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The 2010 Tax Relief Act: What It Means For You

On December 17, 2010, President Barack Obama signed into law the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (“2010 Tax Act”). The new law centers around a temporary, two-year reprieve from the expiration of the Economic Growth and Tax Relief Reconciliation Act of 2001 (“EGTRRA”) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (“JGTRRA”), collectively dubbed the “Bush Tax Cuts” by the press. Expiration of EGTRRA and JGTRRA would have resulted in substantial increases in income, estate, gift, and generation-skipping transfer taxes. The following is a summary of some of the pertinent portions of the 2010 Tax Act.

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Temporary Changes To Income Tax Laws

Prior to passage of the 2010 Tax Act, the 10%, 25%, 28%, 33%, and 35% individual income tax brackets were set to expire at the end of 2010 and the rates were to become 15%, 28%, 31%, 36%, and 39.6% respectively. The 2010 Tax Act temporarily extends the 10%, 25%, 28%, 33%, and 35% brackets for an additional two years, through 2012.

The tax rate on capital gains and qualified dividends for taxpayers who were below the 25% individual income tax bracket was 0% and 15% for those above the 25% tax bracket. These rates were set to rise to 10% and 20%, respectively, at the end of 2010, and dividends were to be subject to individual income tax rates. The 2010 Tax Act extended the 0% and 15% tax rates for capital gains and dividends for an additional two years, through 2012.

Temporary Changes to Estate, Gift, and Generation-skipping Transfer Tax Laws

In 2001, President George Bush signed into law EGTRRA, which phased out estate and generation-skipping transfer taxes (“GST taxes”) so that they were fully repealed in 2010. The 2001 law also provided that the cost basis of assets inherited from an individual who died in 2010 would no longer be adjusted to the date of death value. Instead, inherited assets would retain the decedent’s cost basis except the executor of an estate was permitted to increase the basis of inherited assets by \$1.3 million and by an additional \$3 million if the assets were distributed to a spouse or to a special trust for a spouse.

Beginning in 2011, transfers at death in excess of \$1 million were to be subject to estate, gift and GST taxes with a top tax rate of 55%. However, inherited assets were to receive a new tax basis equal to the date of death value. The 2010 Tax Act changed the estate, gift, and GST tax laws as follows:



2010 Estate Tax

Effective January 1, 2010, the estate tax exemption amount is \$5 million per person or \$10 million per married couple with a top tax rate of 35% on all amounts transferred over the exemption amount. Inherited assets will receive a step-up in basis.

If an individual passed away in 2010, the executor of the deceased individual's estate may choose to opt out of the 2010 estate tax laws. If the executor chooses to opt out, the deceased individual's assets will not be subject to an estate tax but the tax basis of the assets will be subject to the carryover rules explained above.

If an estate is over \$5 million, the executor may want to consider opting out of the estate tax regime but will need to consider the income tax ramifications of subjecting the estate to the carryover basis rules.

2010 Gift Tax

The gift tax exemption in 2010 remains at \$1 million per person and the gift tax rate remains at 35%.

2010 Generation-skipping Tax

To discourage people from attempting to skip estate tax liability in their children's generation by transferring assets to grandchildren, a GST tax is assessed on transfers outright or to trusts for grandchildren or more remote descendants in excess of an amount set by Congress. The 2010 Tax Act sets the GST exemption amount at \$5 million per person or \$10 million per couple and the rate is 0%. The 0% GST rate may provide some individuals who want to transfer significant assets to a grandchild in 2010 with planning opportunities if those transfers can be completed in the limited number of days remaining in 2010.

2011 and 2012 Estate Tax

The estate tax exemption in 2011 is \$5 million per person and \$10 million for married couples. The same exemption amounts are in effect for 2012 but the amounts are indexed for inflation. Assets in excess of the exemption amount are taxed at 35%. The basis of all inherited assets will be adjusted to their date of death values.

Under the previous laws, married couples were forced to engage in estate planning to use each spouse's exemption amount. The typical approach was to have assets worth up to the deceased individual's estate tax exemption transferred tax-free to a trust, commonly referred to as a family trust or credit trust, on the first spouse's death. The benefit of this approach is that the assets in the family trust and all appreciation on those assets is not subject to estate tax when the second spouse dies.

Under the 2010 Tax Act, the estate of a surviving spouse who dies in either 2011 or 2012 may utilize the unused exemption of the first spouse to die. For example, if Husband dies in 2011 or 2012, Wife will be able to transfer assets equal to her unused exemption amount and assets equal to her deceased Husband's unused exemption amount estate tax free. If Husband 1 dies and Wife remarries, and Husband 2 also dies, Wife will be able to transfer assets equal to her unused exemption amount and assets equal to Husband 2's unused exemption amount estate tax free. If Wife dies before Husband 2, it is unclear as to whether Wife may use Husband 1's unused exemption amount.

In order to be able to use the unused exemption of the first spouse to die, an estate tax return must be filed at the time of the first spouse's death, a cost some may wish to avoid. In addition, if a family trust is created at the first spouse's death, not only will the original assets transferred to the family trust escape estate tax but so will the appreciation on such assets. As a result, there is still good reason to use a family trust or credit trust at the first spouse's death.

2011 and 2012 Gift Tax

The lifetime gift tax exemption is \$5 million for a single person and \$10 million for a married couple (indexed for inflation in 2012). Gifts in excess of the lifetime exemption are taxed at 35%. The gift tax exemption is also portable and any unused gift tax exemption may be used by a surviving spouse during 2011 and 2012.

2011 and 2012 GST Tax

The GST tax exemption amount is \$5 million for a single person and \$10 million for a married couple (indexed for inflation in 2012). GST transfers in excess of the exemption are taxed at 35%. The portability of a spouse's unused exemption was not extended to the GST exemption. If a married couple wishes to engage in GST tax planning, a trust should be created upon the first spouse's death to take advantage of the exemption of the first spouse to die.

Estate, Gift And GST Tax Planning Opportunities

The benefits of 2010 Tax Act apply only to transfers made in 2010, 2011 and 2012. As part of the compromise necessary to get enough votes for approval, Congress passed on the opportunity to make changes permanent or at least longer term. While the Act will provide much tax relief during these times of economic uncertainty, the estimated cost of the Act is \$858 billion. Thus, it remains to be seen whether the tax cuts will be extended for years 2013 and beyond.

Contrary to the predictions of some observers, Congress did nothing to restrict the opportunity to leverage gifts during lifetime. Therefore, planning techniques that benefit from valuation discounts and low interest rates will be even more attractive in 2011 and 2012 under the new gift and GST tax laws. These techniques include gifts made to children and grandchildren outright or in trust, gifts to grantor retained annuity trusts ("GRATs"), installment sales to grantor trusts, and creating charitable lead trusts ("CLTs") during life or at death. Because we do not know what will happen in 2013, and because of the substantial increases in the gift, estate and GST tax exemption amounts, now is the perfect time to take advantage of the many planning opportunities that are available to transfer wealth to your children or other heirs free of gift, estate or GST tax.

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Our Trust & Estates attorneys are closely monitoring developments in the estate, gift and GST tax laws. For the latest available information, please visit our Web site at www.ruderware.com. If you have questions about your planning needs, please contact one of our Trusts & Estates attorneys.

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