

## 2011 Federal Tax Update

On December 17, 2010 Congress enacted the 2010 Tax Act (the official name is the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010). In the federal *income tax area*, the Act generally extended the 2001 and 2003 tax cuts through December 31, 2012 and extended a number of other deductions and credits. In the federal *estate tax area*, the Act adopted five changes. We have summarized the effects of the various federal changes briefly below and look forward to hearing from you with your questions and comments.

**Deaths in 2010.** The estate of a person who died in 2010 may choose to be subject to estate tax or may opt out of the estate tax. Congress retroactively gave estates of decedents dying in 2010 a \$5,000,000 exemption; thus, in most instances, estates of \$5,000,000 or less will want to be subject to the estate tax - - because the exemption will mean the actual estate tax will be zero - - and each asset in the estate will receive a new income tax basis that is adjusted to the fair market value on the decedent's date of death.

For estates that are greater than \$5,000,000 the decision is more complicated because the estate can choose to pay estate tax at a rate of 35% on the amount in excess of \$5,000,000, and receive a full income tax basis adjustment, or may opt out and pay zero estate tax but at a cost of not receiving a full income tax basis adjustment. Which is more advantageous depends on the specific assets and circumstances involved.

If you are a beneficiary, executor, or family member of a person who died in 2010 then you should consult with your estate planning advisor.

**Those With Under \$5,000,000.** For 2011 and 2012 Congress has given everyone a \$5,000,000 exemption from the gift, estate, and generation-skipping taxes. That has the effect of substantially reducing the number of taxpayers who are subject to the tax at all. Unfortunately, the exemption automatically decreases to \$1,000,000 on January 1, 2013 unless Congress extends it. Congress did not act to extend the 2001 tax provisions for 2010 until 2010 was almost over(!) so we are reluctant to guess what Congress will do in the next two years.

We could reasonably conclude that the amount of the exemption has never decreased before and so it is unlikely to do so this time, in which case we would assume a \$5,000,000 exemption will be with us for many years. Or, we could reasonably conclude that in 2012 the economic, political, and tax situations will be different and favor a tax increase and the exemption amount could decrease to \$3,500,000, the amount proposed before the adoption of the 2010 Act. Or, we could reasonably expect gridlock in which case \$1,000,000 will be the default result after 2012.

While the federal estate tax exemption has been increased to \$5 million for 2011-2012, the Maine tax laws continue to impose Maine estate taxes for estates of more than \$1 million, subject to deductions such as bequests to spouses and charities.

Individuals and couples with less than \$5,000,000 may be able to simplify their planning. For example, they may have trusts that should be modified or terminated to reduce administrative costs and complexity. In some instances the prudent course may be to wait a year or two to see in what direction Congress goes but the issue is worth review and discussion now.

**Married Couples With Between \$5,000,000 and \$10,000,000.** Married couples with between \$5,000,000 and \$10,000,000 may be fully protected in 2011 and 2012 but we do not know what will happen in subsequent years. Regardless, the Act gives married couples a new benefit, namely the ability of a surviving spouse to use the unused exemption of a deceased spouse (commonly referred to by the short-hand "portability"), that should be considered.

Suppose Jim dies in 2011 with a \$3,000,000 estate all of which passes into a trust for the benefit of his wife, Mary, and their children. Jim's estate has a \$5,000,000 exemption of which \$2,000,000 would not be used. Then in 2012 Mary dies with a \$7,000,000 estate. Before the recent change, Mary's estate would have paid estate tax because her \$7,000,000 estate would have exceeded her \$5,000,000 exemption. However, the portability feature of the new Act allows Mary's estate to use Jim's \$2,000,000 unused exemption, so her estate will pay no tax.

Portability may be very helpful but cannot be relied on. For instance, if a surviving spouse remarries then the use of the deceased spouse's exemption may be lost.

**Individuals With More Than \$5,000,000 and Married Couples With**

**More Than \$10,000,000.** The new Act creates many opportunities to reduce eventual estate taxes because the \$5,000,000 exemption applies not only to estates but also to gifts. For the last decade the gift tax exemption was frozen at \$1 million while the estate tax exemption rose so the reunification of the two exemptions is a welcome change. Many donors are reluctant to make gifts because they do not want to reduce their income or lose investment control but many techniques allow gifts to be made where the donor continues to receive the income and control the investments so those objectives should not present an obstacle to good planning under the new Act.

**The Importance of Comprehensive Planning,** The new Act reduces the gift, estate, and generation-skipping tax rates to 35%. In the last 20 years the rate has been as high as 55% and that will be the rate again on January 1, 2013 unless Congress acts. With the larger exemption, however, at least for the next 2 years fewer people will be paying a federal estate tax. For those people the new concern is income tax basis and continuing Maine estate taxes. Much of the planning done in the last 20 years has involved creating ways to discount assets.

Given these recent developments, you should consider contacting your estate planning attorney to determine whether your estate planning objectives are being met.