U.S. Tax Update - 2010 Tax Relief Act

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On Friday, Dec. 17, 2010, President Obama signed into law the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (the "2010 Tax Relief Act"). While it doesn't provide long-term certainty, Americans (and Canadians with permanent establishments in the United States) can at least be assured that for the next two years, individual and corporate tax rates will remain at 2001 levels. Additionally, dividend rates (which were scheduled to increase to ordinary income rates) and capital gains rates (scheduled to increase to 20%) will likewise remain at the 15% 2001 rate. Other notable changes to the income tax include an increase in the exemption amount for the alternative minimum tax (AMT) and a decrease to the employee-share of a portion of Social Security taxes from 6.2% to 4.2%. Finally, businesses are allowed a 100% deduction for qualified property purchased between Sept. 9, 2010, and Dec. 31, 2011, that they were previously required to amortize and depreciate.

The 2010 Tax Relief Act also makes major changes to the estate tax. In addition to raising the exemption amount from its 2009 level of $3.5 million to $5 million and lowering the 2009 level of tax from 45% to 35%, the new Act makes several other changes to the estate, gift and generation skipping transfer (GST) taxes. First, the 2011 Tax Relief Act allows estates of decedents dying in 2010 to elect out of the estate tax (with the higher exemption amounts and lower rates). Modest estates (i.e. those with net assets of less than $5 million to $6 million) might benefit from paying the tax because assets in the estate would receive a step-up in basis that could be more valuable than any estate tax savings. That is, suppose the estate of a single decedent is worth $5.5 million, but has $5 million in unrealized capital appreciation. The estate would either owe $175,000 in estate taxes [35% of $500,000 net estate] and receive a $5.5 million basis or it could elect to file under the 2010 rules, in which case it would owe nothing in estate taxes. However, when the beneficiaries sell the inherited property, they may owe a combined total of $750,000 in income taxes ($5 million at 15%).

Second, the 2010 Tax Relief Act provides for portability of exemptions between spouses. That is, if a surviving spouse's husband or wife dies in 2011 or 2012 and does not use his or her entire exemption amount, the unused amount will be added to the surviving spouse's exemption amount. For example, suppose that Husband and Wife have a combined estate of $10 million. Suppose further that Husband makes a $1 million taxable gift then dies in 2011, leaving his entire estate to his Wife. Had the Wife died in 2009, she would have a $9 million estate, all but $3.5 million of which would be taxable. Now, provided that the Wife did not remarry, she may add her Husband's unused $4 million exemption to her $5 million exemption, making the entire estate free of taxes.

Note that a different result is obtained where one of the two spouses is not a U.S. citizen. Husband's estate would not receive a deduction for the $4 million bequest to non-citizen Wife

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unless the property is transferred to a qualified domestic trust (QDT) or Wife becomes a citizen shortly after Husband's death. As written, it would appear that the surviving spouse of a non-resident, non-citizen 2011 decedent in a treaty country (like Canada) will have some ability to utilize the unused portion of his or her spouse's exemption so long as an estate tax return was timely filed for the non-citizen decedent spouse.

Finally, the 2010 Tax Relief Act unifies the gift, estate, and GST tax exemptions. Thus, a U.S. citizen making a taxable gift of $1 million uses $1 million of his or her unified exemption amount, leaving $4 million exemption for his or her estate. The exemption for the gift tax is not available for non-resident, non-citizens.

About the Author

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