Tax Law

ALERT

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New Law Temporarily Extends Bush Tax Cuts and Provides New Rules for Estate, Gift, and Generation Skipping Transfer Taxes

On December 17, President Obama signed into law the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the "Act"), extending the Bush tax cuts for two years. To the surprise of many, the Act made substantial changes in the law governing estate, gift, and generation skipping transfer taxes, although also on a temporary basis. In this Special Client Alert, we provide a summary of the key provisions of the Act, as well as explain tax planning actions you should consider taking or not taking during the balance of 2010.

***Action Items for 2010*: Although the Act provides that most tax planning actions can or should be deferred to 2011 or 2012, certain actions may require completion in 2010.**

***Generation Skipping Gifts*: 2010 gifts will generally be desirable only for large gifts directly to (or in trust for) grandchildren and non-family members more than 37½ half years younger than the donor. Although those gifts will be subject to gift taxes at 35% (assuming the $1,000,000 exemption has been used), they will not be subject to generation skipping transfer taxes.**

***Other Generation Skipping Transfers*: Other 2010 generation skipping transfers may be desirable, including certain permissible discretionary distributions from existing irrevocable trusts to grandchildren, more remote descendants, and non-family members more than 37½ years younger than the transferor.**

***Roth IRA Conversions*: Those considering Roth IRA conversions may find that completing the conversion in 2010 and electing to pay the federal tax on the converted assets at the now consistent 35% rate in 2011 and 2012 can be advantageous.**

***Charitable Rollover From IRA*: The Act extended the law permitting a direct transfer of up to $100,000 from the custodian of a traditional IRA to a qualified public charity (although not to a donor advised fund or supporting organization), and the transfer will qualify as part of the required distribution from the IRA in the year in which the transfer was made. Significantly, the Act permits 2010 charitable rollovers from IRAs to be made through January 31, 2011.**

Executive Summary

Income Tax. The most important provision of the Act in the income tax area is the extension through 2012 of the Bush tax cuts for *all* taxpayers. This means that for federal income tax purposes, the highest tax rate for ordinary income will remain at 35% instead of reverting to 39.6% on January 1, 2011. The tax rate for regular long-term capital gains will remain at 15%, instead of reverting to 20% on January 1, 2011. And very significantly, the tax rate on qualified dividend income will remain at 15%, instead of increasing all the way up to 39.6% on January 1, 2011.

Estate, Gift, and Generation Skipping Transfer Taxes. In the estate, gift, and generation skipping transfer ("GST") tax area, the Act prevents for two years, the estate, gift, and GST tax rate from increasing to 55% and the lifetime exemption for estate and GST taxes from decreasing to $1,000,000 on January 1, 2011. In effect, the estate, gift and GST tax exemptions and rates will all be $5,000,000 and 35% for 2011 and 2012.

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For the first time, the estate tax exemption will be "portable" between spouses. This means that the surviving spouse will be able to use the predeceased spouse's unused exemption at the survivor's death.

The gift tax exemption will also be portable between spouses. This means that the surviving spouse will be able to use the predeceased spouse's unused gift tax exemption, as well as the surviving spouse's gift tax exemption, to make lifetime gifts that will not bear gift taxes.

The absence of the GST tax in 2010 and reinstatement in 2011 will provide some clients with a limited time opportunity to make highly tax-effective gifts to grandchildren, more remote descendants, and other significantly younger beneficiaries. However, the GST tax exemption taking effect in 2011 is not portable between spouses.

Provisions for 2010 decedents. The legislation also provides clarification of the applicable law (or laws) for the estates of 2010 decedents, although each such estate must consider the ramifications of newly available tax elections regarding the applicable law. During 2010, there has been no estate tax, but only a very limited adjustment to the income tax basis of the decedent's assets. Many smaller estates would not have paid any tax under the $3,500,000 exemption that was in effect in 2009, but as a result of death in 2010, the decedent's assets were deprived of much of the tax basis increase they would have received had the death occurred in 2009.

The personal representatives of 2010 decedents will now have a choice to apply the original 2010 law of no estate tax and limited basis adjustment *or* apply the new law and pay a 35% estate tax after a $5,000,000 exemption and receive a full step up in tax basis (compared to a 45% estate tax and $3,500,000 exemption for 2009 estates). The default position is the new law, and the personal representative must make an election to obtain the no estate tax, limited basis increase result. The election must be made within nine months of the enactment of the new law, but the form for making the election has not yet been prescribed.

The new law did not, as anticipated, require that grantor retained annuity trusts (GRATs) have a minimum 10-year term. Therefore, short-term GRATs in this low interest rate environment remain an attractive planning tool, particularly if a client wants to make gifts in excess of the new, higher gift tax exemption.

We recommend that you review your existing estate plan and contact us to discuss the impact of the new law on your planning.

Estate, Gift and Generation Skipping Transfer Tax Planning Ramifications

The Act creates a number of planning opportunities and issues that should be addressed relative to the estate, gift and GST taxes:

Many gifts should be deferred to 2011. Prior to the introduction of this legislation, many taxpayers were making or considering significant taxable gifts in 2010 to take advantage of what was thought to be a one time opportunity to have a 35% gift tax rate apply. Now, most gifts in excess of the $13,000 annual gift tax exclusion amount should be deferred to 2011 for taxpayers who have already used their $1,000,000 lifetime exemption. On January 1, the exemption will be $5,000,000, and significant additional tax-free gifts can be made.

2010 Generation skipping gifts and transfers may still be beneficial. It may still be beneficial to make generation skipping gifts to grandchildren and non-family beneficiaries more than 37½ years younger than the donor during 2010. There is no GST tax in 2010, and some may still find it advantageous to make generation skipping transfers in 2010 and pay the 35% gift tax (assuming the $1,000,000 exemption has been used), in order to eliminate further transfer taxation for one or more generations, while preserving the newly enacted $5,000,000 GST tax exemption for future generation skipping transfers. The $5,000,000 GST tax exemption will automatically be allocated to any 2010 GST gift, unless you make the election not to allocate such exemption, which you must do in order to preserve the new $5,000,000 exemption for future use. Please contact us immediately if you wish to consider such a transfer.

Certain existing trusts that permit discretionary distributions by the trustee may find it advantageous to make distributions during 2010 that would otherwise be subject to GST tax, but will not be if the distribution occurs during 2010. Again, please contact us immediately if you have this opportunity.

Gifts in 2011 and 2012. There is no certainty that the lifetime gift tax exemption will remain at $5,000,000 after 2012. Many taxpayers who have already used their $1,000,000 lifetime gift tax exemption will want to consider making another $4,000,000 in gifts during 2011 and 2012. Even if the exemption is reduced after 2012, it is unlikely that Congress would try to impose a retroactive gift tax on those who used the full exemption during 2011 and 2012. Using your full exemption to make gifts will allow you to escape gift tax on the present amount of the gift, and to avoid estate tax on any appreciation in value after the gift that occurs before your death.

New York residents are presented with a unique opportunity as a result of the $5,000,000 gift tax exemption. New York does not impose a gift tax but does impose an estate tax and still only allows a $1,000,000 exemption. Taking advantage of the full $5,000,000 gift tax exemption in 2011 or 2012 will reduce your eventual New York estate tax and not result in any federal gift tax.

Bypass trusts will still be advantageous. Under the law in effect through 2009, the "bypass" trust was often created in order to take full advantage of both spouses' estate tax exemptions. At the death of the first spouse, if the decedent left everything to the survivor, the predeceased spouse's estate tax exemption would not be used, and the surviving spouse's taxable estate would include the full amount of the assets inherited from the predeceased spouse. In that situation, only the surviving spouse's estate tax exemption amount could be applied to reduce estate taxes. To avoid this result, a bypass trust was often created after the first spouse's death under the terms of the estate plan and funded with the amount that the decedent could pass free of estate tax to beneficiaries other than the surviving spouse and charities (e.g., children and other individuals). Properly structured, the assets in the bypass trust, regardless of value at the time of the surviving spouse's death, were not subject to estate tax in the surviving spouse's estate. The bypass trust could also effectively preserve the predeceased spouse's GST tax exemption.

With the Act's introduction of portability of the estate tax exemption, bypass trusts are not necessarily required to utilize both spouses' estate tax exemptions. However, such trusts may still be beneficial for other reasons. Beginning in 2012 (and assuming no further changes in the law), the $5,000,000 exemption is indexed for inflation. When the first spouse dies, that spouse's unused exemption is not further indexed for inflation after his or her death. It will be frozen at its level at the time of the first death. The survivor's exemption will continue to be indexed until the survivor dies. This means that it may still be advantageous to fund a bypass trust at the first death in order to protect future appreciation in the assets in the bypass trust from estate taxes in the surviving spouse's estate, while preserving use of the survivor's full exemption (which continues to be indexed for inflation). Moreover, a properly structured bypass trust can provide significant protection against the surviving spouse's creditors, and can protect the rights of the remainder beneficiaries (e.g., the predeceased spouse's children) from actions taken by the surviving spouse that would alter or eliminate their inheritance rights.

Keeping a bypass trust as part of your estate plan will also be useful if the portability feature does not remain in the law after 2012. Hopefully it is now a permanent feature of the law, but each year the legislative process becomes increasingly difficult to predict.

The portability provision in the new law was written in a way that prevents one from accumulating exemptions through multiple marriages. Only the unused credit of the spouse to whom you were last married may be carried over to your estate. In contrast, a bypass trust will also protect against the loss of the predeceased spouse's exemption by reason of the surviving spouse's marriage to a new spouse. Also, the unused estate tax exemption of the first spouse will be available to the second spouse only if the predeceased spouse's estate files an estate tax return and elects on the return to pass the unused exemption to the surviving spouse. The statute of limitations will remain open for the estate tax return of the predeceased spouse for the limited purpose of determining the amount of exemption available to the estate of the surviving spouse.

Taxpayers should focus on amount that will go to the bypass trust. Taxpayers who have estate plans that fund a bypass trust at the first death with the full estate tax exemption amount must be aware that for at least 2011 and 2012, this will mean that up to $5,000,000 (but no more than one-half of all community property in community property states) will go into that trust. In estates of more modest size, this may be far more assets than the couple desired to put into this kind of irrevocable trust. We previously warned of this problem in 2009, when the exemption increased to $3,500,000.

Window to make qualified disclaimers with respect to 2010 decedents may have been extended. In a number of cases, when someone died in 2010, the surviving spouse disclaimed a portion of the predeceased spouse's property in order to reduce his or her eventual estate tax. In some families, the children who benefited from the disclaimer also disclaimed in favor of their children to take advantage of the absence of the GST tax in 2010. Some families were reluctant to use disclaimers due to concern that the estate, gift and GST taxes might be restored retroactively to apply in 2010. Under Internal Revenue Code ("IRC") Section 2518, a qualified disclaimer must be made within nine months after the decedent's death so the window had closed for decedents who passed away early in 2010.

The Act extends the period to make a qualified disclaimer so that the period will close not sooner than nine months after the date of enactment of the Act. This will extend the period to September 17, 2011, which becomes September 19

because the 17th is a Saturday. Waiting so long may be problematic because a disclaimer cannot be made if the beneficiary has accepted the benefit of the property, and certain state disclaimer statutes may also impose nine month limitations. A disclaimer may still be possible but the state's law will have to be studied. It should be noted that there is some uncertainty about the validity of disclaimers made under the new federal tax law that do not comply with state law requirements. Please consult with your estate planning attorney before making disclaimers at this time that are beyond the time limits under your state law rules.

Evaluating options for 2010 decedents. As noted in the Executive Summary above, the Act provides a choice for estates of 2010 decedents. The default rule is that estate tax will apply with a maximum rate of 35%, a $5,000,000 exemption, and full fair market value basis accorded the assets. This will likely be advantageous for estates of less than the new $5,000,000 estate tax exemption, or in which the decedent's estate plan deferred estate taxes until the surviving spouse's death, both of which would have no estate tax due but would benefit from the full basis increase. The personal representative may elect to apply the previous 2010 rules and have no estate tax and only the limited basis increase. The election to apply these rules must be filed in a time and manner to be prescribed by the Secretary of the Treasury.

If the personal representative determines that a 2010 estate should be subject to estate tax, the earliest date that the estate tax return and payment of tax will be due is September 19, 2011 (nine months from date of enactment, then to the next business day). If the personal representative elects the no tax and carryover basis regime, the basis allocation report required by Section 6018 will also not be due before that date. If you are the personal representative of the estate of a 2010 decedent, please contact the lawyer in our group with whom you are working in order to evaluate the options.

Income and Employment Tax Provisions

In addition to the preservation of current income tax rates for two more years, the Act contains a number of other significant income and employment tax provisions. We will summarize the most important ones here:

Retention of 2009 income tax rates makes 2010 Roth IRA conversion more attractive. We have previously reported that if you convert an individual retirement account ("IRA") into a Roth IRA during 2010, you are permitted to pay one-half of the resulting income tax in each of 2011 and 2012. While this deferral of the tax seems beneficial, until now there has been uncertainty over the tax rates that would be applicable in those years. Under the Act, the 35% maximum federal income tax rate will remain in effect through 2012, so taxpayers who convert IRAs to Roth IRAs before the end of 2010 will be able to pay the tax in 2011 and 2012 at a federal income tax rate no higher than 35%.

Temporary reduction in employee share of payroll taxes. For 2011, employees will pay FICA tax at a rate of 4.2% instead of 6.2% on the first $106,800 of taxable wages. Self-employed individuals will pay 10.4% instead of 12.4% on the first $106,800 of their net earnings from self-employment. There was no reduction to the employer share of the FICA taxes, which remains at 6.2% of the first $106,800 of wages paid to an employee in 2011.

Itemized deduction phase-out will not apply in 2011 and 2012. Through 2009, there was a phase-out of itemized deductions for taxpayers whose adjusted gross income exceeded certain levels. The phase-out was originally an amount equal to 3% of the taxpayer's adjusted gross income in excess of a specified inflation adjusted amount. The phase-out percentage was reduced to 2% in 2006 and 2007, 1% in 2008 and 2009 and does not apply at all for 2010. The Act continues the non-application of the phase-out for 2011 and 2012. Barring further legislation, the phase-out will return in 2013 at the 3% amount.

No phase-out of personal exemption deductions for 2011 and 2012. Like itemized deductions, through 2009, the deduction permitted for personal exemptions was phased out above certain levels of adjusted gross income. There is no phase-out for 2010 and under the Act, there will also be no phase-out for 2011 and 2012. The phase-out will return in 2013 unless further legislation is enacted.

AMT Patch. The alternative minimum tax ("AMT") exemption amount is not useful for high income taxpayers because it begins to phase out when adjusted gross income is higher than $150,000 on a joint return or $112,500 for an unmarried taxpayer. Nevertheless, this exemption is continually covered in the press because the amount does not automatically increase for inflation, causing more and more taxpayers to become subject to the AMT. Congress acts periodically to increase the exemption amount to prevent the AMT from applying to taxpayers for whom it was never intended to apply. The Act continues this patch for 2010 and 2011 for which the AMT exemption will be $72,450 and $74,450 respectively for joint returns and $47,450 and $48,450 respectively for unmarried taxpayers.

Temporary expensing of business machinery and equipment. For new machinery and equipment purchased by a business after September 8, 2010, and before January 1, 2012, the business may write off 100% of the cost. There is no dollar limit on the amount to which this write-off can be applied.

Retroactive reinstatement of certain expired business tax incentives. A number of business tax incentives that had expired at the end of 2009 were retroactively reinstated through 2011 by the Act. The most important of these are the research credit, the new markets tax credit, the work opportunity credit, the ability to write off leasehold improvements over 15 years, and the ability to deduct environmental remediation costs. Each of these is reinstated for 2010 and 2011.

Retroactive reinstatement of write-off for certain motion picture and television production costs. The provisions of IRC Section 181, which permitted the producer of a motion picture film or television program to write off the first $15,000,000 of the cost of production also expired at the end of 2009. The Act retroactively reinstates IRC Section 181 for 2010 and also makes it applicable in 2011.

Retroactive extension of special basis adjustment rule for S corporation making charitable contributions of property. Through 2009, if an S corporation made a charitable contribution of appreciated property, the shareholder was only required to reduce the tax basis in his stock by the adjusted basis of the contributed property, rather than by its fair market value. The Act reinstates this provision for 2010 and 2011. This is a helpful provision that enables the shareholder to benefit from the fair market value deduction if the S corporation donates appreciated capital gain property in the same manner he would if he made the donation individually.

Direct IRA charitable contribution reinstated. Through 2009, a taxpayer over age 70½ could have the custodian of his regular IRA make a transfer to a public charity (although not to a donor advised fund or supporting organization) of up to $100,000 from his IRA without being required to take the amount into income. The transfer also counted as part of the required distribution from the IRA for the year in which the transfer was made. The Act reinstates this ability for 2010 and 2011 and provides that if a taxpayer makes a charitable transfer by January 31, 2011, he can elect to treat the transfer as made in 2010.

100% gain exclusion on the sale of certain small business stock extended. The Small Business Jobs Act of 2010, enacted on September 27, 2010, increased the amount of excludible gain to 100% on the sale of qualifying small business stock acquired between September 28, 2010, and December 31, 2010. This was obviously a very short window and caused the provision to have limited utility. The Act extends this period through December 31, 2011, giving taxpayers another full year to purchase qualifying stock.

In order to qualify for the gain exclusion, the taxpayer must acquire stock of a C corporation at original issuance and hold the stock for more than five years. The corporation must be engaged in an active business and cannot have more than $50 million of assets. The maximum amount of gain that can be excluded is the greater of 10 times the taxpayer's basis in the stock or $10 million.

Other provisions. The Act contains numerous other income tax provisions. In order to keep the length of this Alert manageable, we have only reported on the ones we believe will be of most interest to our clients. If you read or hear about other provisions that you believe may be applicable to your situation, please feel free to contact a member of our group for more information.

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