THE CATHOLIC FOUNDATION

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THE Good Advisor

Recent Changes that Affect Individual Taxpayers

INTRODUCTION

On December 17, 2010, President Obama signed into law the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (TRUIRJCA). Like the Pension Protection Act of 2006 and the Economic Growth and Tax Relief Reconciliation Act of 2001, this new law has a wide-ranging impact on individual and corporate taxpayers. Although news reports emphasized how TRUIRJCA extends the Bush-era income tax rates, there are other key provisions that deserve a closer look.

In this issue of ***The Good Advisor***, we review the new tax law. We will pay special attention to how the new tax law intersects with charitable giving. Many commentators have said that people would regularly give to charity with or without the benefit of a charitable deduction. Nonetheless, advisors should be prepared to discuss the current tax climate with donors, including ideas about how charitable giving can play a role in their planning.

INCOME TAX PROVISIONS THAT AFFECT INDIVIDUALS

Probably the most discussed provision of the new law is an ***extension of individual income tax rates through 2012***.

Under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), the income tax rates were reduced to 15%, 25%, 28%, 33% and 35%. Originally, these rates were to be gradually lowered over several years, but the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) made the lower rates effective on January 1, 2003. EGTRRA also introduced a sixth tax bracket – the lowest tax bracket of 10%.

Under the sunset provisions of the Bush-era legislation, these rates would have reverted back to the higher rates in effect prior to EGTRRA after December 31, 2010. However, TRUIRJCA preserves the Bush-era tax rates for 2011 and 2012.

Relief from the "marriage penalty" continues. Provisions that double the standard deduction and widen the 15% tax bracket for joint filers will stay in effect for 2011 and 2012. Otherwise, the tax imposed on a married couple could be greater than the tax owed if husband and wife had filed separately.

Another item that favors the taxpayer in the new law is an ***extension of reduced rates on capital gains and qualified dividends through 2012***. Under JGTRRA, the tax rate for capital gains on property held for more than one year was reduced from 20% to 15%. And, for taxpayers with a top marginal tax rate of 10% or 15% the rate was further reduced to 0%. The same Bush-era legislation that reduced capital gains taxes also lowered the rate on qualified dividends. Instead of being taxed as ordinary income, qualified dividends are taxed at 15% or 0%, depending on the individual's top marginal tax rate (same as for capital gains).

In prior years, the overall limit on itemized deductions for high income taxpayers (known as the ***"Pease" limitation***) would reduce what a taxpayer could deduct by 3% of adjusted gross income for deductions in excess of a certain dollar amount (not to be reduced more than 80%). EGTRRA incrementally rolled back the Pease limitation on itemized deductions: a one-third reduction of the limit in 2006 and 2007; a two-thirds reduction in 2008 and 2009; and no limit at all in 2010. TRUIRJCA extends the repeal of the Pease limitation for 2011 and 2012.

Similarly, the personal exemptions claimed by high income taxpayers once had to be reduced by 2% for each $2,500 in adjusted gross income in excess of a certain dollar amount. EGTRRA also incrementally rolled back the phase-out in personal exemptions for high income taxpayers until there was no reduction at all in 2010. TRUIRJCA extends the repeal of the personal exemption phase-out in 2011 and 2012.

An especially popular provision with wage earners is the ***payroll tax holiday***. Employers are required to withhold a certain percentage of wages on every paycheck for social security. Both the employee and the employer are normally required to contribute 6.2% of wages towards this obligation (a total of 12.4%). However, in 2011 the employee's contribution is reduced 2% so only 4.2% of the employee's wages are required to satisfy the payroll tax. Note that the maximum amount of annual wages subject to the payroll tax is $106,800. A person earning this amount (or more) will have an additional $2,136 in take-home pay.

When considering what short-term benefit can be had by this additional pay, many donors might be interested in making or increasing annual contributions to charity.

Congress has put into place an ***Alternative Minimum Tax (AMT) exemption "patch"*** for 2010 and 2011. This temporary measure will prevent the AMT from applying to a greater number of taxpayers (due to a low statutory exemption amount). The exemption amounts for 2011 are $74,450 for married persons filing joint returns, $37,225 for married persons filing separate returns, and $48,450 for unmarried individuals.

PROVISIONS THAT AFFECT CHARITABLE GIVING

IRA Charitable Rollover

The new law revives the IRA Charitable Rollover that permits donors age 70 1/2 and over to make a qualified charitable distribution up to $100,000 directly from an IRA to a charity in 2011. The distribution is not taxable income for donors, and the amount counts towards the required minimum distribution for that tax year.

Extension of the Increased Deduction Limits for Contributions of Real Property Made for Conservation Purposes

There are annual limits on how much of a charitable contribution can be deducted under IRC Sec. 170. The standard limit on the deduction of long-term capital gain property to a qualified public charity is 30% of adjusted gross income (AGI). However, a charitable gift of real property made for conservation purposes can be deducted up to 50% of AGI for a limited time. Furthermore, the carryover of the excess contribution amount into future years is increased from five to fifteen years.

In order for the gift to qualify, the property must be subject to a perpetual easement or restrictive covenant that prevents the development of the property, safeguarding its natural character or historic significance. There are even more beneficial rules for farmers and ranchers who make such a gift if the contribution does not prevent the use of the donated land for farming or ranching purposes. The enhanced deduction for contributions of real property made for conservation purposes is extended through the end of 2011.

Extension of the Enhanced Deduction for Contributions of Certain Inventory

Inventory is considered ordinary income property for purposes of determining the deduction for a charitable contribution. Under normal rules, the deduction for a gift of ordinary income property is reduced by whatever would be considered gain (which usually leaves the deduction at cost basis). However, there are exceptions: gifts of food inventory (made by corporate or non-corporate taxpayers), book inventory and computer inventory (made by corporations) will only be reduced by one-half of what would be gain if it had been sold, or up to twice the donor's cost basis (whichever amount is less). The enhanced deduction for contributions of certain inventory is extended through the end of 2011.

Favorable Basis Adjustment to Stock of S Corporations Making Charitable Contributions of Property

Before the passage of the Pension Protection Act of 2006, if an S corporation made a gift to a qualified charity, each shareholder would account for his or her pro rata share of the contribution when determining income tax liability. To wit, a shareholder would reduce his or her basis in the stock by the amount of the charitable contribution that flows through to the shareholder.

However, after the PPA and subsequent legislation, the amount of a shareholder's basis in S corporation stock reduced by reason of a charitable contribution made by the corporation is limited to the shareholder's pro rata share of the adjusted basis of the contributed property, not its fair market value. This benefit to S corporation shareholders is extended through 2011.

TRANSFER TAX PROVISIONS

The Return of the Estate Tax

Many of your clients will be interested in the impact of TRUIRJCA on Federal transfer taxes. To start, the Federal estate tax has returned. The estate tax applicable exclusion amount equals $5 million and the top tax rate is 35% in 2011. For years after 2011, the applicable exclusion amount is indexed for inflation and can increase in increments of $10,000.

Option to Subject 2010 Estate to Taxation

Due to EGTRRA's sunset provision, there was no Federal estate tax in 2010. However, modified carryover basis rules applied to the estate property. This meant the decedent's income tax basis is the starting point for determining basis for the heir who receives the property. The executor could allocate $1.3 million towards the basis for all heirs and an additional $3 million towards property to the spouse.

Under the new law, however, the executor of an estate of someone who died in 2010 has another option besides the no estate tax/modified carryover basis regime: choose to subject the estate to taxation under the 2011 rates and applicable exclusion amount (tax rate of 35% and a $5 million applicable exclusion amount). The executor must weigh the advantage of subjecting the estate to the tax in order to utilize the stepped-up basis rules (the fair market value at the time of death determines basis, which is to the advantage of the heir who receives the property).

Step-Up Basis

The stepped-up basis is part of the revived Federal estate tax. Assets acquired through the estate receive a basis of the value of the asset on the date of death (or the value of the asset up to six months following the date of death if the executor chooses the alternate valuation date).

Portability of the Unused Spousal Applicable Exclusion Amount

In the event the decedent dies in 2011 or 2012, the decedent's estate may use some, all or none of the applicable exclusion amount. If the decedent's estate uses only some or none of the applicable exclusion amount, the executor can elect to transfer the unused applicable exclusion amount to the surviving spouse. Thus, the estate of the surviving spouse has his or her individual applicable exclusion amount plus what was left by the first spouse to die.

Gift Tax in 2011 and 2012

The tax rate for the gift tax is 35% (like the estate tax). The lifetime exclusion for taxable gifts is $5 million.

Restoration of the Unified Credit

Prior to EGTRRA, there was a unified credit—the lifetime exclusion for gifts was the same amount as the estate tax applicable exclusion. EGTRRA decoupled the credit amount—the lifetime gift tax exclusion was restricted to $1 million and the estate tax applicable exclusion amount gradually increased to $3.5 million. The new law re-links the gift and estate tax applicable exclusion amounts.

Generation Skipping Transfer Tax in 2010-2012

Due to the sunset provision of the Economic Growth and Tax Relief Reconciliation Act of 2001, there was no generation skipping transfer (GST) tax in 2010. However, the new law replaces the no-GST tax regime in 2010 with a 0% GST tax rate and a $5 million exemption (so no GST tax applies to 2010 transfers).

The GST tax in 2011 and 2012 corresponds with the $5 million applicable exclusion amount and a tax rate of 35%.

SUNSETS, UPCOMING LEGISLATION AND LOOKING FORWARD

A startling but, perhaps, not surprising aspect of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 is its sunset provision. Every part of the new law discussed in this newsletter has an expiration date of 2011 or 2012. What will the new law be after the temporary fix ends? It is difficult to say. After the unexpected one-year repeal of the estate tax in 2010, it is difficult to predict what Congress will do.

However, an unpredictable Congress does not mean there is no need to look towards 2013 and beyond. Periodic reviews are an integral part of meeting retirement and estate planning goals. And this planning can be flexible to anticipate or accommodate changes in the law. The ultimate goal is not simply to avoid income and transfer taxes –there are more important things like providing for loved ones and leaving a legacy through charitable giving.

New Tax Developments

Charitable Deduction Denied for Contribution to Donor Advised Foundation

The donor transferred appreciated stock to a purported donor advised fund: a segregated account maintained by a foundation qualified under IRC Sec. 501(c). The donor took a charitable deduction for the value of the stocks at the time of the transfer. The stock was sold by the foundation and the proceeds invested in an aggressive manner per the donor's request.

Later, the donor instructed the foundation to distribute funds in lieu of an education loan to one of his children (a permitted use of donated funds under the terms of the agreement with the foundation). Under the terms of this loan program, the borrowed money (and interest) could be repaid either through payments generally commencing 5 years after graduation or by the recipient's providing charitable services for a designated period of time that depended on the number of educational year financed by the loan.

The Tax Court ruled that the contribution to the foundation did not qualify as deduction because the donor did not relinquish dominion and control over the assets. Nor did the donor obtain proper substantiation of the charitable gift (a written statement by the charity that no goods or services were provided in consideration of the gift did not satisfy this requirement because the donor did actually receive the benefit of the educational loan).

Furthermore, the donor was properly assessed negligence penalties because neither the attorney opinion letter describing the tax benefits of giving to the foundation (but not on the operation of its student loan program), nor the incomplete advice offered by the accountant who was not fully appraised of the details concerning the student loan program would absolve the donor.

Viralam v. Commr., 136 T.C. No. 8; Docket No. 21355-03 (February 14, 2011).

Nevada State Supreme Court Denies Donor's Claim to Recover Contribution from Donor Advised Fund

A donor made a large contribution to a donor advised fund (DAF). Unfortunately, the entity administering the DAF paid exorbitant salaries to its two directors, made no distributions to any charity despite the donor's requests, and subsequently lost its status as a public foundation. The donor sued in Nevada state court to rescind the DAF agreement and recover the contribution as well as damages, fees and other relief.

In its affirmation of the trial court ruling denying the donor's claim, the Nevada State Supreme Court pointed to the terms of the DAF agreement which state the gift is unrestricted and the donor gives up any and all interest in the donation. Thus, the donor did not suffer any damages when the charity refused his grant recommendation. This ruling underlines the fact that a donor can only ask that the DAF make a grant to a qualified charity, not demand that a grant be made.

Ray Styles v. Friends of Fiji, Nev. S.Ct., No. 51642 (February 8, 2011).

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The TaxRelief Act of 2010: A Closer Look at the New Law

In This Issue:

Why Is the New Law Important?

When Will It End? Regarding the Sunset Provision

Income Tax Provisions that Affect Individuals

Provisions that Affect Charitable Giving

Transfer Tax Provisions

Introduction: Why Is the New Law Important?

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (TRUIRJCA) has a wide-ranging impact on individual and corporate taxpayers. In the newsletter, we summarized some aspects of the new law and how those aspects intersected with charitable giving. In particular, we examined general changes that affected individuals, the extension of several provisions that encourage charitable giving, and wholesale changes to the estate, gift and generation skipping transfer tax laws.

This booklet expands the discussion on the new law. Note that this summary of TRUIRJCA is not exhaustive. In particular, provisions concerning energy and business are not covered. Other provisions that affect individuals have been omitted.

When Will It End? Regarding the Sunset Provision

A sunset provision is a part of an enacted law that effectively returns the tax code to a state that would exist as if the law had never been passed. Sunset provisions have been included in a tax law when Congress utilizes a procedure called "reconciliation." The Congressional Budget Act of 1974 established the reconciliation process as a way to ensure that certain laws will conform to tax and spending levels set in a budget resolution. Thus, changes recommended by committees pursuant to a reconciliation instruction are incorporated into the reconciliation measure. The sunset provision ensures that the proposed law will satisfy the tax and spending levels as described by the budget resolution.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) contained a sunset provision; as written, certain provisions of and amendments made by EGTRRA would not apply after December 31, 2010. Also, the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) contained a similar sunset provision. Thus, the date of December 31, 2010 held enormous importance.

In anticipation of the great changes in tax policy that would arrive at the end of 2010, Congressional leaders (with President Obama's assent) crafted a law that would effectively hold many parts of the EGTRRA and JGTRRA in place for one or two additional years—in effect, TRUIRJCA simply moved back the effective date of the sunset provision to December 31, 2012.

Plus, TRUIRJCA included many so-called "tax extenders"—one or two year temporary measures that Congress has passed in successive years. An example of a tax extenders is the AMT exemption patch. The AMT exemption amount is set by statute, and is not indexed to inflation. In order to avoid a greater number of people becoming exposed to the parallel tax system of the AMT, Congress has increased the exemption amount on a yearly basis. Such tax extender bills are expedient to enact and offer a short term fix to a problem, but do not permanently change the tax code. Like the EGTRRA and JGTRRA provisions, these tax extenders are temporary.

Tracking Expiring Federal Tax Provisions

Every year, the Joint Committee on Taxation publishes a list of expiring federal tax provisions over the next ten years. Whether the provision will expire completely or simply revert to the law in effect before the present-law version of the provision, the publication lists the code section and expiration date.

One can access the list through www.jct.gov. The current list was published on January 21, 2011 as JCX-2-11.

Income Tax Provisions that Affect Individuals

Income Tax Rates Preserved

The change in income tax rates introduced by EGTRRA—the reduction in the five basic rates to 15%, 25%, 28%, 33% and 35% and the addition of the lowest income tax bracket of 10%—was extended through 2012. Originally, under EGTRRA, the rates were to be gradually lowered over several years. However, JGTRRA made the low rates effective on January 1, 2003. Under the sunset provisions of the Bush-era legislation, after December 31, 2010 these rates would have reverted back to the higher rates in effect prior to EGTRRA. However, TRUIRJCA preserves the Bush-era tax rates for 2011 and 2012. Also, the range of income defined by each tax bracket remains indexed to inflation.

Marriage Penalty Avoided

The relief from the "marriage penalty" afforded by EGTRRA continues under TRUIRJCA. The provisions that double the standard deduction for a married couple filing jointly and widen the 15% tax bracket for these filers (in an amount double the size of the corresponding rate bracket for a single person) will stay in effect for 2011 and 2012. Otherwise, the tax imposed on a married couple could be greater than the tax owed if husband and wife had filed separately.

Capital Gains and Dividend Rates Intact

The capital gain and qualified dividend tax rates introduced by JGTRRA—15% and 0%—were extended through 2012. Under JGTRRA, the tax rate for capital gains on property held for more than one year was reduced from 20% to 15%. And for taxpayers with a top marginal tax rate of 10% or 15% the rate was further reduced to 0%. The same Bush-era legislation that reduced capital gains taxes also lowered the rate on qualified dividends. Instead of being taxed as ordinary income, qualified dividends are taxed at 15% or 0%, depending on the individual's top marginal tax rate (same as for capital gains).

Suspension of the Pease Limitation and PEP

In past years, an overall limit on itemized deductions for high income taxpayers (known as the "Pease" limitation) would reduce what a taxpayer could deduct by 3% of adjusted gross income for deductions in excess of a certain dollar amount (not to be reduced more than 80%). EGTRRA incrementally rolled back the Pease limitation on itemized deductions:

- A one-third reduction of the limitation in 2006 and 2007
- A two-thirds reduction in 2008 and 2009
- No limit at all in 2010

TRUIRJCA extends the effective repeal of the Pease limitation for 2011 and 2012.

Similarly, the personal exemptions claimed by high income taxpayers once had to be reduced by 2% for each $2,500 in adjusted gross income in excess of a certain dollar amount. EGTRRA also incrementally rolled back the personal exemption phase-out (PEP) for high income taxpayers until there was no reduction at all in 2010. TRUIRJCA extends the repeal of the personal exemption phase-out in 2011 and 2012.

Payroll Tax Holiday

An especially popular provision with wage earners is the payroll tax holiday. Employers are required to withhold a certain percentage of wages on every paycheck for social security. Both the employee and the employer are normally required to contribute 6.2% of wages towards this obligation (a total of 12.4%). However, in 2011 the employee's contribution is reduced 2% so only 4.2% of the employee's wages are required to satisfy the payroll tax. Note that the maximum amount of annual wages subject to the payroll tax is $106,800. A person earning this amount (or more) will have an additional $2,136 in take-home pay.

AMT Exemption

Congress has put into place an Alternative Minimum Tax (AMT) exemption "patch" for 2010 and 2011. This temporary measure will prevent the AMT from applying to a greater number of taxpayers (due to a low statutory exemption amount). The exemption amounts for 2010 and 2011 are as follows:

Filing Status	2010	2011
Married Filing Joint Return (or Surviving Spouses)	$72,450	$74,450
Married Filing Separate Returns	$36,225	$37,225
Unmarried Individuals	$47,450	$48,450

Tax Deductions

Certain tax deductions that benefit individuals were extended by TRUIRJCA, including:

- The Option to Deduct State and Local Sales Tax
- Tuition Expenses – An "above the line" deduction
- Student Loan Interest – Both an increased adjusted gross income limit before phase-out of the deduction and an extension of the availability beyond sixty months after loan payments begin

Tax Credits

Many popular tax credits that benefit individuals were extended by TRUIRJCA, including:

- Child Tax Credit – An increase in the credit to $1,000
- American Opportunity Tax Credit – An enhanced version of the Hope Credit that credits 100% of the first $2,000 of tuition expenses, and 25% of the next $2,000
- Adoption Credit – An increase in the credit to $10,000
- Dependent Care Tax Credit – An increase in the amount of eligible expenses and the applicable percentage for the credit

Provisions that Affect Charitable Giving

IRA Charitable Rollover

The new law revives the IRA Charitable Rollover that permits donors age 70½ and over to make a qualified charitable distribution directly from an IRA to a charity in 2010 and 2011. The distribution is not taxable income for donors, and the amount counts towards the required minimum distribution for that tax year.

There are certain rules that apply to a qualified charitable distribution from an IRA, including:

- The charity must be a public charity or private foundation that may receive general contributions (except not a Donor Advised Fund, nor a Sec. 509(a) Supporting Organization)
- The distribution must otherwise qualify as a charitable income tax deduction
- An individual may direct up to $100,000 per year in this manner
- The distribution does not qualify for a charitable deduction

Note that donors who completed an IRA Charitable Rollover before January 31, 2011 have an option: to elect to treat the distribution as made in either 2010 or 2011.

Extension of the Increased Deduction Limits for Contributions of Real Property Made for Conservation Purposes

There are annual limits on how much of a charitable contribution can be deducted under IRC Sec. 170. The standard limit on the deduction of long-term capital gain property to a qualified public charity is 30% of adjusted gross income (AGI). However, a charitable gift of real property made for conservation purposes can be deducted up to 50% of AGI for a limited time. Furthermore, the carryover of the excess contribution amount of this gift into future years is increased from five to fifteen years.

In order for the gift to qualify, the property must be subject to a perpetual easement or restrictive covenant that prevents the development of the property, safeguarding its natural character or historic significance. There are even more beneficial rules for farmers and ranchers who make such a gift if the contribution does not prevent the use of the donated land for farming or ranching purposes. The enhanced deduction for contributions of real property made for conservation purposes is extended through the end of 2011.

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Inventory is considered ordinary income property for purposes of determining the deduction for a charitable contribution. Under normal rules, the deduction for a gift of ordinary income property is reduced by whatever would be considered gain (which usually leaves the deduction at cost basis). However, there are exceptions: gifts of food inventory (made by corporate or non-corporate taxpayers), book inventory and computer inventory (made by corporations) will only be reduced by one-half of what would be gain if it had been sold, or up to twice the donor's cost basis (whichever amount is less). The enhanced deduction for contributions of certain inventory is extended through the end of 2011.

Favorable Basis Adjustment to Stock of S Corporations Making Charitable Contributions of Property

Before the passage of the Pension Protection Act of 2006, if an S corporation made a gift to a qualified charity, each shareholder would account for his or her pro rata share of the contribution when determining income tax liability. To wit, a shareholder would reduce his or her basis in the stock by the amount of the charitable contribution that flows through to the shareholder.

However, after the PPA and subsequent legislation, the amount of a shareholder's basis in S corporation stock reduced by reason of a charitable contribution made by the corporation is limited to the shareholder's pro rata share of the adjusted basis of the contributed property, not its fair market value. This benefit to S corporation shareholders is extended through 2011.

Transfer Tax Provisions

Option to Subject 2010 Estate to Taxation

Due to the sunset provision of the EGTRRA, there was no Federal estate tax in 2010. However, modified carryover basis rules applied to the estate property. This meant the decedent's income tax basis is the starting point for determining basis for the heir who receives the property. The executor could allocate $1.3 million towards the basis for all heirs and an additional $3 million towards property to the spouse.

Under the new law, however, the executor of an estate of someone who died in 2010 has another option besides the no estate tax/modified carryover basis regime: choose to subject the estate to taxation under the 2011 rates and applicable exclusion amount (tax rate of 35% and a $5 million applicable exclusion amount). The executor must weigh the advantage of subjecting the estate to the tax in order to utilize the stepped-up basis rules (the fair market value at the time of death determines basis which is to the advantage of the heir who receives the property).

The Revived Estate Tax

The federal estate tax has returned. The estate tax applicable exclusion amount equals $5 million and the top tax rate is 35% in 2011. For years after 2011, the applicable exclusion amount is indexed for inflation and can increase in increments of $10,000. The stepped-up basis is part of the revived federal estate tax. Assets acquired through the estate receive a basis of the value of the asset on the date of death (or the value of the asset up to six months following the date of death if the executor chooses the alternate valuation date). However, the revived estate tax under TRUIRJCA is also subject to its sunset provision, which means a return to a $1 million applicable exclusion amount and a top rate of 55% in 2013 if Congress takes no action.

Portability of the Deceased Spousal Unused Exclusion Amount

In the event the decedent dies in 2011 or 2012, the decedent's estate may use some, all or none of the applicable exclusion amount. If the decedent's estate uses only some or none of the applicable exclusion amount, the executor can elect to transfer the unused applicable exclusion amount to the surviving spouse. Thus, the estate of the surviving spouse has his or her individual applicable exclusion amount plus what was left by the first spouse to die.

Portability and the Relevance of Bypass Trusts

For years, married couples have utilized bypass trusts as a way to make full use of the available estate tax exemption. At the death of the first spouse, the will divides the estate into two parts. One part, equal to the applicable exclusion amount, is placed in a trust that provides liberal benefits to the surviving spouse, but bypasses his or her estate at death. The other part either passes outright to the surviving spouse or is placed in a marital trust for the spouse's benefit.

Many commentators have noted that some married couples may be less inclined to use the bypass trust in 2011 and 2012 because of the availability of the deceased spousal unused exclusion amount. At first glance, it would seem the applicable exclusion amount not used by a spouse who dies in 2011 or 2012 would not be wasted—any part of the applicable exclusion amount not used would eventually be available to the estate of the surviving spouse, so none of the exemption is lost as a result of not planning with a bypass trust.

However, a bypass trust may still be useful for several reasons:

- The deceased spousal unused exclusion amount transferred at the time of the first spouse's death may not suffice to protect assets in the surviving spouse's estate which continue to grow.
- The portability of a spouse's unused exclusion amount may not apply to state estate taxes because many states have effectively de-coupled their own estate tax from the current federal estate tax law.
- A bypass trust can provide protection from creditors of the surviving spouse.
- Assets in the bypass trust eventually go to individuals the deceased spouse names in his or her trust as beneficiaries.
- The deceased spousal unused exclusion amount does not apply to generation-skipping transfer tax.
- The portability provision is temporary. The federal estate tax in 2013 may or may not include portability depending how Congress does or does not act.

Restoration of the Unified Credit

Prior to EGTRRA, there was a unified credit—the lifetime exclusion for gifts was the same amount as the estate tax applicable exclusion. EGTRRA de-coupled the credit amount—the lifetime gift tax exclusion was restricted to $1 million and the estate tax applicable exclusion amount gradually increased to $3.5 million. The new law re-links the gift and estate tax applicable exclusion amounts for 2011 and 2012.

The Gift Tax

The tax rate for the gift tax is 35% (like the estate tax). As noted above, the lifetime applicable exclusion amount for taxable gifts is $5 million in 2011 and 2012.

The Generation Skipping Transfer Tax

Due to the sunset provision of EGTRRA, there was no generation skipping transfer (GST) tax in 2010. However, the new law replaces the no GST tax regime in 2010 with a 0% GST tax rate and a $5 million exemption (so no GST tax applies to 2010 transfers).

The GST tax in 2011 and 2012 corresponds with the $5 million applicable exclusion amount and a tax rate of 35%.

In Closing

Given the short-term nature of TRUIRJCA, one salient characteristic of the new tax law is its impermanence. The same difficult tax policy questions Congress faced in late 2010 will remain up for debate in 2011 and 2012. Many commentators on Federal tax laws have noted the difficulty posed by this uncertainty. For instance, estate planning becomes more complex when considering the possibility the law could drastically change in two years (and complexity costs time and money).

As ever, tax professionals must be wary of the need to maintain flexibility in estate planning so that a change in the law does not have adverse effects. Also, informing clients of anticipated changes in the law gives them the opportunity to act right away before the law changes or wait until it turns to their advantage.

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Plus, TRUIRJCA included many so-called "tax extenders"—one or two year temporary measures that Congress has passed in successive years. An example of a tax extenders is the AMT exemption patch. The AMT exemption amount is set by statute, and is not indexed to inflation. In order to avoid a greater number of people becoming exposed to the parallel tax system of the AMT, Congress has increased the exemption amount on a yearly basis. Such tax extender bills are expedient to enact and offer a short term fix to a problem, but do not permanently change the tax code. Like the EGTRRA and JGTRRA provisions, these tax extenders are temporary.

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Income Tax Provisions that Affect Individuals

Income Tax Rates Preserved

The change in income tax rates introduced by EGTRRA—the reduction in the five basic rates to 15%, 25%, 28%, 33% and 35% and the addition of the lowest income tax bracket of 10%—was extended through 2012. Originally, under EGTRRA, the rates were to be gradually lowered over several years. However, JGTRRA made the low rates effective on January 1, 2003. Under the sunset provisions of the Bush-era legislation, after December 31, 2010 these rates would have reverted back to the higher rates in effect prior to EGTRRA. However, TRUIRJCA preserves the Bush-era tax rates for 2011 and 2012. Also, the range of income defined by each tax bracket remains indexed to inflation.

Marriage Penalty Avoided

The relief from the "marriage penalty" afforded by EGTRRA continues under TRUIRJCA. The provisions that double the standard deduction for a married couple filing jointly and widen the 15% tax bracket for these filers (in an amount double the size of the corresponding rate bracket for a single person) will stay in effect for 2011 and 2012. Otherwise, the tax imposed on a married couple could be greater than the tax owed if husband and wife had filed separately.

Capital Gains and Dividend Rates Intact

The capital gain and qualified dividend tax rates introduced by JGTRRA—15% and 0%—were extended through 2012. Under JGTRRA, the tax rate for capital gains on property held for more than one year was reduced from 20% to 15%. And for taxpayers with a top marginal tax rate of 10% or 15% the rate was further reduced to 0%. The same Bush-era legislation that reduced capital gains taxes also lowered the rate on qualified dividends. Instead of being taxed as ordinary income, qualified dividends are taxed at 15% or 0%, depending on the individual's top marginal tax rate (same as for capital gains).

Suspension of the Pease Limitation and PEP

In past years, an overall limit on itemized deductions for high income taxpayers (known as the "Pease" limitation) would reduce what a taxpayer could deduct by 3% of adjusted gross income for deductions in excess of a certain dollar amount (not to be reduced more than 80%). EGTRRA incrementally rolled back the Pease limitation on itemized deductions:

- A one-third reduction of the limitation in 2006 and 2007
- A two-thirds reduction in 2008 and 2009
- No limit at all in 2010

TRUIRJCA extends the effective repeal of the Pease limitation for 2011 and 2012.

Similarly, the personal exemptions claimed by high income taxpayers once had to be reduced by 2% for each $2,500 in adjusted gross income in excess of a certain dollar amount. EGTRRA also incrementally rolled back the personal exemption phase-out (PEP) for high income taxpayers until there was no reduction at all in 2010. TRUIRJCA extends the repeal of the personal exemption phase-out in 2011 and 2012.

Payroll Tax Holiday

An especially popular provision with wage earners is the payroll tax holiday. Employers are required to withhold a certain percentage of wages on every paycheck for social security. Both the employee and the employer are normally required to contribute 6.2% of wages towards this obligation (a total of 12.4%). However, in 2011 the employee's contribution is reduced 2% so only 4.2% of the employee's wages are required to satisfy the payroll tax. Note that the maximum amount of annual wages subject to the payroll tax is $106,800. A person earning this amount (or more) will have an additional $2,136 in take-home pay.

AMT Exemption

Congress has put into place an Alternative Minimum Tax (AMT) exemption "patch" for 2010 and 2011. This temporary measure will prevent the AMT from applying to a greater number of taxpayers (due to a low statutory exemption amount). The exemption amounts for 2010 and 2011 are as follows:

Filing Status	2010	2011
Married Filing Joint Return (or Surviving Spouses)	$72,450	$74,450
Married Filing Separate Returns	$36,225	$37,225
Unmarried Individuals	$47,450	$48,450

Tax Deductions

Certain tax deductions that benefit individuals were extended by TRUIRJCA, including:

- The Option to Deduct State and Local Sales Tax
- Tuition Expenses – An "above the line" deduction
- Student Loan Interest – Both an increased adjusted gross income limit before phase-out of the deduction and an extension of the availability beyond sixty months after loan payments begin

Tax Credits

Many popular tax credits that benefit individuals were extended by TRUIRJCA, including:

- Child Tax Credit – An increase in the credit to $1,000
- American Opportunity Tax Credit – An enhanced version of the Hope Credit that credits 100% of the first $2,000 of tuition expenses, and 25% of the next $2,000
- Adoption Credit – An increase in the credit to $10,000
- Dependent Care Tax Credit – An increase in the amount of eligible expenses and the applicable percentage for the credit

Provisions that Affect Charitable Giving

IRA Charitable Rollover

The new law revives the IRA Charitable Rollover that permits donors age 70½ and over to make a qualified charitable distribution directly from an IRA to a charity in 2010 and 2011. The distribution is not taxable income for donors, and the amount counts towards the required minimum distribution for that tax year.

There are certain rules that apply to a qualified charitable distribution from an IRA, including:

- The charity must be a public charity or private foundation that may receive general contributions (except not a Donor Advised Fund, nor a Sec. 509(a) Supporting Organization)
- The distribution must otherwise qualify as a charitable income tax deduction
- An individual may direct up to $100,000 per year in this manner
- The distribution does not qualify for a charitable deduction

Note that donors who completed an IRA Charitable Rollover before January 31, 2011 have an option: to elect to treat the distribution as made in either 2010 or 2011.

Extension of the Increased Deduction Limits for Contributions of Real Property Made for Conservation Purposes

There are annual limits on how much of a charitable contribution can be deducted under IRC Sec. 170. The standard limit on the deduction of long-term capital gain property to a qualified public charity is 30% of adjusted gross income (AGI). However, a charitable gift of real property made for conservation purposes can be deducted up to 50% of AGI for a limited time. Furthermore, the carryover of the excess contribution amount of this gift into future years is increased from five to fifteen years.

In order for the gift to qualify, the property must be subject to a perpetual easement or restrictive covenant that prevents the development of the property, safeguarding its natural character or historic significance. There are even more beneficial rules for farmers and ranchers who make such a gift if the contribution does not prevent the use of the donated land for farming or ranching purposes. The enhanced deduction for contributions of real property made for conservation purposes is extended through the end of 2011.

Extension of the Enhanced Deduction for Contributions of Certain Inventory

Inventory is considered ordinary income property for purposes of determining the deduction for a charitable contribution. Under normal rules, the deduction for a gift of ordinary income property is reduced by whatever would be considered gain (which usually leaves the deduction at cost basis). However, there are exceptions: gifts of food inventory (made by corporate or non-corporate taxpayers), book inventory and computer inventory (made by corporations) will only be reduced by one-half of what would be gain if it had been sold, or up to twice the donor's cost basis (whichever amount is less). The enhanced deduction for contributions of certain inventory is extended through the end of 2011.

Favorable Basis Adjustment to Stock of S Corporations Making Charitable Contributions of Property

Before the passage of the Pension Protection Act of 2006, if an S corporation made a gift to a qualified charity, each shareholder would account for his or her pro rata share of the contribution when determining income tax liability. To wit, a shareholder would reduce his or her basis in the stock by the amount of the charitable contribution that flows through to the shareholder.

However, after the PPA and subsequent legislation, the amount of a shareholder's basis in S corporation stock reduced by reason of a charitable contribution made by the corporation is limited to the shareholder's pro rata share of the adjusted basis of the contributed property, not its fair market value. This benefit to S corporation shareholders is extended through 2011.

Transfer Tax Provisions

Option to Subject 2010 Estate to Taxation

Due to the sunset provision of the EGTRRA, there was no Federal estate tax in 2010. However, modified carryover basis rules applied to the estate property. This meant the decedent's income tax basis is the starting point for determining basis for the heir who receives the property. The executor could allocate \$1.3 million towards the basis for all heirs and an additional \$3 million towards property to the spouse.

Under the new law, however, the executor of an estate of someone who died in 2010 has another option besides the no estate tax/modified carryover basis regime: choose to subject the estate to taxation under the 2011 rates and applicable exclusion amount (tax rate of 35% and a \$5 million applicable exclusion amount). The executor must weigh the advantage of subjecting the estate to the tax in order to utilize the stepped-up basis rules (the fair market value at the time of death determines basis which is to the advantage of the heir who receives the property).

The Revived Estate Tax

The federal estate tax has returned. The estate tax applicable exclusion amount equals \$5 million and the top tax rate is 35% in 2011. For years after 2011, the applicable exclusion amount is indexed for inflation and can increase in increments of \$10,000. The stepped-up basis is part of the revived federal estate tax. Assets acquired through the estate receive a basis of the value of the asset on the date of death (or the value of the asset up to six months following the date of death if the executor chooses the alternate valuation date). However, the revived estate tax under TRUIRJCA is also subject to its sunset provision, which means a return to a \$1 million applicable exclusion amount and a top rate of 55% in 2013 if Congress takes no action.

Portability of the Deceased Spousal Unused Exclusion Amount

In the event the decedent dies in 2011 or 2012, the decedent's estate may use some, all or none of the applicable exclusion amount. If the decedent's estate uses only some or none of the applicable exclusion amount, the executor can elect to transfer the unused applicable exclusion amount to the surviving spouse. Thus, the estate of the surviving spouse has his or her individual applicable exclusion amount plus what was left by the first spouse to die.

Portability and the Relevance of Bypass Trusts

For years, married couples have utilized bypass trusts as a way to make full use of the available estate tax exemption. At the death of the first spouse, the will divides the estate into two parts. One part, equal to the applicable exclusion amount, is placed in a trust that provides liberal benefits to the surviving spouse, but bypasses his or her estate at death. The other part either passes outright to the surviving spouse or is placed in a marital trust for the spouse's benefit.

Many commentators have noted that some married couples may be less inclined to use the bypass trust in 2011 and 2012 because of the availability of the deceased spousal unused exclusion amount. At first glance, it would seem the applicable exclusion amount not used by a spouse who dies in 2011 or 2012 would not be wasted—any part of the applicable exclusion amount not used would eventually be available to the estate of the surviving spouse, so none of the exemption is lost as a result of not planning with a bypass trust.

However, a bypass trust may still be useful for several reasons:

- The deceased spousal unused exclusion amount transferred at the time of the first spouse's death may not suffice to protect assets in the surviving spouse's estate which continue to grow.
- The portability of a spouse's unused exclusion amount may not apply to state estate taxes because many states have effectively de-coupled their own estate tax from the current federal estate tax law.
- A bypass trust can provide protection from creditors of the surviving spouse.
- Assets in the bypass trust eventually go to individuals the deceased spouse names in his or her trust as beneficiaries.
- The deceased spousal unused exclusion amount does not apply to generation-skipping transfer tax.
- The portability provision is temporary. The federal estate tax in 2013 may or may not include portability depending how Congress does or does not act.

Restoration of the Unified Credit

Prior to EGTRRA, there was a unified credit—the lifetime exclusion for gifts was the same amount as the estate tax applicable exclusion. EGTRRA de-coupled the credit amount—the lifetime gift tax exclusion was restricted to $1 million and the estate tax applicable exclusion amount gradually increased to $3.5 million. The new law re-links the gift and estate tax applicable exclusion amounts for 2011 and 2012.

The Gift Tax

The tax rate for the gift tax is 35% (like the estate tax). As noted above, the lifetime applicable exclusion amount for taxable gifts is $5 million in 2011 and 2012.

The Generation Skipping Transfer Tax

Due to the sunset provision of EGTRRA, there was no generation skipping transfer (GST) tax in 2010. However, the new law replaces the no GST tax regime in 2010 with a 0% GST tax rate and a $5 million exemption (so no GST tax applies to 2010 transfers).

The GST tax in 2011 and 2012 corresponds with the $5 million applicable exclusion amount and a tax rate of 35%.

In Closing

Given the short-term nature of TRUIRJCA, one salient characteristic of the new tax law is its impermanence. The same difficult tax policy questions Congress faced in late 2010 will remain up for debate in 2011 and 2012. Many commentators on Federal tax laws have noted the difficulty posed by this uncertainty. For instance, estate planning becomes more complex when considering the possibility the law could drastically change in two years (and complexity costs time and money).

As ever, tax professionals must be wary of the need to maintain flexibility in estate planning so that a change in the law does not have adverse effects. Also, informing clients of anticipated changes in the law gives them the opportunity to act right away before the law changes or wait until it turns to their advantage.

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