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Legal Update
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Tax and Estate Planning Effects of the 2010 Tax Act

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (2010 Tax Act) was enacted on December 17, 2010. It reflects a compromise negotiated by the President with congressional Republican leaders and contains a number of notable changes to the federal income and estate tax rules. We review some of the most significant and offer planning tips.

Income Tax Changes

Rates. Current individual federal income tax brackets that were scheduled to go up in 2011 are extended for two years, through 2012. The top individual rate will remain at 35 percent instead of the scheduled 39.6 percent.

Capital Gains and Dividends. Capital gains and dividends are currently subject to federal tax at 15 percent for taxpayers in the 25 percent ordinary income tax bracket and above. This rate was also scheduled to go up in 2011; instead, this current rate is extended for two years, through 2012.

Alternative Minimum Tax. The alternative minimum tax was not repealed as many have suggested, but the current law was "patched" for two years to increase exemptions.

Two percent Payroll Tax Holiday. The 2010 Tax Act reduces by 2 percent for 2011 both the social security tax on wages and the self employment tax on self-employed individuals. Accordingly, employees will pay 4.2 percent on wages up to $106,800, and self-employed individuals will pay 10.4 percent on self-employment income up to the same threshold.

Other Provisions. The 2010 Tax Act includes a large number of other income tax provisions. Among these are two-year relief provisions affecting the "marriage penalty" and the earned income tax credit. There are significant education incentives as well.

Estate Tax Changes

Nearly a decade ago, the 2001 Tax Act provided increased estate and generation-skipping tax exemptions and lower marginal rates, phased-in through 2009; that law phased out estate and generation-skipping taxes altogether for 2010—substituting new "carryover-basis" rules for 2010. However, under the 2001 Tax Act the estate and generation-skipping taxes were scheduled to come back in 2011 at 2001 levels (lower exemption amounts and higher tax rates). The 2010 Tax Act provides significant estate and generation-skipping tax relief for two years.

Rates and Exemptions. For 2011 and 2012, the estate tax exemption is set at $5 million per person, and the top federal estate tax rate is 35 percent.

Maximum Transfer Tax

RATES AND EXEMPTIONS

	Estate Tax		Generation-Skipping Transfer Tax		Gift Tax	
YEAR	MAXIMUM RATE	EXEMPTION	MAXIMUM RATE	EXEMPTION	MAXIMUM RATE	EXEMPTION
2009	45%	$3.5 million	45%	$3.5 million	45%	$1 million
2010	0%*	$5 million	0%	$5 million	35%	$1 million
2011-2012	35%	$5 million	35%	$5 million	35%	$5 million

* The 2010 Act provides executors of 2010 estates with an election as described below.

2010 Estates—an Election. Estates of decedents dying in 2010 will be given a choice: executors and administrators can elect to be taxed under the new rules applicable to 2011 and 2012 (the 35 percent estate tax rate with a $5 million exemption) or they can elect the 2010 rules in effect before the enactment of the 2010 Tax Act—i.e., no estate tax but carryover basis rules.

Estates of $5 million or less, as well as estates of more than $5 million that would be entitled to significant marital or charitable deductions, will likely choose the new estate tax rules in order to get a full basis step-up. This is a complicated area, and executors of estates of decedents dying in 2010 should seek professional advice.

Portability. The 2010 Tax Act promises to allow the executor of a decedent's estate to transfer any unused estate tax exemption to a surviving spouse. This provision may simplify planning for some married couples, but its application appears to be limited to situations in which both spouses die after December 31, 2010.

Caution—State Death Taxes. The estate tax relief provisions in the 2010 Tax Act apply only to the federal estate tax, not state inheritance and estate taxes. It is not clear how states will react, so those reviewing their estate plans should be mindful of the possible impact of state death taxes.

Gift Tax Changes

The same 2001 Tax Act that led to the one-year repeal of the estate tax for 2010 also included significant changes to the federal gift tax. It "decoupled" the gift tax from the estate tax: the gift tax exemption was fixed at $1 million and the maximum federal gift tax rate for 2010 was capped at 35 percent. The new 2010 Tax Act resets the maximum gift tax rate at 35 percent, and it will reunify the estate and gift taxes which were split apart a decade ago, effective January 1, 2011. Notably, the 2010 Tax Act also increases the lifetime gift tax exemption from $1 million to $5 million, but only for 2011 and 2012.

IMPORTANT PLANNING POINTS

2010 Gifts. You should not make 2010 taxable gifts at the end of this year, in excess of annual exclusion and the lifetime exemption amounts available to you and your spouse, except in rare circumstances where the focus will be on gifts to grandchildren to save generation-skipping transfer taxes.

2011 Gifts. You should make 2011 and 2012 taxable gifts, beginning promptly after January 1, 2011, in order to use the $4 million increase in the lifetime exemption amount.

Annual Exclusion Gifts. Annual exclusion gifts are still encouraged for both 2010 and 2011. The maximum amount remains at $13,000 per gift recipient.

Generation-Skipping Transfer Tax Changes

The generation-skipping transfer tax will be back in effect January 1, 2011. Under the new tax act, there will be a $5 million lifetime exemption and a 35 percent maximum federal tax rate for two years, through 2012. This increased exemption and lower maximum rate will present many estate planning opportunities for those wishing to consider generation-skipping transfers to grandchildren and great-grandchildren. This is a complicated and highly technical area; anyone interested in pursuing these opportunities should seek professional advice.

Other Matters

IRA Charitable Rollover. The 2010 Tax Act extended for two years the IRA charitable rollover provision that expired at the end of 2009. Qualifying taxpayers (over the age of 70½) may make tax-free distributions from an IRA to charity up to $100,000 per taxpayer, per taxable year. In order to give taxpayers the opportunity to take advantage of this new provision for 2010, the 2010 Tax Act allows taxpayers to make charitable transfers in January of 2011, treating them as if made in 2010.

Some Provisions That Were Not Included. Several widely anticipated changes were not enacted. Notably, the proposed restrictions on the use of grantor retained annuity trusts or "GRATs" were not included in the 2010 Tax Act. Accordingly, there remain planning opportunities here. Similarly, proposed changes to the rules governing valuation of intra-family transfers were not included in the 2010 Tax Act.

Other Planning Opportunities. Low interest rates continue to present attractive estate planning opportunities. In addition to GRATs, you may want to consider intra-family loans, sales of assets and charitable lead trusts.

For more information about the 2010 Tax Act or any matter raised in this Legal Update, please consult your regular Mayer Brown contact or any of the following lawyers.

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1210