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Personal Tax Planning Provisions in TRA 2010

On December 17, 2010 President Obama signed the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (TRA 2010). This legislation extends, but only for two years, many of the Bush-era individual income tax and transfer tax cuts.

Estate Tax

Prior to the enactment of TRA 2010, the federal estate tax was phased out entirely for decedents whose deaths occur in 2010, and then reinstated for the years 2011 and thereafter with an exemption amount of US$1 million for US decedents and a top tax rate of 55 percent. TRA 2010 changes this so that the estate tax is reinstated retroactively for 2010, and continued for 2011 and 2012, with an estate tax exemption amount of US$5 million and a top tax rate of 35 percent. Barring further action from Congress, the exemption amount will decrease to US$1 million, and the top tax rate will increase to 55 percent, starting in 2013.

For 2010 decedents only (that is, persons whose deaths occur in 2010), the executor may elect not to have the federal estate tax apply. If this election is made, however, then modified "carryover basis" rules will apply with respect to property acquired or passing from that 2010 decedent. Under this alternative, the heirs will generally "inherit" the decedent's historical income tax basis of the property without any adjustment for the date-of-death value of the assets. As part of this election, the executor will generally be permitted to add up to US$1.3 million to the income tax basis of such inherited

Contacts:

Joseph D. Edwards
+1.813.202.1339

Jeffrey S. Levin
+1.212.872.9840

Ellen K. Meehan
+1.216.479.8366

John B.T. Murray, Jr.
+1.561.650.7213

James Spallino, Jr.
+1.216.479.8424

James S. Tsang
+852.2103.0306

Lee A. Wendel
+1.614.365.2748

property. An additional US$3 million basis increase would be available for property acquired by the surviving spouse or a qualifying trust for the surviving spouse's benefit. For estates of those 2010 decedents whose deaths occurred prior to December 17, TRA 2010 extends to September 17, 2011 (the date nine months after the date of enactment) (i) the due date for the federal transfer tax reports (either an estate tax return or the modified carryover basis election form), (ii) the due date for the federal estate tax payment, if any, and (iii) the deadline for qualified disclaimers related to the decedent's assets.

TRA 2010 also introduces the new concept of "portability" for an individual's unused estate tax exemption. This means that the decedent's surviving spouse may succeed to and use any unused portion of the deceased spouse's unused US$5 million exemption for either federal estate or gift tax purposes. However, the deceased spouse's executor must prepare and file a timely federal estate tax return (which otherwise may not be needed) to take advantage of this benefit. Further, under TRA 2010 this new portability feature is available only if both spouses' deaths occur during 2011 or 2012, or one spouse's death occurs during either of these years and the surviving spouse then uses the deceased spouse's unused exclusion amount to make otherwise taxable gifts prior to the end of 2012. The authors of this portability provision contemplate that Congress will extend its application to subsequent years, but Congress must authorize it.

The above changes are for federal estate tax purposes. State transfer taxes still must be considered on a case-by-case basis, especially for those states that are no longer coupled to the federal estate tax. Moreover, wills and revocable trusts with formula testamentary dispositions based on federal estate tax provisions should be promptly reviewed to confirm that the testator's intentions would still be achieved, especially for those states that enacted special estate tax interpretative legislation during 2010.

Gift Tax

For 2010, the gift tax exemption amount remains at US$1 million with a top tax rate of 35 percent. TRA 2010 again unifies the exemption amount for federal estate and gift taxes and increases the gift tax exemption amount to US$5 million for 2011 and 2012 gifts. The exemption amount for both gift and estate taxes will be indexed for inflation beginning in 2012. The gift tax rate will remain at 35 percent for gifts made in 2011 or 2012. Barring further action from Congress, the exemption amount will revert to US$1 million, and the top tax rate will become 55 percent, starting in 2013.

Generation-Skipping Transfer Taxes

For 2010 only, the generation-skipping transfer (GST) tax does not apply to lifetime gifts or death-time transfers made directly to recipients such as grandchildren or others who are two or more generations below the person making the transfer. Further, TRA 2010 clarifies that a gift or bequest made to such a grandchild or other "skip" person in trust during calendar year 2010 will not result in application of the GST tax when distributions are made from the trust to that grandchild or other skip person in later years. The donor's 2010 US gift tax return, which reports these transfers, must preclude the automatic application of the donor's GST exemption to these transfers. Otherwise, this one-time benefit would be lost. Also, federal gift tax could still be payable on those gifts.

For any other kind of transfer, the GST exemption for 2010 through 2012 will be US$5 million, and when applicable, the top GST tax rate will be 35 percent. As with the estate and gift tax exemption amounts, the GST exemption amount is indexed for inflation starting in 2012. Also, barring further action from Congress, the exemption amount will fall to approximately US$1.4 million, depending on inflation, and the top tax rate will revert to 55 percent, starting in 2013. The portability concept does **not** apply to the unused GST tax exemption of a predeceased spouse.

Income Tax

In addition to these transfer tax changes and the extension of the current income tax rates through 2012, the following income tax provisions were extended for two years:

- TRA 2010 preserves the 15 percent tax rate on qualified dividends and long-term capital gains. Those rates will increase in the year 2013 to 39.6 percent and 20 percent, respectively, unless Congress takes further action.
- TRA 2010 extends, **but only** for the tax years 2010 and 2011, the provision for making a nontaxable IRA distribution to charity. If you are age 70-1/2 or older, you may make a nontaxable distribution of up to US$100,000 directly from your IRA to a public charity. Any such IRA distribution made to a public charity after December 31, 2010 and before February 1, 2011 may be counted as a 2010 distribution.

The foregoing is intended to be a general summary of the transfer tax provisions and income tax provisions of TRA 2010 that may be of greatest interest to our private wealth clients and their advisers. If you would like to discuss these matters, please contact your principal Squire Sanders lawyer or any of the persons listed in this Alert. TRA 2010 contains other, significant federal tax

provisions that are not addressed in this Alert.