

# **THE 2010 TAX ACT HAS (GULP!) ARRIVED**

Presenter: Robert J. Kolasa

[robert@kolasalaw.com](mailto:robert@kolasalaw.com)

Lake County Estate Planning Council

January 13, 2011

# What Gridlock? What Deficit?

**“Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010”** (Law 12/17/2010)

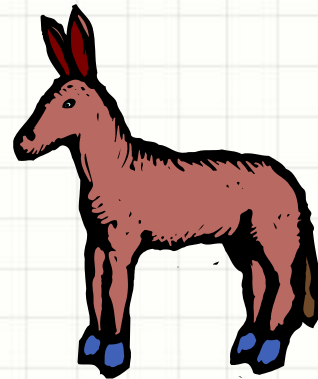
## **Tax Cuts for ALL**

- even > \$250K of Income)



## **Stimulative Spending**

- Extends Unemployment Insurance Benefits (\$68B)
- 2% Payroll Tax Cut (\$111.7B)



**\$858 Billion Cost of 2010 Tax Act**





# 2010 Tax Act – Extending A “Sunset”

- **The EGTTTRA “Sunset”**

- 2000 Tax Cuts Set to Expire **1/1/2011**
  - Reinstates higher (39.6%) tax rates, etc.
  - Reinstates 1999 Estate Tax Laws  
(\$1M Exclusion Amount with top 55% rate)

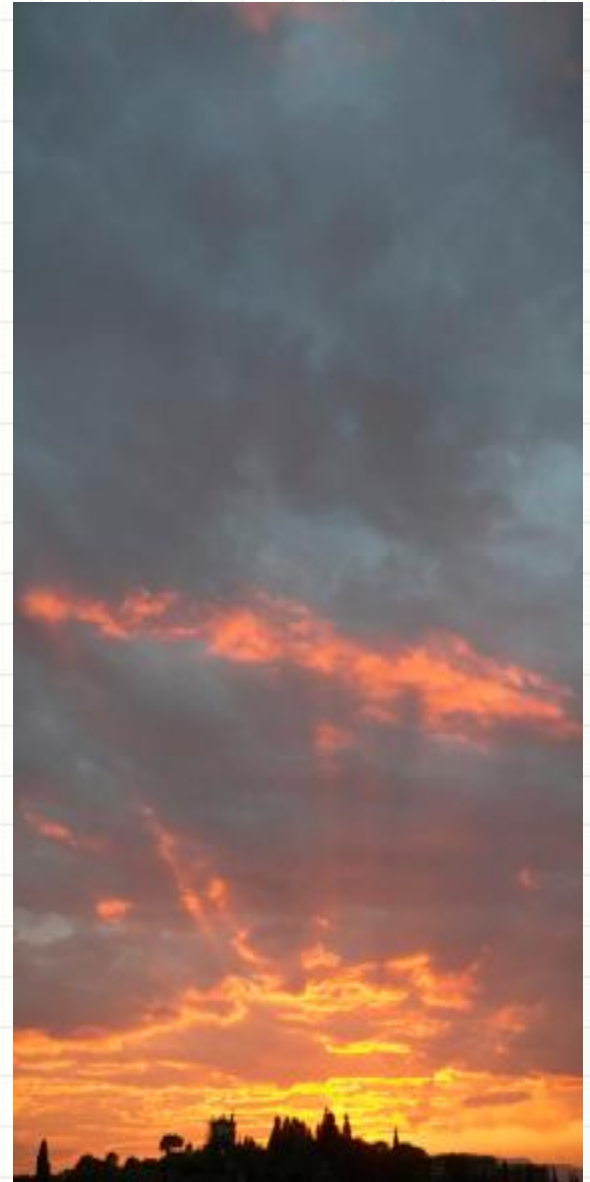
- **2010 Tax Act** (2011 & 2012 only)

- **Extends “Sunset” 2 Years**

(2000 Tax Cuts Expire **1/1/2013**)

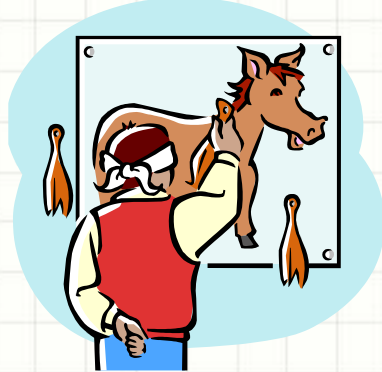
- **“NEW” Estate/Gift Tax Rules**

- \$5M “Unified” Exclusion
- Top 35% Rate
- Estate Tax Portability
- 2010 – “Elective” Carryover Basis



# OUR BIZARRE TAX ENVIRONMENT

## **“Temporary Tax” Provisions are the Norm**



- Maddening For Planners!
- Bad for Business Planning!
- Bad for Growth?!!

**ON 1/1/2013**

## **HERE WE GO AGAIN AS 2010 ACT EXPIRES!!!**

- Higher rates income tax & repeal other 2000 tax provisions;
- Pre-2000 Estate Tax Laws Reinstated  
((\$1M Exclusion Amount with top 55% rate))

**Another “Temporary” Law to the Rescue in 2013?**

# Today's Presentation

1

- Quick Overview of Income Tax Provisions

2

- New Estate, Gift & GST Rates, Exclusions & Rules

3

- Estate Tax Portability

4

- Carryover Basis (2010 only)

# PART #1

## 2011-12 Income Tax Relief

	<u>TOPIC</u>	<u>EXPLANATION</u>	<u>COST</u>
1.	<b>AMT PATCH</b> <b>Retained</b>	AMT Exemptions <ul style="list-style-type: none"><li>• \$72,450 - Joint Filers</li><li>• \$47,750 - Single Filers</li></ul>	<b>\$136.7 Billion</b>
2.	<b>PAYROLL TAX HOLIDAY</b> <b>NEW</b> <b>(2011 only)</b>	2% Decrease (to 4.25%) in Employee's Portion of Social Security Taxes	<b>\$111.7 Billion</b>
3.	<b>INCOME TAX RATES*</b> <b>Retained</b>	Rates remain at 2010 Levels (10% to 35%)	<b>\$97.5 Billion</b>
4.	<b>CHILD TAX CREDIT</b> <b>Retained</b>	\$1,000 Credit @ Child <i>(Phase-out if AGI &gt; \$110k)</i>	<b>\$91.4 Billion</b>

- 51% OF 2010 TAX ACT'S COST IN THESE FOUR ITEMS
- \*\$89.3 Billion to extend 10% income tax bracket for 2 years

# 2011-12 Income Tax Relief (Con'd)

	<u>TOPIC</u>	<u>EXPLANATION</u>	<u>COST</u>
5.	<b>QUALIFIED DIVIDENDS</b> <b>Retained</b>	<b>15% Taxation</b> (Zero Tax for 10% & 15% brackets)	<b>\$27.3 Billion</b>
6.	<b>CAPITAL GAINS RELIEF</b> <b>Retained</b>	<b>15% Taxation</b> (Zero Tax for 10% & 15% brackets)	<b>\$25.9 Billion</b>
7.	<b>MARRIAGE PENALTY RELIEF</b> <b>Retained</b>	<b>Relief Retained</b> (15% Bracket & Standard Deduction Tweaks)	<b>\$26.9 Billion</b>



# 2011-12 Income Tax Relief (Con'd)

	<u>TOPIC</u>	<u>EXPLANATION</u>	<u>COST</u>
8	<b>BONUS DEPRECIATION</b> <b>Retained</b>		<b>\$20.9 Billion</b>
9.	<b>ITEMIZED DEDUCTION &amp; PERSONAL EXEMPTION PHASE-OUT RELIEF</b> <b>Retained</b>		<b>\$20.7 Billion</b>
10.	<b>AOTC (formerly HOPE) EDUCATION CREDIT</b> <b>Retained</b>		<b>\$17.6 Billion</b>
11.	<b>ENERGY IMPROVEMENT CREDIT</b> <b>Retained 2011</b>	<i>Lower benefits than 2010</i>	<b><i>Undisclosed</i></b>

# 2011-12 Income Tax Relief (Con'd)

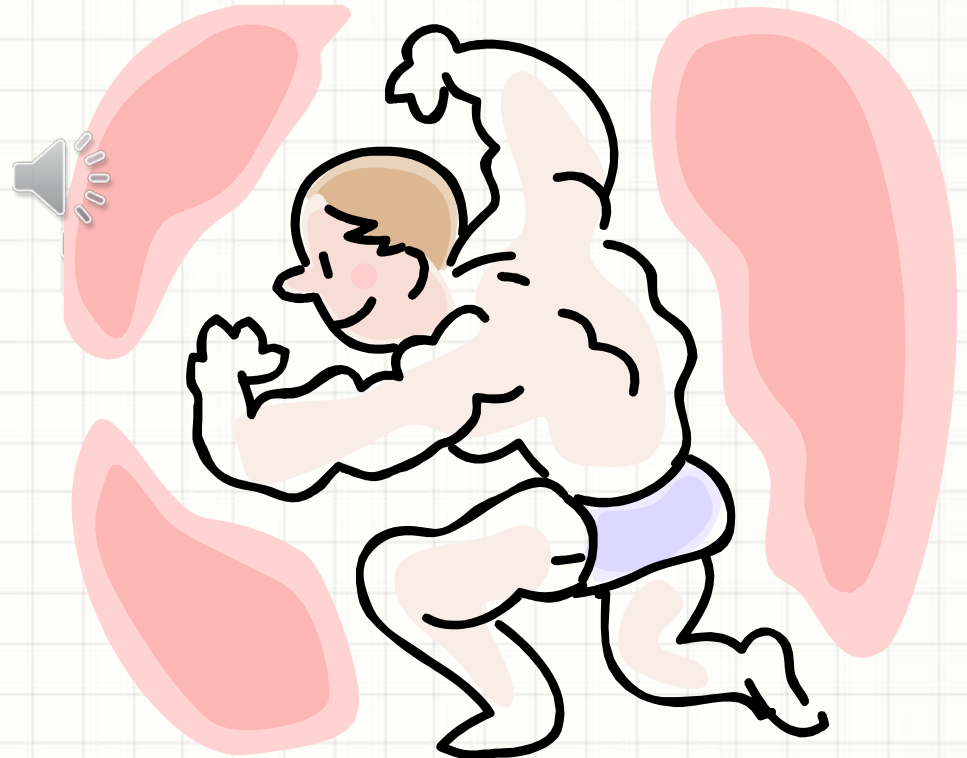
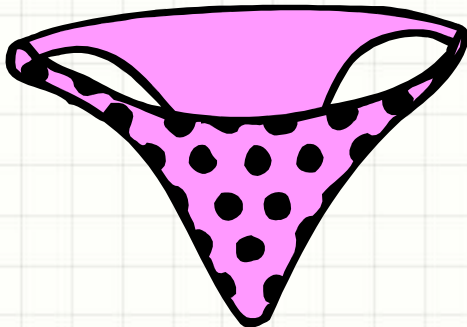
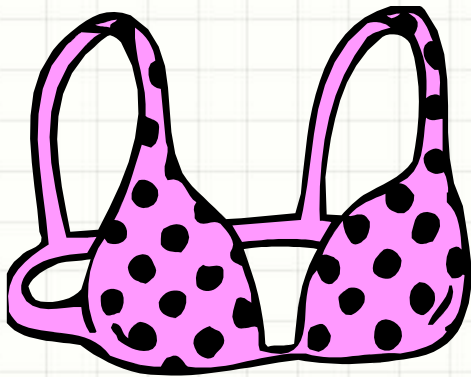
- **IRA CHARITABLE ROLLOVERS - Reenacted**
  - Expired 2009 Law: Up to \$100,000 Tax Free Distributions allowable from IRAs to Charities
  - New Law reenacts for 2010 & 2011 only
    - Strange Twist: 1/31/2011 Deadline for 2010 IRA Charitable Rollovers
- **Miscellaneous Other Income Tax Relief**

Employer provided education assistance; sales tax deduction; higher education tuition deduction; teacher's classroom expense deduction ; enhanced 179 expensing; research tax credit; work opportunity tax credit [and additional minor provisions herein intentionally omitted...]

## PART #2

# SEXY ESTATE, GIFT & GST TAX CHANGES

Projected Cost: \$68 Billion – 2 Years; \$300 Billion 10 Years



# Simplified Estate Tax Summary

<u>ESTATE TAX</u>	<u>2010</u>	<u>2011-2012</u>	<u>2013 "Sunset"</u>
Exclusion Amount	<b>\$5 Million</b>	<b>\$5 Million*</b> Plus "DSUE**" Possible <b>\$10 Million</b>	<b>\$1 Million</b>
*\$5M Exclusion Indexed for Inflation **"DSUE" = Deceased Spousal Unused Exclusion up to \$5 Million			
Maximum Tax Rate	<b>35%</b> <b>(0% if "Election" Carryover Basis)</b>	<b>35%</b>	<b>55%</b>

**2010  
Decedents**

## Estate Tax Repeal "Optional"

- Carryover Basis; OR
- Estate Tax Regime with \$5 Million Exclusion; 35% Rate



# Simplified Gift Tax Summary

<u>GIFT TAX</u>	<u>2010</u>	<u>2011-2012</u>	<u>2013 “Sunset”</u>
Exclusion Amount	\$1 Million	\$5 Million Plus 2011-12 Estate Portability up to \$5M “ <u>DSUE*</u> ” Possible \$10 Million	\$1 Million
		* \$5M Exclusion Indexed for Inflation	
		**“DSUE” = Deceased Spousal Unused Exclusion up to \$5 Million	
Maximum Tax Rate	35%	35%	55%

## REENACTS “UNIFIED” ESTATE & GIFT TAX EXCLUSIONS

- SAME \$5 Million Exclusion Amount (2011-12) for:
  - Estate Tax Purposes
  - Gift Tax Purposes

# Simplified GST Tax Summary

<u>ESTATE TAX</u>	<u>2010</u>	<u>2011-2012</u>	<u>2013 “Sunset”</u>
Exclusion Amount	<b>\$5M</b>	<b>\$5 Million</b>	<b>\$1 Million</b>
GST Tax Rate	<b>0%*</b>	<b>35%</b>	<b>55%</b>

- Prior to the new law, GST was repealed in 2010;
- 2010 Tax Act reinstated GST with a tax rate of 0% for 2010
- No GST Tax “Portability”

## **\*2010 was the “Golden Opportunity” to Make a GST Transfer**

- 2010 Gifts to “Skip Persons” results in Zero GST Tax:
  - Outright to Grandchildren or Great-Grandchildren;
  - Or to Trusts having only “Skip Persons” as beneficiaries;
  - Must “opt out” of automatic GST allocation rules.
- Make GST Tax-Free Distributions from Non-Exempt GST Trusts

# Does \$5M to \$10M Exemption Amount Kill Estate Tax Planning?

- "...ESTATE TAX PLANNING IS DEAD AS A DOOR NAIL"
- "I'VE HEARD VERY LITTLE ABOUT THE NEW EXEMPTION AMOUNT"
- "I'VE VISCEERATED MYSELF, BUT I'VE HEARD VERY LITTLE ABOUT THE NEW EXEMPTION AMOUNT"

# Who's Hurt by the New Law?

Profession	"Bad" Spin	"Good" Spin
<b>Losers &amp; Winners?</b> <b>ATTORNEYS</b>	<ul style="list-style-type: none"><li>• Less Emphasis on Tax Motivated Transactions;</li><li>• Clients less motivated to act;</li><li>• Internet &amp; non-specialist encroachment;</li><li>• Less referrals from generalist attorneys</li></ul>	<ul style="list-style-type: none"><li>• Clients will "do it themselves" &amp; screw up;</li><li>• More probate cases;</li><li>• Trickle down" of wealthy clients to middle market firms;</li><li>• Need to focus on non-tax substantive matters</li></ul>
<b>Winners?</b> <b>ACCOUNTANTS</b>	Less estate tax returns due to high estate exclusion amount	More estate tax returns driven by estate tax portability
<b>Losers?</b> <b>INSURANCE</b>	Ends Insurance Estate Tax Liquidity Planning for Middle Market Clients	Increase in Gift Tax Exclusion to \$5M permits ILIT Funding
<b>Losers?</b> <b>CHARITIES</b>	Wealthy less motivated to engage in tax motivated charitable transactions	Donors have More Money to Donate
<b>Winners?</b> <ul style="list-style-type: none"><li>• <b>BANKERS</b></li><li>• <b>FINANCIAL PLANNERS</b></li></ul>	More Money to Manage	Estate Tax Compliance Services are less important



# **Special 9/17/2011 Filing Deadline**

- **2010 Decedents**
  - **Filing Estate Tax Return;**
  - **Filling Carryover Basis Tax Return;**
  - **Paying Estate Taxes;**
  - **Making Disclaimers**
- **Reporting 2010 GST Transfers**
  - **“Election Out” of Automatic GST Allocation Rules**

# IMPOUNDERABLES

- **What will happen in 2013?**

- Will “Sunset” cause return to pre-2000 Law?
  - \$1 Million Estate & Gift Tax Exclusions
  - 55% rate
- Hard to see Federal Exclusion less than \$3.5 Million (2009 Law)
- Most likely Estate Tax Portability will be Retained
- In 2013, expect another “Temporary” Extension with \$3.5M to \$5M Exclusion, depending on politics

- **Will Illinois Estate Taxes be reenacted in 2011 at 2009 Levels? (\$2 Million IL Exclusion)**

**“The new Law Cannot be Fully Embraced until the above Uncertainties are Resolved.”**

**Robert J. Kolasa 1/13/2011**

# NEWSFLASH – PROBABLE IL ESTATE TAX REENACTMENT IN 2011



- Passed both Houses in morning– 1/12/2011
- **\$2 Million** Estate Tax Exclusion
- No Estate Tax Portability Provisions

# Shifting Paradigm for Attorneys

- **Tax Driven Strategies Less Useful**

(Credit Shelter Trust Planning, ILITs & Discount Planning...)

- **Review Outdated Strategies**

- Reevaluate all FLPS & Discount Mechanisms
- “Old” Marital & Credit Shelter Formulas

- **Revise Focus?**

- Saving Illinois Estate Taxes;
- Secure Future Estate Tax Portability;
- Asset Protection;
- “Dive into” Elder Law, IRS Audits; Exempt Organizations, Marital Planning, Corporate & Partnership Law





# The Decline of the Credit Shelter Trust?

- **Many Clients may not be subject to Estate Taxes**
  - New Law = “Chilling Effect” on Estate Tax Planning
- **Should Spousal Share be in Credit Shelter Trust?**

100% Basis Step-Up  
for **OUTRIGHT** Spousal  
Share

**VERSUS**

Spousal Share in  
**CREDIT SHELTER  
TRUST**

100% Basis Step-Up  
for Spousal Share in  
**MARITAL TRUST**

**\*Better if Federal Estate Taxes**  
(over \$10M estate; or \$5M  
without portability?)

**\*Better if No Federal Estate Taxes?**  
(under \$10M estate; or  
\$5M without portability?)

## **Countervailing Considerations**

- Increase in Value Avoids Estate Taxes **[Positive]**
- No Restriction in Drafting “Control” Mechanisms **[Positive]**
- Saves IL Estate Taxes **[Positive]**
- **Loss of Basis Step-up [Negative]**

# Does a \$2M Credit Shelter Trust Make Sense to Solely Save IL Estate Taxes?

- Husband & Wife worth \$4M; \$2M Credit Shelter Trust Funded 1<sup>st</sup> to die
- Assume No Federal Taxes upon Survivor's Death, with Survivor Estate = \$2M
- **Do IL Estate Tax Savings Outweigh Loss of Basis Step-up?**

<u>Credit Shelter Trust</u>	<u>Survivor's Estate</u>	<u>IL Estate Taxes Saved</u>	<u>25% Cap Gains Tax (Trust &gt; 2M)</u>
\$2M	\$2M	\$253,986	\$0
\$2.5M	\$2M	\$301,799	\$125,000
\$3M	\$2M	\$352,158	\$250,000
\$4M	\$2M	\$456,071	\$500,000
\$5M	\$2M	\$565,603	\$750,000



## Credit Shelter Trusts- IL Estate Tax Savings:

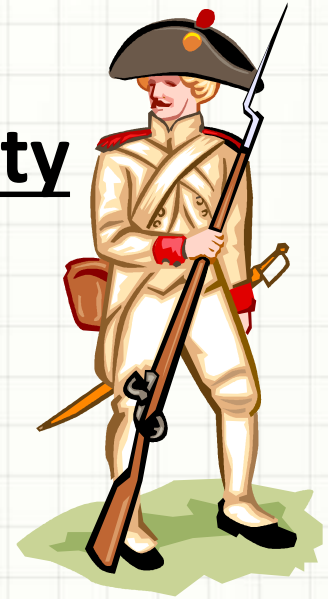
- **IL Estate Tax Savings** may be GREATER THAN increased income taxes due to lost **Basis Step-Up** (absent high Credit Shelter Trust growth)
- Case by case analysis

# Credit Shelter Trust Drafting

- **The Alternative: “I Love You” Wills/Trusts**
  - (Spouse 100% Beneficiary with Estate Tax Portability Planning)
- **Pressure to Liquidate Existing Credit Shelter Trusts in Zero Estate Tax Scenarios**
- **Disclaimer Trusts** (with Credit Shelter Component)
- **Joint Trusts** (Disclaimer and/or Credit Shelter Trusts)
- **Credit Shelter Provisions Permitting Optional Inclusion in Spouse’s Estate for Basis Step-up**
  - Inclusion to extent does not incur estate taxes in spouse’s estate;
  - Independent Trustee with “Best Interests” Distribution Standard;
  - Testamentary General Power of Appointment to Spouse;
    - Have Trust Protector Grant or through Formula Clause
      - GPA may not work well with Disclaimer Credit Shelter Trusts

# PART #3

## The “Revolution” of Estate Tax Portability



- Prior Law:
  - Credit Shelter Trusts to Utilize Both Spouses' Exclusion Amounts
  - If Assets go to Surviving Spouse, Exclusion of 1<sup>st</sup> to Die may be “Wasted”
- Portability = Surviving Spouse Uses 1<sup>st</sup> to Die's “Wasted” Estate Tax Exclusion



# “Portability” Estate Planning

(Presume both deaths 2011)

	Husband <u>Dies 1<sup>st</sup></u>	Wife <u>Dies 2nd</u>
ASSETS (\$10M)	\$0 (All to Wife)	\$10,000,000
Wife’s Exclusion	\$0	(\$5,000,000)
Husband’s Exclusion	\$0	<u>(\$5,000,000)</u>
FEDERAL ESTATE TAX	\$0	\$0

**Both \$5M Estate Tax Exclusions are Utilized  
Even though Assets Have Not Been Split**

# The Dark Side of Estate Tax Portability?

***Dating Ad: Love Starved Millionaire Needs Bride with Tax Attributes.***

***Applicants must be poor, terminally ill and upon death generate a \$5 Million Deceased Spousal Unused Exclusion (“DSUE”). Applicant must also sign prenuptial agreement providing estate tax portability election will be made upon death.***



**Legal Advice for Widows and Widowers: DO NOT MARRY A “RICH” SPOUSE WHO MAY DIE AND DOWNSTROKE YOUR VALUABLE DSUE!!!**

# The Portability “Blues”

- **Provision is Set to Expire on 12/31/2012**
  - Likely Congress will make Permanent
  - Otherwise, both Spouses Must die 2011-12 to Avail Portability Benefits
- **Election Required on Deceased Spouse's Timely Filed Estate Tax Return** (extended SOL)
  - Malpractice Trap?
  - Election should be Made for ALL Deceased Spouses?
  - Procure Spousal Consent if Election not made?
  - Exculpatory language for Executor if election not made?
  - Can Deceased Spouse's Will/Trust “Control” Election?
- **“DSUE” Limited to the “Last Deceased Spouse”**

# Portability Examples

## HUSBAND #1 Predeceases Wife in 2011

- **Husband #1 Prior Taxable Gifts of \$3M** (“Unused Exclusion = \$2M)
- Wife marries Husband #2 in 2012 who Dies (“Unused Exclusion = \$1M)

### #1 HUSBAND #1 Predeceases Wife in 2011: “DSUE” = \$2M

Wife’s Exclusion Amount	\$5 Million
<b>Husband #1 “DSUE”</b>	<b><u>\$2 Million</u></b>
Total	\$7 Million

### #2 HUSBAND #2 Predeceases Wife in 2012: “DSUE” = \$1M

Wife’s Exclusion Amount	\$5 Million
<b>Husband #2 “DSUE”</b>	<b><u>\$1 Million</u></b>
Total	\$6 Million

- **ZERO** “DSUE” if no Portability Election Made
- What if Wife made \$7 Million Gift in 2011, is there a “recapture” of the \$1 Million “Excess” DSUE?

**#3 If Wife Dies in 2011 with \$3M Taxable Estate?**  
**What is Wife's DSUE for Husband #2?**

Joint Committee on Taxation Example #3 (APPEARS "WRONG")

Wife's Exclusion Amount	\$5 Million
Husband #1 "DSUE"	<u>\$2 Million</u>
Total	\$7 Million
Less Taxable Estate	<u>(\$3 Million)</u>
Wife's "DSUE"	\$ 4 Million

Alternate Calculation (PROBABLY "CORRECT")

Wife's Basic Exclusion	\$5 Million
Less Taxable Estate	<u>(\$3 Million)</u>
Wife's "DSUE"	\$ 2 Million



## **PART #4**

# **CARRYOVER BASIS**

**Extinct After 2010**



# CARRYOVER BASIS – 2010 Decedents

## Much Ado About (Almost) Nothing?

### 2000 Act: Carryover Basis = Mandatory

- Tax Return > \$1.3M Non-Cash Assets
- Estate Tax Repeal in 2010

### 2010 Act: Carryover Basis = Elective

- 2010 Decedents
  - **May** Elect Carryover Basis Rules;
  - Default: Estate Tax Regimen with \$5 Million Exclusion

- Practical Effect

- All Estates < **\$5 Million** Default \$5M Estate Exclusion
- Most Estates > **\$10 Million** Elect Carryover Basis
- Estates between **\$5-10 Million** “Crunch Numbers”



# To Elect, or Not Elect Carryover Basis?

## Estates between \$5 to \$10 Million

- Client's Reluctance to Pay Immediate Estate Tax
  - Due 9/17/2011
- Mathematical Modeling to Calculate "Break Even" Point where Estate Tax = Income Tax
  - Estates *Greater than* BE Point Elect Carryover Basis
- Independent Variables:
  - Size of Gross Estate & Cost Basis
  - Estate Tax Exclusion Amount & Estate Tax Rate
  - Carryover Basis Adjustments
  - Income Tax/capital Gains Tax Rate
- Non-Tax Factors Not to Make Election

# **CARRYOVER BASIS CALCULATION:**

Code Section 1022

## **"Aggregate Basis Increase":**

### **1. Lesser of:**

- Historical Cost Basis at Decedent's Death; or
- Fair Market Value at Death

### **2. PLUS \$1.3M "Regular" Basis Increase**

### **3. PLUS \$3M "Spousal" Basis Increase**

# Step #1: Lesser of: Historical Cost Basis or Fair Market Value at Death

- **Historical Cost Basis**

- Lack of Decedent's Records Prevalent
- Educated Guess
- Guard Against Preparer Penalties
  - Clients sign Basis Affidavits?

- **Fair Market Value**

- Date of Death Appraisals still Needed





## Step #2: \$1.3M “Regular” Basis Increase

- Applicable to Every 2010 Decedent
  - Except Nonresident Aliens only receive a \$60,000 Increase
- Further Increased by:
  - Unused Capital Loss & NOL Carryovers;
  - Code Section 165 “Built in Loss Property”

## Step #3: \$3M “Spousal” Basis Increase

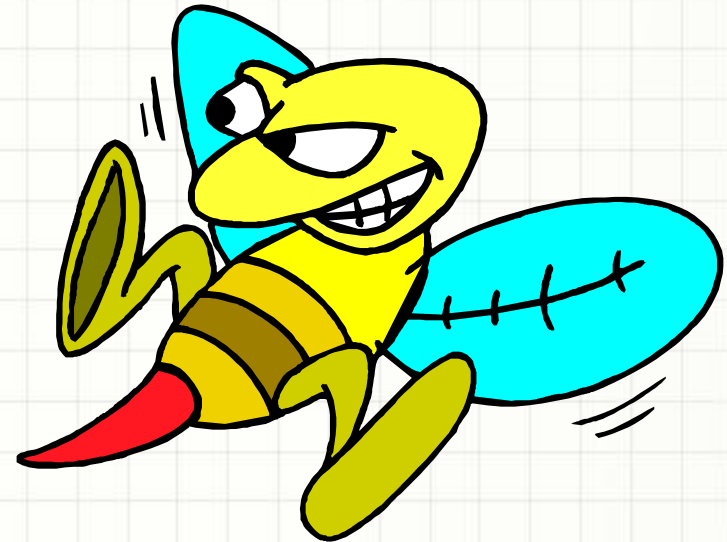
- **Outright Transfer Property to Spouse;**
- **Qualified Terminable Interest” (QTIP)**
  - Spouse must have “qualifying income interest”;
  - No lifetime distributions to non-spouses;
  - Broader Definition than Estate Tax Rules
- **Credit Shelter Trusts w/ Non-Spouse Beneficiaries**
  - **Does Not Qualify** for \$3M Spousal Basis Increase
  - Common Result in 2010 for standard A/B Trusts
  - Solutions:
    - Disclaimer by Non-Spouses
    - Virtual Representation Agreement stating that law as of 12/31/09 should apply;
    - Renunciation

# Carryover Basis Example

<u>ASSET</u>	<u>FMV</u>	<u>Basis</u>	<u>Bene.</u>	<u>Allocate</u> <u>#1</u>	<u>Allocate</u> <u>#2</u>	<u>Allocate</u> <u>#3</u>
Mutual Funds	\$3M	\$2M	Son #1	\$433k	\$325	\$0
Stocks	\$3M	\$2M	Son #2	\$433k	\$325	\$0
Inventory (ordinary Income)	\$3M	\$1M	Son #3	\$433K	\$650K	\$1.3M
<b>THEORY</b> <b>Allocate \$1.3M</b>				<b>Allocate \$1.3M Equally</b>	<b>Allocate to % of Appreciation</b>	<b>Allocate to Reduce Taxes</b>

# Executor Liability in Basis Allocation?

- Breach of Duty if Fails to Treat Beneficiaries “Fairly”?
- “Best Case” if Will/Trust has Basis Allocation Rules
  - Unlikely
- \$3M Spousal Basis may breeds less Conflict
  - 2<sup>nd</sup> Marriages?
- Special Spousal Basis Trust Formulas
  - “Largest” Fair Market Value of Property;
  - “Smallest” Fair Market Value of Property;
  - “Fairly Representative” of appreciation & depreciation



# Other Technical Problems

- Multiple “Executors” Disagree Basis Allocation
  - i.e., Executor & Trustee
- Property Must be “Owned” by the Decedent
  - Excludes POA Property; QTIPs; some GRATS/QPRTs
- IRD Property (i.e., IRAs) Excluded;
- “Negative” Basis Assets;
- No Automatic Long-term gains for inherited assets
- Satisfying pecuniary bequests with carryover basis assets



# Carryover Basis Return Filings

## Form 8939 – Due 9/17/2011

- **Severe Penalties Non-Filing:**
  - \$10,000 Penalty for “Late” Filings of Form 8939
  - \$50 @ Beneficiary Failure to Provide Information
  - Enhanced Penalty = **5% Property** for “Intentional Disregard” of Filing Requirements
  - Reasonable Cause Waiver
- **Does not Address Carryover Basis “Election”**
- **No Instructions released yet Form 8939**
- **Executor must provide:**
  - Name & tax number of recipient;
  - Description of Property
  - Basis and Date of Death Value of Property
  - Amount of Basis Increase



**QUESTIONS?**