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Federal Taxes: The Cliffhanger Edition

"To Be Continued…" Few things are as tantalizing and concurrently as maddening as the "cliffhanger." For centuries this time-tested plot device has kept audiences waiting and anticipating. While the cliff-hanger is a compelling narrative technique, does it have a place in federal tax policy?

In December 2010, Congress passed and the President signed the Tax Relief, Unemployment Reauthorization, and Job Creation Act of 2010.[1]

This act addressed a number of pressing tax issues (including an extension of the "Bush" income tax rates) and added several taxpayer friendly provisions in the area of estate and gift taxes. However, Congress also inserted a "sunset" provision, which means significant parts of the law will expire by the end of 2012. What happens when Congress and the President leave open the question of *what will happen next?*

Resolving the uncertainty in the tax law may not result in a nice, neat ending where the heroes prevail and everyone rides off into a sunset. In this issue of Techniques, we take a look at key topics in federal transfer and income taxes by examining the recent past, considering the short-term present and looking at future possibilities. This issue also offers suggestions in advising individuals on charitable giving and estate planning. Hopefully, these insights will assist you in advising clients as they anticipate the effects of whatever new law lies on the other side of this financial cliffhanger.

FEDERAL TRANSFER TAXES

Past

As we all remember, the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) made significant changes to federal estate taxes, gift taxes and generation skipping transfer taxes (GST). Prior to 2001, these three taxes were an integrated regime applied to gratuitous transfers of property during life and after death known as the "unified transfer tax system." The estate tax and gift tax shared a single applicable exclusion amount, and all three taxes had the same marginal tax rates.

EGTRRA changed this transfer tax system by "decoupling" the estate tax and gift tax credits, providing instead that each would again have its own applicable exclusion amount. The estate tax applicable exclusion amount gradually rose to $3.5 million in 2009 while the gift tax applicable exclusion amount remained at $1 million. Tax rates for both the gift and estate tax were reduced over the course of several years until 2010, when the gift tax rate was 35% and the estate tax was repealed. Due to the sunset provision in EGTRRA, there would be no GST tax in 2010

Present

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 ("Tax Relief Act") modified the transfer tax system, but only for the period of 2010-2012. The gift tax credit and estate tax credit were "unified" once again as a $5 million applicable exclusion amount.[2] The top gift and estate tax rate was set at 35%, and the generation skipping transfer tax was reinstated with a flat rate of 35% and a $5 million applicable exclusion amount.

The Tax Relief Act introduced the new concept of the portability of a deceased spouse's unused applicable exclusion amount to a surviving spouse.[3] If someone dies in 2011 or 2012, the decedent's estate

may use some, all or none of the $5 million applicable exclusion amount. If the decedent's estate only uses some or none of the $5 million applicable exclusion amount, the decedent's spouse has the benefit of adding the unused amount to his or her own applicable exclusion amount upon death. However, keep in mind that the portability of the applicable exclusion is not automatic: The executor of the first spouse to die must file an estate tax return computing the amount of the exclusion used and make an election on the return to allow the remainder to be used by the surviving spouse, even if the estate of the first spouse was not required to file an estate tax return.[4]

Future Possibilities

The temporary status of the Tax Relief Act requires Congress to address tax provisions that sunset after 2012. If Congress fails to act on this expiration, the transfer tax rates and applicable exclusion amounts in place prior to EGTRRA will return. The tax rates in 2012 and beyond for estate, gift and GST tax will be 55%, and the applicable exclusion amount will be $1 million for each tax.[5] The estate and gift taxes would again be de-coupled, and the option of spousal portability would end.

While there is no certainty Congress will act, it seems more likely than not that Congress will make some change in transfer taxes to avoid or mitigate the sunset of the Tax Relief Act. There are proposals dealing with transfer taxes being discussed in Washington, including those put forth by the President in his 2012 budget proposal. A review of the President's budget proposal and his additional comments on transfer taxes provides some insight into the direction transfer taxes may go.

One of the President's proposals is to once again separate the estate tax credit and gift tax credit.[6] Under this plan, an estate would have an applicable exclusion amount of $3,500,000 and the tax rate for estates would increase to 45%. The federal gift tax would allow an applicable exclusion amount of $1,000,000 with a top gift tax rate of 45%.

These proposed changes significantly increase the amount of an estate subject to taxes, as well applying a higher tax rate to that estate as compared to present law. However, it should be noted that the proposed applicable exclusion amounts and the proposed tax rate are better than the pre-EGTRRA applicable exclusion and tax rate. A donor who takes advantage of the 2011 and 2012 provisions to make a charitable gift would enjoy the tax advantages of today's higher applicable exclusion and lower tax rate.

What to Do

In 2010, the federal estate tax lapsed and the federal gift tax rate dropped to 35%. At that time, CPAs and attorneys called on their clients to review their estate plans to see how the absence of an estate tax might affect the distribution of their estate.

In 2011 and 2012, practitioners should suggest ways that clients can take advantage of a historically large applicable exclusion amount of $5 million and relatively low transfer tax rates.

Also, practitioners should be mindful of how state death taxes can depend on what happens on the federal level. Many states have a stand-alone estate tax or inheritance tax (or both) that act independent of current federal law. But, many more states have an estate tax linked to the pre-EGTRRA federal estate tax credit for paid state estate taxes—if such a credit returns after 2012, so will the obligation to pay estate taxes on the state level.

Many individuals will be reluctant to adjust estate plans year after year, but the current temporal nature of the federal transfer tax system requires such adjustments in order to achieve the best outcome—wealth transfer at a lower tax cost.

FEDERAL INCOME TAXES

Past

According to the Federal Office of Management and Budget, the tax which generates the greatest amount of revenue for the U.S. government is the federal income tax.[7] We all know that a taxpayer calculates federal income tax liability based upon gross income, which is defined as income from whatever source derived.[8] From gross income, each taxpayer may take an exemption for themselves, their spouse,[9] and for each of their dependents.[10]

In addition to the exemption, we also know that a taxpayer may elect either to take a "standard" deduction (the amount of which is adjusted

yearly), or to "itemize" deductions by separately listing their deductions.[11] Itemized deductions encompass a number of areas including: medical and dental expenses, state and local taxes paid, home mortgage interest, and casualty losses. It also includes the most important deduction for philanthropic organizations—gifts to charity.[12]

For years under the IRC, both deductions and exemptions were subject to limitations. 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%).[13] Similarly, the "Personal Exemption Phaseout" reduced a high income taxpayer's personal exemptions by 2% for each $2,500 in adjusted gross income in excess of a certain dollar amount.[14] Both provisions were phased out until completely repealed in 2010.

Once the taxpayer has taken all exemptions, adjustments and deductions allowed, the amount of income that remains is taxable income. The tax rates are applied to the taxable income to calculate the amount of tax owed. Since 2001, federal income tax rates start at 10% and increase to a top rate of 35%.

Present

Although not as radically as the changes to estate and gift taxes, the Tax Relief Act also made changes to Federal income taxes. Under this Act, Federal income tax rates in 2011 stayed at the rates implemented under EGTRRA, and will apparently continue at those levels through 2012. The 2011 income tax rates start at 10% and increase to a top rate of 35%. The Tax Relief Act maintained the repeal of the Personal Exemption Phaseout and the Pease Limitation for 2011 and 2012.[15]

Future

Continuing federal budget problems seem to be pointing to significant changes in federal income taxation. Reports from Washington show that both an increase in tax rates and a limitation on income tax deductions and exemptions may be a possibility. This could have a significant impact on estate and philanthropic planning in 2012 and beyond.

In August, the Budget Control Act of 2011, adopted in response to the federal government reaching its debt limit, opened the door to any number of tax changes. The Budget Control Act mandated the formation of a bi-partisan committee to recommend deficit reduction measures, including tax increases.[16]

In addition to any other action taken by Congress, one tax change that is already being discussed in Washington is a cap on the amount of itemized deductions provided to taxpayers. President Obama proposed a recommended cap in the value of itemized deductions as part of his budget, and has consistently stated that he is in favor of Congress passing some form of a cap.[17] One of the proposals is a cap on itemized deductions of 28%, and would likely be coupled with a return of the Pease limitation on itemized deductions.[18]

What to Do

A taxpayer planning a gift to charity may benefit from a greater income tax savings by donating under the 2011 tax structure rather than waiting for further Congressional actions. A charitable gift of $100,000 in 2011 would lead to an itemized income tax deduction that produces an income tax savings of $35,000. Waiting until 2013 risks the implementation of a cap which would provide only a $28,000 income tax savings, and the donor would have lost a $7,000 dollar tax savings.

COMING SOON… PLANNING FOR THE RIDE INTO THE SUNSET

Waiting to see what will happen next in a fictional story can be exciting. On the other hand, waiting to find out how Congress will resolve the problem posed by the sunset of the Tax Relief Act is more like a dilemma for individual taxpayers.

Planning, whether in "reel" life or "real" life, is very important. A fictional hero knows that being prepared—carrying a rope in his backpack or remembering the importance of a secret key—can make a difference between surviving or…falling off a cliff. Today, advising a client to plan and act now on estate and philanthropic matters may be the resolution that leads to a successful financial ride into the sunset.

Endnotes

1 Public Law 111-312, 124 Stat. 3296, enacted December 17, 2010.

2 124 Stat. 3301, §303; IRC §2010.

3 124 Stat. 3301, §303; IRC §2010.

4 IRC §2010(c)(5)(A).

5 However, the GST tax applicable exclusion would be adjusted for inflation recorded in the years since EGTRRA was passed, and so would be a higher amount.

6 White House Budget, Federal Receipts, page 197, at www.whitehouse.gov/sites/default/files/omb/budget/fy2012/assets/message.pdf

7 The annual receipts of the Federal Government can be found at http://www.whitehouse.gov/omb/budget/Historicals. The 2010 Individual Income Tax provided $898,549,000,000 in revenue compared with the next highest tax, corporate income tax, which produced $191,437,000,000.

8 IRC §61.

9 A spouse is never considered a dependent of the taxpayer. IRC §151(b) states that individuals are allowed "An exemption of the exemption amount for the tax payer; and an additional exemption of the exemption amount for the spouse of the taxpayer if a joint return is not made by the taxpayer and his spouse, and if the spouse, for the calendar year in which the taxable year of the taxpayer begins, has no gross income and is not the dependent of another taxpayer."

10 IRC §151.

11 IRC §63.

12 IRS Form 1040 Schedule A Itemized Deductions.

13 IRC § 68.

14 IRC §151(d)(3).

15 IRC §151(d)(3)(F); IRC §68(g).

16 Section 401 et. seq., Budget Control Act of 2011. The language of the bill states that the goal of the committee is "to reduce the deficit by at least $1.5 trillion dollars over the period of fiscal years 2012 to 2021." Sec. 401(b)(2).

17 One such mention can be found in the Remarks by the President on Fiscal Policy, George Washington University, April 13, 2011. http://www.whitehouse.gov/the-press-office/2011/04/13/remarks-president-fiscal-policy. See also: The Budget Message of the President, http://www.whitehouse.gov/sites/default/files/omb/budget/fy2012/assets/message.pdf

18 The Kiplinger Tax Letter Vol. 86, No. 14, July 8, 2011.

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