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Federal Tax Update

INSIDE THIS ISSUE:

Temporary Changes 1
Make Gifts Now 1
Estate Tax & "Portability" 2
Limitations on GST Exemption 2
Proposed Changes to MRDs 2
GRATS Under Attack 3
Discounts for Gifts Limited 3
Income Tax Changes 3
Illinois Estate Tax 4
What should you do? 4

Summary of The Tax Relief Act of 2010 and Other Proposed Tax Changes

Temporary Changes

The changes are only temporary. That is the biggest take-away from the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (the "Tax Relief Act of 2010" of the "Act"). So take advantage of them now.

As you probably know, the Federal government enacted a new tax act at the end of December. This was a compromise negotiated between President Obama and Congressional Republicans, mostly about extending the Bush Era tax cuts. Since it was a compromise, the changes made by the Tax Relief Act of 2010 are only temporary, most expiring at the end of 2012.

Further, President Obama recently proposed his budget for the 2012 fiscal year. President Obama proposes to make some of the Tax Relief Act of 2010 permanent, while maintaining that some are temporary. In addition to those changes regarding the Tax Relief Act of 2010, President Obama has proposed other changes to the tax laws that affect estate and gift taxes.

Make Gifts Now

One change made by the Tax Relief Act of 2010 was a substantial increase in the gift tax exemption. In 2010, the lifetime gift tax exemption was $1 million. That meant you could give away up to $1 million during your life without paying gift tax on that amount. Even if you gave away more than $1 million, the gift tax rate was an historically low 35% on those gifts over $1 million.

The Tax Relief Act of 2010 increased the gift tax exemption to $5 million for 2011 and 2012 (adjusted for inflation in 2012), with the gift tax rate remaining at 35%. After 2012, the exemption is slated to return to $1 million. The President's proposed budget assumes the exemption returns to $1 million. That means, if you ever thought about making large gifts to your children or grandchildren, the next two years is the time to do it.

Obviously, for many people, a $5 million gift is out of the question. Even some with the wherewithal may not want to give up control of the family business or discourage their children from attaining their own goals by relying on such large gifts. However, even smaller gifts over the next two years would be advisable. Further, there are ways to make gifts, thereby removing assets from your estate, while still allowing you to retain some of the benefits and control of the gifted asset.

Be sure to take advantage of the temporary increase in the gift tax exemption. It could be gone in 2013.

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Estate Tax and "Portability"

The Tax Relief Act of 2010 also increased the estate tax exemption to $5 million for 2011 and 2012 (adjusted for inflation in 2012), returning to $1 million in 2013. In addition, the Act instituted "portability." That means if the first spouse to die does not use all of his or her $5 million estate tax exemption, the surviving spouse can "port-over" the unused exemption to his or her estate. Thus, the second to die could pass $10 million estate tax free. However, as the law currently stands, both spouses must die before December 31, 2012 and the executor of the estate of the first to die must file an estate tax return electing to carry-over the unused exemption. President Obama has proposed making portability permanent to allow couples to take advantage of the estate tax exemption without elaborate planning and re-titling of assets.

However, portability is not a substitute for proper estate planning. For instance, portability does not account for state estate taxes, nor does it provide asset protection or remove the appreciation from the estate tax regime. With proper estate planning, you can maximize the amount of assets passing estate tax free, and ensure that the appreciation after the death of the first spouse remains outside of the surviving spouse's estate. In addition, portability is limited to the unused exemption of the most recently deceased spouse. Therefore, if the surviving spouse remarries and the second spouse dies, using his or her full estate tax exemption, the surviving spouse loses out completely on the unused exemption of the first deceased spouse. Proper estate planning can preserve that exemption.

Annual exclusion gifts are still a good idea, especially if you are not in a position to make large gifts to children or grandchildren.

Limitations on GST Exemptions

If you make gifts, including at your death, to your grandchildren (or to a trust for your grandchildren), those gifts are subject to a Generation Skipping Transfer Tax ("GST Tax"). Pursuant to the Tax Relief Act of 2010, you have a GST Tax exemption of $5 million that you can allocate to those gifts. That means you can give up to $5 million to your grandchildren without incurring a GST Tax at a rate of 35%, which is in addition to any estate and gift taxes. If the gift is to a dynasty trust, the trust can continue for all your future descendants without ever incurring a GST Tax or estate tax. President Obama has proposed to limit the GST Exemption to 90 years. Pursuant to his proposal, after 90 years, distributions from that dynasty trust would be subject to GST Tax.

Proposed Changes to MRDs

President Obama has proposed eliminating the Minimum Required Distributions ("MRDs") from qualified retirement plans for individuals with plans totaling $50,000 or less. Under most qualified retirement plans, like 401(k)s and IRAs, the owner must begin taking minimum distributions upon attaining age 70 ½ or be subject to a tax penalty. If all of the individual's IRAs, 401(k)s, and other qualified plans total $50,000 or less, then, under President Obama's proposal, the individual would not need to take minimum distributions from the plans. However, if the plans have already begun payments, like annuities, those plans are excluded from the President's proposal.

Grantor Retained Annuity Trusts Under Attack

While the Tax Relief Act of 2010 did not institute any limitations on Grantor Retained Annuity Trusts (GRATS), President Obama has taken up the perennial proposal to limit GRATS to a 10-year term and require a remainder gift greater than zero. As noted in our prior Federal Tax Update Newsletter, with a GRAT, you transfer certain assets to a trust. For a set term, the trust pays you a fixed amount of income (an annuity). At the end of the term, the remaining assets in the trust pass to your children, or whomever you wish to designate as the remainder beneficiary. The value of the gift to your children is calculated as the present value of the child's future interest in the assets and currently can be structured to be even zero. However, there has been much talk in Congress over the past few years of creating a minimum term for GRATs and eliminating the possibility of a remainder gift of zero. President Obama has apparently signed on to these proposals. Thus, now is a good time to create a GRAT, especially with the current low rates used to calculate the present value of the gift.

Given the uncertainty about the changes to the tax laws, you should take advantage of them now, before they disappear.

Discounts for Gift Tax Purposes May Be Limited

Currently, you can make a gift of a minority interest in a closely held business and receive a discount on the gift tax value. That means, for example, although the actual fair market value of the interest in the business may be $100,000, you could discount the gift by 35% and report a gift of only $65,000 on the gift tax return.

President Obama has proposed effectively eliminating the ability to discount the value of those gifts. The argument is that taxpayers should take a consistent approach to valuation; taxpayers should not be able to discount the value of the gift for gift tax purposes, but rely on the true fair market value of the gift for capital gains tax purposes.

For many, given the increased gift tax exemption, the ability to discount the gift may be unnecessary. However, the possible loss of the ability to discount gifts further encourages gifting at this time.

Income Tax Changes - Temporary

The income tax changes made by the Tax Relief Act of 2010 are also temporary, so enjoy them now. You have two years to enjoy the continued reduced qualified capital gains and dividend tax rate of 15%. Likewise, you have two years to enjoy the continued reduced ordinary income tax rates. In addition, you have two years to enjoy the delayed phase-out of certain itemized deductions as well as the personal exemption phase-out. You also have two years to take advantage of the continued increases in the Child Tax Credit, the Earned Income Tax Credit, the Adoption Credit, and the Dependent Care Credit, and you have two years to enjoy the Alternative Minimum Tax ("AMT") patch.

Further, your portion of Social Security taxes is reduced from 6.2% to 4.2% for wages earned in 2011. Your employer's portion of Social Security taxes remains 6.2% for 2011. That means you should see a reduction in withholdings on your paycheck. Unfortunately, for Illinois residents, much of the federal "payroll tax holiday" will be offset by the increase in Illinois income taxes.

Illinois Estate Tax

In addition to the changes in federal estate tax laws made by the Tax Relief Act of 2010, Illinois recently renewed its estate tax. The previous Illinois estate tax law expired at the end of 2010. As before, the Illinois estate tax is based on the old federal estate tax credit for state estate taxes. Although this credit is no longer available for federal estate taxes, Illinois still uses the old formula for the credit amount as its estate tax. Further, the Illinois estate tax exemption is $2 million, which is $3 million less than the federal exemption. That means a decedent with an estate between $2 million and $5 million may end up paying Illinois estate tax but no federal estate tax.

However, Illinois also renewed the law allowing the creation of a state marital trust, deferring any Illinois estate tax until the death of the surviving spouse. Thus, you can allocate the difference between the Illinois exemption and the federal exemption to a special state marital trust so that no estate tax – state or federal – is paid on the death of the first spouse. If the surviving spouse exhausts the state marital trust, then on the death of surviving spouse, there will be no state estate tax paid on that amount. Note that this deferral of Illinois estate tax requires proper estate planning which straight reliance on the portability of the federal estate tax exemption would omit.

An estate plan is like a car: periodic tune-ups keep you from stalling out. Be sure you know what your plan provides. Review it during important life events and every few years.

What should you do?

Now is a great time to make gifts: certain assets are still at depressed values, the lifetime gift tax exemption and the GST Tax exemption are each at $5 million, and coupled with the possible limitations on GRATs and valuation discounts, the sooner you can make your gifts, the better. There are many ways to make gifts and they each can provide different benefits.

In addition, now is also an important time to review your current estate plan. Many estate plans are based on formula gifts, which may lead to unintended consequences with the $5 million estate tax exemption (e.g. all of your assets going to your children, with nothing going to your surviving spouse). Moreover, your financial situation may have changed since your estate plan was last revised, necessitating additional revisions. Further, your estate plan may not account for the difference between the Illinois estate tax exemption and the federal estate tax exemption. Please contact us to discuss your individual situation.

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