounts, and review trust instruments. Please contact your outside advisors and your Wilmington Trust relationship manager immediately if you need assistance with a year-end gift.

Planning implications for year-end gifts under the Act really depend on whether the transfer is a gift only or is also a GST transfer, and the family’s overall goal on tax-saving.

Year-End Gifts

Note that the Act does not change the existing rules regarding other exemptions from the gift tax. As noted in our year-end letter, annual exclusion gifts of \$13,000 per recipient (\$26,000 if from a married couple) can still be made, as well as direct payments to a health and/or educational institution on behalf of another.

For anyone planning to make a gift to children only (i.e., no transfers that skip a generation), a gift in 2010 can take advantage of only a \$1 million exemption, while a gift in 2011 would be able to use a \$5 million exemption. Any taxable portion of the gift would be taxed at the same rate of 35% for both years.

As a simple example, if a parent transfers \$3 million to a child in 2010, and has not previously used any part of the lifetime gift exemption, the gift tax would be \$700,000, while the same gift made in 2011 would generate no gift tax. (This example assumes no state gift tax applies, as is typically the case, and that the parent has already made an annual exclusion gift of \$13,000 to the child.)

Year-End GST Gifts and Transfers

By contrast, if the family’s focus is on GST planning and GST tax savings, the rate for 2010 only is 0%, so outright gifts to grandchildren, where appropriate, would be free of GST tax, and do not require allocation of the GST exemption.

Note that by setting the GST tax rate at 0% for 2010, rather than continuing its repeal during 2010, the Act reinstates the GST transfer system, permitting transfers in trust under the previously existing GST rules (except, of course, using the new 2010 rate and exemption), something that was in doubt before passage of the Act.

- Thus, GST exemption of up to \$5 million can be allocated to GST trusts in 2010.
- Further, transfers—outright or in trust—in 2010 can take advantage of the annual GST exclusion. (Note that the rules for the annual GST exclusion differ in some significant respects from the annual gift exclusion, although the dollar amount of \$13,000, or \$26,000 if from a married couple, per recipient is the same.)
- In addition, under a complex set of rules known as the “move down rule,” certain transfers in trust for the benefit of one “skip generation,” typically grandchildren, can be made in 2010 at a 0% rate and without the need to allocate any part of the \$5 million GST exemption.

Keep in mind, however, that GST gifts in 2010 above the \$1 million gift exemption will be taxed at the 35% gift tax rate, whereas GST gifts in 2011 can take advantage of a \$5 million exemption for both the GST and gift taxes.

Finally, distributions in 2010 from existing irrevocable trusts that are not exempt from the GST tax will be tax-free. As noted in our year-end letter, there are many factors for a trustee to consider besides tax consequences in determining whether to make a discretionary distribution.

GST planning will require complex tradeoffs between paying gift and GST taxes, as well as among outright gifts, trusts providing GST protection for a single generation, and long-term dynasty trust gifts.

Gifts for 2011 and 2012

The Act presents enormous opportunities for high-net-worth families to transfer wealth, not only in 2010, but in 2011 and 2012.

- Single individuals may transfer up to \$5 million free of gift and GST tax, while married couples may transfer up to \$10 million free of gift and GST tax.
- Unless changed by Congress, this opportunity will expire in 2013, when rates are scheduled to increase to a maximum of 55% and the exemptions are scheduled to drop to \$1 million (indexed in the case of GST).

Estate Planning

Although the Act provides tremendous opportunities for gift and GST planning for 2010 through 2012, estate planning will remain difficult due to the uncertainty about long-term estate, gift, and GST rates and exemptions.

It continues to be important to review your existing estate plan to make sure that it still meets your goals as the exemption amounts change. As discussed in our year-end letter, many estate plans provide for trusts to be funded at death under a formula using the maximum amount that is free from the estate or GST tax. Such trusts would be funded at \$5 million in 2011, but at \$1 million (or approximately \$1.4 million, if a GST exempt trust) in 2013, unless Congress takes further action before then. Neither amount may suit a testator’s goal for his or her family.

In our view, estate planning should not rely on the portability of a deceased spouse’s unused exemption. Not only is it difficult to be assured of full use of the unused exemption, but it is also scheduled to expire at the end of 2012. Further, through careful estate planning by the first-to-die spouse, for example, by establishing a credit shelter trust, appreciation earned after

the first spouse's death will be sheltered from the estate tax, which would not be the case if the estate plan instead relied upon the portability rule.

INCOME TAX

The Act extends all of the Bush income tax cuts that were enacted in 2001 and 2003 and were scheduled to expire on December 31, 2010, but again only through 2012. Specifically, the Act extends:

- All of the Bush-era income tax cuts, including those for taxpayers with incomes over \$200,000 (single) and \$250,000 (married).
- The 15% rate on capital gains and dividends.
- The temporary repeal of the personal exemption phase-out.
- The temporary repeal of the itemized deduction limitation.

EXTENSION OF EXPIRED TAX PROVISIONS

The Act extends a number of income tax provisions for individuals and businesses that had expired at the end of 2009, but generally for 2010 and 2011 only. Several items of significant interest to high-net-worth individuals are the extension of the:

- IRA charitable rollover: individuals aged 70½ or older again may transfer up to \$100,000 directly from an IRA to "qualified charities." The Act also permits charitable IRA transfers made in January 2011 to be treated as if made in 2010.
- Deduction for state and local sales taxes. Once again, taxpayers will be allowed the choice of deducting their state and local income taxes or sales taxes.
- Enhanced deduction for donations of conservation easements.
- Extension of bonus depreciation, permitting 100% expensing of capital investments placed in service after September 8, 2010 through December 31, 2011, and 50% bonus depreciation for investments placed in service during 2012.
- Extension of a variety of business tax relief provisions, including the research credit for 2010 and 2011 and the exclusion of small business capital gains for qualifying small business stock held for more than five years, if acquired before January 1, 2012.

ALTERNATIVE MINIMUM TAX

The Act provides a "patch" for 2010 and 2011, bringing the exemption roughly to 2009 levels, so that approximately 21 million additional taxpayers will not become subject to the AMT for 2010 and 2011.

Unfortunately, however, taxpayers will not know in 2011 whether they will be subject to AMT for 2012.

BENEFITS FOR WORKERS, UNEMPLOYED, AND FAMILIES

The Act also includes a number of benefits for workers, lower to middle income taxpayers, and the unemployed, including:

- Reduction of the employee portion of Social Security payroll taxes and of self-employment taxes for 2011 only, from 6.2% to 4.2%.
- Extension of unemployment benefits for 13 months.
- Extension of "marriage penalty relief" for 2011 and 2012.
- Extension of a number of credits and education incentives, including the earned income tax credit, the modified child tax credit, the expanded dependent care credit, and the American Opportunity tax credit for students for 2011 and 2012.

WHAT THE ACT DOES NOT DO:

First the bad news: The Act does not eliminate uncertainty, as all tax relief is extended only through 2012. All tax rates would then revert to the higher rates and lower exemptions in effect before the Bush tax cuts.

Now the good news:

- The Act leaves in place current Grantor Retained Annuity Trust (GRAT) rules, so that individuals may still establish GRATs with short terms. See our year-end letter for a discussion on the importance of the GRAT term for planning and the legislation passed in the House (though not in the Senate) to impose new requirements for GRATs. With continuing low interest rates, short-term GRATs will still be an effective vehicle for families seeking to transfer wealth to the next generation.
- The Act also does not impose restrictions on valuation discounts for family limited partnerships or limited liability companies that were proposed in the Administration's Fiscal Year 2011 Revenue Proposals.

In its entirety, the Act is 74 pages long, and we are only summarizing those provisions we think are most relevant. It may be prudent to speak to your attorney and other advisors about all of the provisions of the Act that may affect your personal situation.

We realize that the last quarter of 2010 has been a very confusing period for our clients, as we have waited for some legislative certainty. With the passage of the Act, we have a “window of certainty” for 2010 through 2012. We look forward to working with you to take advantage of opportunities created under the Act.

ABOUT THE AUTHOR

Carol G. Kroch, Esq.

Managing Director, Charitable Trusts and Head of Wealth and Financial Planning, Wilmington Trust Company

Carol is responsible for oversight of charitable trusts and for leading a team of attorneys and financial planners that focuses on trust and estate planning, income tax and financial planning, and philanthropic planning for Wealth Advisory Services. She holds a J.D. from Boston College Law School and a bachelor's degree from Wellesley College. Carol is a frequent speaker on trust, estate, and charitable gift planning, and nonprofit governance.

Contributing Authors:

Donna G. Barwick, JD, CFP®

*Vice President and Senior Fiduciary Advisor
Wealth Advisory Services
Wilmington Trust FSB, Georgia*

Donald P. DiCarlo, J.D., LL.M. (Tax)

*Managing Director
Wilmington Trust FSB, Pennsylvania*

Thomas W. Kelley, CPA, CFP®

*Vice President and Senior Financial Planner
Wealth and Financial Planning Group
Wilmington Trust FSB, Maryland*

Mary B. Hickok, Esq.

*Managing Director, Trust Counsel
Wealth and Financial Planning
Wilmington Trust Company*

Marguerite C. Weese, J.D., LL.M. (Tax)

*Senior Financial Planner
Wilmington Trust FSB, Pennsylvania*

Advisory Trust is part of the Wilmington Trust corporate family, which has been in the wealth management business for 105 years, serving as trustee and advisor for prominent individuals, families, and foundations. Founded in Wilmington, Delaware, in 1903 by T. Coleman du Pont, one of the great industrialists and entrepreneurs in our nation's history, the Wilmington Trust corporate family currently serves wealth advisory clients in all 50 states.

This article is for informational purposes only and is not designed or intended to provide financial, tax, legal, accounting, or other professional advice since such advice always requires consideration of individual circumstances. If professional advice is needed, the services of a professional advisor should be sought. This article focuses on the federal estate, gift, and income tax advantages of year-end planning strategies. While some of these strategies may have favorable state tax benefits, those are beyond the scope of this article.

IRS Circular 230 disclosure: To ensure compliance with requirements imposed by the IRS, we inform you that, while this article is not intended to provide tax advice, in the event that any information contained in this article is construed to be tax advice, the information was not intended or written to be used, and cannot be used, for the purpose of (i) avoiding tax related penalties under the Internal Revenue Code or (ii) promoting, marketing, or recommending to another party any matters addressed herein.

CFP® and Certified Financial Planner® are trademarks of Certified Financial Planner Board of Standards.