

# The Tax Compromise of 2010

Two years of great planning opportunities ahead

With a stroke of his pen on Dec. 17, President Obama signed into law what some experts are calling the most significant tax legislation in the past decade. It ended a lengthy tax debate that felt more like a roller-coaster ride - fraught with drama and political theater. All of that now sets the stage for an even more vociferous tax battle in two years that will likely frame the 2012 presidential election.

The tax act, officially known as the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, delivers some temporary certainty on tax rates for the next two years. The key word here is "temporary."

At Laird Norton Tyee, we view the temporary nature of some parts of this legislation as a once-in-a-lifetime planning opportunity that should not be overlooked. Before getting to the opportunities though, we'll take a brief tour through the parts of the new legislation that may have the greatest impact on you and your family. The new law includes numerous benefits for businesses as well, which we will not address.

## Individual Income Taxes

The tax rates on ordinary income that we have enjoyed for the past decade (10% to 35%) have been extended through 2012. Also for the next two years, current rules for most itemized deductions and personal exemptions will not be limited based on income.

Importantly for you, tax rates on qualified dividends and most long-term capital gains remain at their 2010 levels of 0% and 15% but only through 2012.

Some popular tax deductions that expired at the end of 2009 have been revived for 2010 and 2011 including:

- The deduction of state and local general sales taxes
- Tax-free distributions from individual retirement plans for charitable purposes. The new law also allows individuals to make charitable transfers during January of 2011 and treat them as if made during 2010. These provisions are only available to those over age 70-1/2. Expanded deductions and carryover rules for contributions of capital gain real property for conservation purposes are continued through 2012
- The income tax rates for estates and trusts remain at their 2010 levels for 2011 and 2012 (15% to 35%)

## Alternative Minimum Taxes

More than 20 million taxpayers benefit in 2010 and 2011 from the new law's extension of the so-called Alternative Minimum Tax "patch." Basically, this provision maintains and inflation-adjusts the 2009 exemptions that operate to minimize a taxpayer's income subject to the AMT. In addition, for two more years, the AMT can be offset by personal tax credits.

## Benefits for Families

Tax provisions that benefit families, which would have expired at the end of this year, have been extended through 2012.

- Relief from the marriage penalty for those in the 15% tax bracket and those eligible for the earned income tax credit
- The expanded and (for some) refundable child tax credit in its 2010 form
- The dependent care credit is extended in its 2010 form through 2012. The current expanded credit amounts and eligibility provisions would otherwise have returned to pre-2001 levels the end of this year
- Expanded adoption expense deduction and credit provisions that would have expired at the end of 2011 are extended through 2012

## Provisions for employed and unemployed workers

For 2011 only, employees who currently pay a 6.2% Social Security tax will pay 4.2%. This applies to wages up to \$106,800. For an individual who makes at least \$106,800, this saves \$2,136. The employer contribution to Social Security Tax remains at 6.2%. For the self-employed, the tax rate on the first \$106,800 of self-employment income is reduced to 10.4%.

Unemployed individuals can receive unemployment compensation for a period of 79 weeks (up to 99 weeks in certain states with high unemployment). The new law continues this expanded coverage for one more year. It is applicable for those who become newly unemployed and those currently unemployed who have not yet received the maximum benefit available in their state.

## Estate, Gift and Generation-Skipping Taxes

The new law greatly expands the estate, gift, and generation-skipping tax rules, which we see as creating huge, but temporary, family wealth transfer opportunities.

The numerous changes in estate taxes may be the least-discussed but possibly the farthest-reaching provisions in the legislation. Most important, the estate and gift tax regimes are reunified after 2010 with a shared \$5 million exemption amount and tax rate schedule that tops out with a rate of 35%. This means that a person can give away as much as \$5 million during life or at death without triggering an estate or gift tax. Individuals, who can afford it, may make generous gifts during their lifetimes rather than deferring the gifts and their families' enjoyment of them until death. This will greatly expand families' opportunities to shift wealth to other generations. In addition, that \$5 million exemption will be adjusted for inflation after 2011.

For the families of those who die after 2010, if the decedent doesn't fully utilize the exemption with lifetime gifts or taxable at-death transfer, his or her executor can elect to transfer the decedent's unused exemption to the decedent's surviving spouse. The surviving spouse may use that expanded exemption for both lifetime gifts and at-death transfers. This feature, referred to as "portability," may lessen some estate plan complications involving multiple trusts, at least until the death of the second spouse.

The generation-skipping tax (GST) exemption also temporarily increases to \$5 million with a maximum tax rate of 35%. Like the estate and gift tax exemption, this exemption will be adjusted for inflation after 2011 but is not portable between spouses. Combined with the expanded lifetime gift tax exemption, this broader GST exemption will enable huge tax savings for families of wealth, allowing them to skip part of the transfer tax that would normally apply when wealth transfers from grandparent to parent to grandchild.

The changes discussed above apply after 2010. What happens for 2010? The repeal of the estate and generation-skipping taxes tax for 2010 has been repealed, retroactive to January 1, 2010. That means the estates of decedents, who die or have already died this year, **do** face an estate tax but with an exemption amount of \$5 million and a top rate of 35%. But for these estates, the executor may elect-out of the estate tax and instead subject the estate to the modified carryover basis rules that are otherwise repealed for 2010. If you believe this election could apply in your family, please contact us or consult with your tax advisor. The generation-skipping transfer tax also applies to transfers during 2010, but the tax rate applied to those transfers in 2010 is 0%. The lifetime and at-death, generation-skipping tax exemption for 2010 is \$5 million. This means that for what's left of 2010, unlimited amounts may be transferred to grandchildren with no GST cost. The gift tax for 2010 is unchanged with a top rate of 35% and a \$1 million lifetime exemption and would apply to transfers to grandchildren.

## Conclusion

We cannot emphasize enough that the planning opportunities afforded by this new legislation, particularly in the estate taxes section, are short-lived. At the end of 2012, the estate, gift and generation-skipping tax rules that we expected to face in 2011 return. They include the \$1 million lifetime and at-death estate and gift tax exemption and a generation-skipping tax exemption of \$1 million, adjusted for inflation since 1998. The top tax rate will be 55%, except for those whose lifetime and at-death transfers exceed \$10 million for whom there is a limited 5% additional surtax on transfers up to \$17.184 million.

It is possible that these expanded transfer tax opportunities will not be extended again after 2012. We strongly recommend that clients consult their tax advisors about their wealth transfer plans that may have been “on hold” during 2010 due to tax uncertainty. With the expanded gift tax exemption, some wealth transfer “wishes” that were considered out of reach due to tax cost may have become affordable.

It is also a great opportunity to talk to your Laird Norton Tyee advisor about the continued favorable rates for Roth IRA conversions, strategies for transitioning closely held stock portfolios at the now extended lower capital gain tax rates, and how all of these opportunities can strengthen your overall financial plan.

## About the author

**Kristi Mathisen** serves as Laird Norton Tyee's in-house expert on tax and estate planning issues. She provides advice on philanthropic strategies to the firm's client service team and to clients directly. She is an attorney and CPA and has more than 20 years of finance-related experience, much of it in accounting.

Kristi has a bachelor's degree in business administration with an accounting concentration from the University of Washington and a Juris Doctor from the University of Washington School of Law. She is a member of the Washington State and King County Bar Associations, the Washington State Society CPA and the American Institute of CPAs.

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