December 17, 2010

House Votes 277-148 to Approve Senate Tax Cut Extension Bill

Late last night, after much debate and politicking, the House approved H.R. 4853, the $859 billion Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (the "Tax Relief Act"). The legislation passed the Senate by a vote of 81-19 on December 15 and is expected to be signed into law as early as today by President Obama.

The Tax Relief Act has far-reaching implications for almost all Americans, as it not only extends President Bush's federal income tax cuts but also sets the federal estate, gift and generation-skipping transfer ("GST") tax rates and applicable exclusion amounts for 2010 through 2012.

I. THE TAX RELIEF ACT EFFECT ON ESTATE PLANNING AND ESTATE ADMINISTRATION

Estate, Gift and GST Tax Applicable Exclusion Amounts

The Tax Relief Act sets the applicable exclusion amounts for the estate, gift and GST taxes at $5 million per person—reunifying the amount that can be given during lifetime or at death at the same amount. Under the new law, starting on January 1, 2011, a married couple together will be able to transfer $10 million either during their lifetimes or at death, a substantial increase from the combined $2 million lifetime giving and $7 million at death giving that a couple could achieve in 2009. The applicable exclusion amount for lifetime giving remains $1 million for gifts made in 2010 , but increases to $5 million for estate and GST tax purposes for decedents dying or transfers made on or after January 1, 2011. The tax rate for GST transfers made in 2010 is zero, so an outright gift to a grandchild made this year would not generate any GST tax, regardless of the amount.

Estate, Gift and GST Tax Rates

The rate for estate, gift and GST taxes in 2011 and 2012 will be 35%, a reduction from the 45% rate that was in effect in 2009.

"Portability"

An important change made by the Tax Relief Act is that a surviving spouse may utilize the unused estate (but not GST) applicable exclusion amount of the first spouse to die, if that spouse's Executor or other representative elects on an estate tax return (whether or not the estate is large enough to otherwise require the filing of an estate tax return) to allow the surviving spouse to utilize the unused applicable exclusion amount. A surviving spouse may use the unused applicable exclusion amount only of the deceased spouse he or she was most recently married to before the surviving spouse's death. No accumulation of the unused applicable exclusion amounts of more than one deceased spouse is permitted. So, for example, assume Jane Doe is married to John, who dies in 2011 with $3 million of unused estate tax applicable exclusion amount, and his Executor elects to permit Jane to use his $3 million unused applicable exclusion amount. Jane then marries

Bob, who dies in 2012 with $2 million of applicable exclusion amount, and his Executor elects to permit Jane to use his $2 million unused applicable exclusion amount. When Jane dies in 2012 with her own unused $5 million of applicable exclusion amount, she may transfer $7 million of assets free from federal estate tax ($5 million using her own unused applicable exclusion amount and $2 million using Bob's unused applicable exclusion amount).

Even with the new portability provisions, you should continue to plan with "credit shelter" or "disclaimer" trusts, as these trusts continue to provide benefits. While portability allows the unused applicable exclusion amount of the first spouse to die to be used by the survivor, the appreciation on the assets of the first to die may still be subject to estate tax on the death of the survivor unless a trust is used. Moreover, as mentioned above, a decedent's GST applicable exclusion amount is not portable. It is unclear how the statutes enacted by many states will interpret such formula bequests in the case of individuals who die in 2010 (i.e., whether $3.5 million or $5 million). Please contact us to have your wills reviewed to make sure that the full $5 million is now taken into account, assuming that is what you want.

Treatment of those Dying in 2010

Surprisingly to many, the estate tax is reinstated retroactively for this year. However, for 2010 decedents there is a choice: (1) the Executor or other representative of the estate can do nothing and the estate will be subject to the estate tax with the new $5 million applicable exclusion amount, the 35% tax rate and a basis step-up to date of death value for the decedent's assets; or (2) instead, a special election can be made to opt out of the estate tax but forego the stepped-up basis so that all of the decedent's assets will have a "carry-over" basis. Calculations will have to be made for each estate to determine which option creates the more advantageous tax result.

Estate tax returns for estates of decedents dying in 2010 and not electing to opt out of the estate tax will be due nine months after date of enactment of the Tax Relief Act. It is not clear at this time the procedure that will have to be followed for estates electing to opt out of the estate tax, but rules should be promulgated shortly with accompanying forms.

Planning Ideas in Light of the Tax Relief Act

Gifts

Clearly, you should consider making lifetime gifts in 2011 and 2012 to take advantage of the additional $4 million of lifetime giving that can be made free from federal gift tax. Note that if you have previously exhausted your lifetime giving amount of $1 million, you now have an "extra" $4 million of tax-free gifting that can be made in 2011 and 2012. Not only will the amount transferred be free from federal gift and estate tax, but also any appreciation on gifted amounts will escape transfer taxation.

Although most clients will want to wait until 2011 to make gifts, clients who wish to transfer substantial amounts to grandchildren should consider taking advantage of the zero GST tax rate available until the end of 2010 to make gifts to grandchildren in 2010 even if those gifts may be subject to gift tax.

Even with the increased amounts available for lifetime giving, consideration should continue to be given to optimizing the amount that may be transferred through the use of grantor retained annuity trusts ("GRATs") and valuation discounts, which planning tools are not affected by the Tax Relief Act, despite the legislation introduced throughout 2009 and 2010 to reduce the effectiveness of such techniques.

Clients may want to consider making taxable gifts before 2012, as it is possible that the gift and estate tax rates will increase above 35% after 2012.

II. THE TAX RELIEF ACT INCOME TAX PROVISIONS AFFECTING INDIVIDUALS

The Tax Relief Act provides, among other benefits, an extension of many of the Bush income tax cuts that were due to expire on January 1, 2011.

Tax Rates. Current ordinary income tax rates, which were scheduled to rise to a top rate of 39.6%, will be extended through 2012, with a top rate of 35%. The current long-term capital gains rates, which were scheduled to rise to 20%, will be extended through 2012 with a top rate of 15% (25% or 28% for certain capital assets). The qualified dividend tax rate was scheduled to revert to the ordinary income tax rate (with a top rate of 39.6%), but has been extended through 2012.

Exemption and Deduction Phase-Outs. The personal exemption and itemized deduction phase-outs (the so-called "Pease limitation") for high-income taxpayers were eliminated in 2010, but were set to return in 2011. The Act extends the elimination of the phase-outs for high-income taxpayers through 2012.

Marriage Penalty Relief. Provisions which address the so-called "marriage penalty" related to tax rates, deductions and credits were scheduled to sunset. The Act extends these favorable provisions through 2012.

Alternative Minimum Tax ("AMT"). Without a patch, AMT exemption amounts were set to decrease dramatically in 2010, and personal credits would not have been allowed against the AMT. The Act provides the necessary AMT "patches" for 2010 and 2011.

Employee FICA and Self-Employment Taxes. The Act replaces the "Making Work Pay Credit" with a reduction of 2% in the employee's portion of the FICA tax and the self-employment tax on amounts up to $106,800 for 2011.

Charitable Rollovers. The Act extends the $100,000 "charitable rollover" for 2010 and 2011 for taxpayers who are older than 70½. This provision is beneficial to high income earners who are often subject to the Pease limitation phase-out of charitable deductions. Under the charitable rollover provisions, a taxpayer who is over 70½ can direct up to $100,000 from an IRA directly to a charity and will not have to include the rollover amount in his or her gross income (note that there is no charitable deduction in this case either), thereby escaping any Pease limitation phase-out of the charitable deduction. The amount directed to charity counts towards the taxpayer's required minimum distribution for the year. The Act allows taxpayers who are over 70½ to make a charitable rollover during January 2011 and elect to treat the rollover as if it had been made on December 31, 2010.

Traditional Tax Extenders. The Act extends through December 31, 2011, a series of expired (or expiring) tax provisions that are typically extended annually as part of a tax extenders package. These tax provisions include various energy, individual tax relief, business tax relief and temporary disaster relief provisions.

We await President Obama's signature on the new law and further guidance from the Treasury Department and will keep you advised as further developments occur.

We Can Help

For more information, consult with one of us or any member of Katten's Trusts and Estates Practice.

CHARLOTTE

A. Victor Wray, Charlotte Chair	704.444.2020	victor.wray@kattenlaw.com
Diane Blackburn Burks, Associate	704.344.3153	diane.burks@kattenlaw.com
William E. Underwood, Jr., Of Counsel	704.444.2010	bill.underwood@kattenlaw.com

CHICAGO

Michael O. Hartz, Chicago Chair	312.902.5279	michael.hartz@kattenlaw.com
David M. Allen, Associate	312.902.5260	david.allen@kattenlaw.com
Alan M. Berry, Of Counsel	312.902.5202	alan.berry@kattenlaw.com
Victor H. Bezman, Partner	312.902.5204	victor.bezman@kattenlaw.com
Samuel M. Dotzler, Associate	312.902.5249	samuel.dotzler@kattenlaw.com
Anthony L. Engel, Associate	312.902.5316	anthony.engel@kattenlaw.com
Juli D. Gilliam, Associate	312.902.5328	juli.gilliam@kattenlaw.com
Jonathan Graber, Partner	312.902.5317	jonathan.graber@kattenlaw.com
Stuart E. Grass, Partner	312.902.5276	stuart.grass@kattenlaw.com
Charles Harris, Partner	312.902.5213	charles.harris@kattenlaw.com
Melvin L. Katten, Senior Counsel	312.902.5226	melvin.katten@kattenlaw.com
Tye J. Klooster, Associate	312.902.5449	tye.klooster@kattenlaw.com
Emily M. Litznerski, Associate	312.902.5299	emily.litznerski@kattenlaw.com
Allan B. Muchin, Of Counsel	312.902.5238	allan.muchin@kattenlaw.com
Kelli Chase Plotz, Associate	312.902.5347	kelli.plotz@kattenlaw.com
Philip J. Tortorich, Partner	312.902.5643	philip.tortorich@kattenlaw.com
Neil H. Weinberg, Partner	312.902.5646	neil.weinberg@kattenlaw.com

LOS ANGELES

Abby L. T. Feinman, West Coast Co-Chair	310.788.4722	abby.feinman@kattenlaw.com
Carol A. Johnston, West Coast Co-Chair	310.788.4505	carol.johnston@kattenlaw.com
Amy I. Dunphy, Associate	310.788.4554	amy.dunphy@kattenlaw.com
Heather Van Vactor, Associate	310.788.4531	heather.vanvactor@kattenlaw.com
Boryana V. Zeitz, Associate	310.788.4548	boryana.zeitz@kattenlaw.com

NEW YORK

Joshua S. Rubenstein, National Chair	212.940.7150	joshua.rubenstein@kattenlaw.com
Ronni G. Davidowitz, New York Chair	212.940.7197	ronni.davidowitz@kattenlaw.com
Mal L. Barasch, Counsel	212.940.8801	mal.barasch@kattenlaw.com
Lawrence B. Buttenwieser, Counsel	212.940.8560	lawrence.buttenwieser@kattenlaw.com
Neil V. Carbone, Partner	212.940.6786	neil.carbone@kattenlaw.com
Allison S. Clayton, Associate	212.940.6533	allison.clayton@kattenlaw.com
Alexandra Copell, Associate	212.940.8588	alexandra.copell@kattenlaw.com
Marla G. Franzese, Counsel	212.940.8865	marla.franzese@kattenlaw.com
Robert E. Friedman, Counsel	212.940.8744	robert.friedman@kattenlaw.com
Jacqueline Garrod, Associate	212.940.6661	jacqueline.garrod@kattenlaw.com
David S. Goldstein, Associate	212.940.6740	david.goldstein@kattenlaw.com
Lauren M. Goodman, Associate	212.940.6344	lauren.goodman@kattenlaw.com
Jasmine M. Hanif, Partner	212.940.6491	jasmine.hanif@kattenlaw.com
Milton J. Kain, Counsel	212.940.8750	milton.kain@kattenlaw.com
Theresa A. Kraker, Associate	212.940.6678	theresa.kraker@kattenlaw.com
Dana B. Levine, Special Counsel	212.940.6668	dana.levine@kattenlaw.com
Patience J. O'Neil, Special Counsel	212.940.3888	patience.oneil@kattenlaw.com
Marianna Schwartsman, Associate	212.940.8581	marianna.schwartsman@kattenlaw.com
Beth D. Tractenberg, Partner	212.940.8538	beth.tractenberg@kattenlaw.com
Kathryn von Matthiessen, Partner	212.940.6631	kathryn.vonmatthiessen@kattenlaw.com

Katten
KattenMuchinRosenman LLP

www.kattenlaw.com

CHARLOTTE CHICAGO IRVING LONDON LOS ANGELES NEW YORK WASHINGTON, DC