

# INCOME & ESTATE TAX

*How will the changes affect you?*

# Focus

In December 2010, legislation came together at "the last minute" to deal with the Bush tax cuts which were set to expire at the end of 2010. The Estate Tax was scheduled to revert to a one million dollar exemption in 2011. The estate tax exemption was 3.5 million in 2009 and there was no estate tax in 2010 until this legislation was passed.

## Some of the key ESTATE TAX provisions in effect for 2011 include:

**An exemption of \$5 million dollars for each person's estate, however, Minnesota still has a \$1 million exemption;**

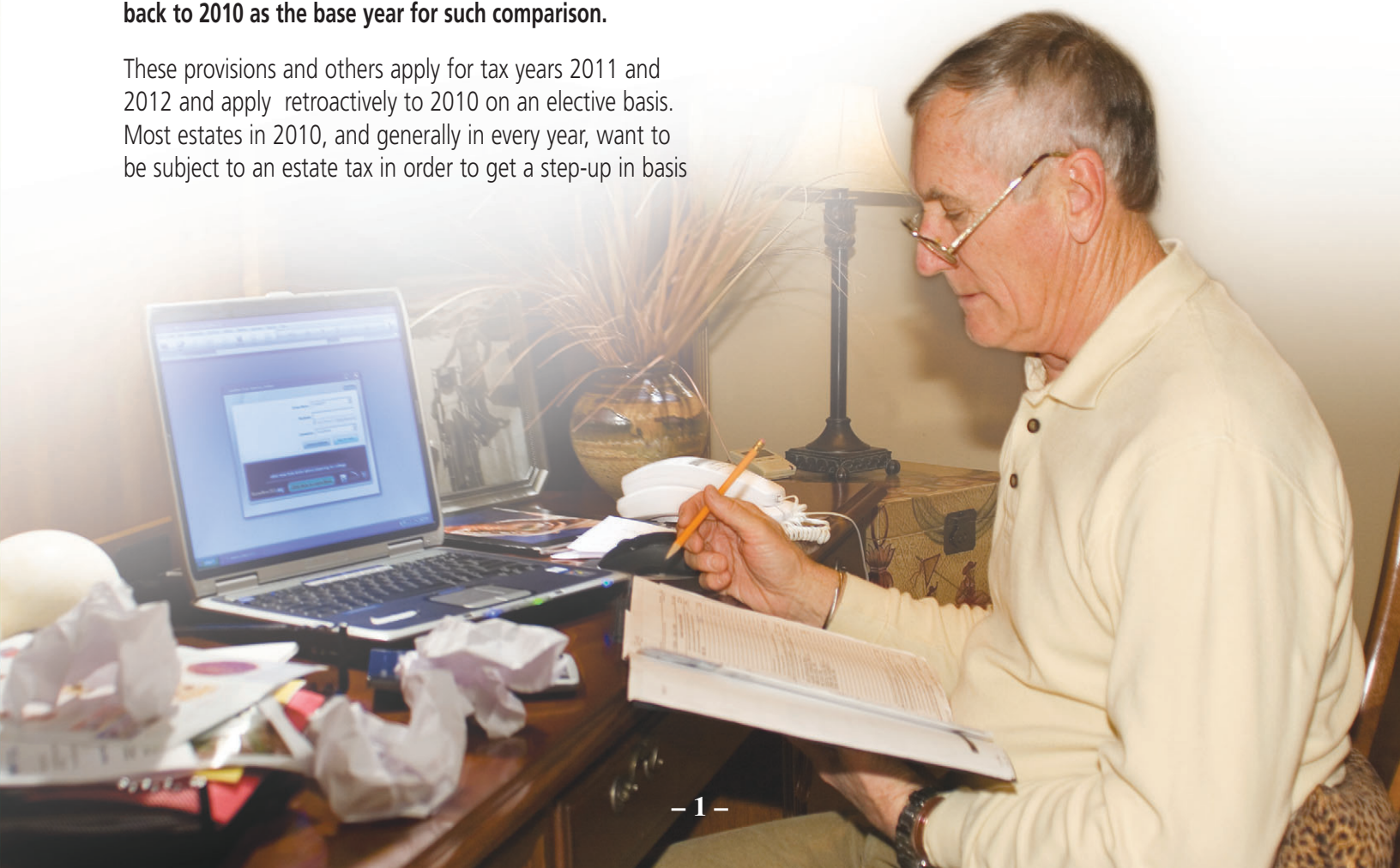
**A top estate tax rate for those who owe tax is 35%;**

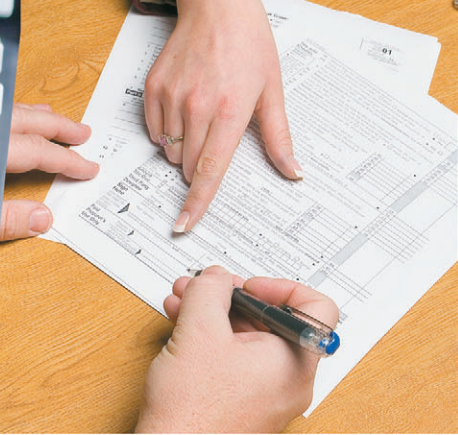
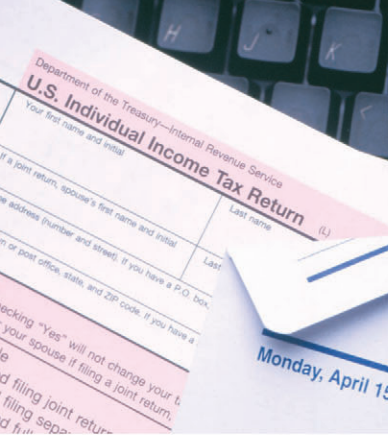
**The \$5 million dollar exemption is indexed for inflation with \$10,000 incremental upward adjustments relating back to 2010 as the base year for such comparison.**

These provisions and others apply for tax years 2011 and 2012 and apply retroactively to 2010 on an elective basis. Most estates in 2010, and generally in every year, want to be subject to an estate tax in order to get a step-up in basis

in the estate assets. The basis adjustment at death allows for the receipt of tax free sale proceeds to the extent of the stepped-up basis of an inherited asset and, even if not sold, an inherited depreciable asset can be depreciated for a tax benefit on Form 1040 of the new owner.

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## Legislation affecting INCOME TAX is as follows:

### RATES

This year's rates carry over from last year, but the brackets have been adjusted for inflation.

### CAPITAL GAINS

Rates continue at historic lows for both long-term capital gains and dividends. For taxpayers in the 15% income tax bracket and below, the rate is zero. For those in the 25% bracket and above, the rate is 15%.

### PAYROLL TAXES

Last year's big surprise was a temporary two-percentage-point cut in the employee's share of Social Security taxes, saving a maximum of \$2,136 per worker. There is no phase-out, and each partner of a married couple can get the rebate.

For most workers this cut will come as an automatic adjustment to withholding. For the self-employed (whose tax rate falls to 10.4% from 12.4%), it will be built into a quarterly withholding worksheet. Note: this provision will expire at the end of 2011.

### ALTERNATIVE MINIMUM TAX (AMT)

The "patch" enacted by Congress sets the AMT exemption at \$47,450 for single filers and \$74,450 for married couples, slightly higher than for 2010. This will expire at the end of 2011.

### Roth IRA Conversions

The income limit for conversions has been permanently removed, so this year all taxpayers may still convert ordinary IRAs into Roth IRAs. But taxpayers who convert to Roth IRAs in 2011 no longer have the option of deferring conversion income into later years, as was true for 2010 conversions. Those who converted in 2010 do have until next Oct. 17 to decide whether to use this deferral.

### ENERGY TAX CREDITS FOR HOMEOWNERS

The amount of the energy tax credit has shrunk in 2011 to a maximum of \$500 per tax payer per lifetime. Those who took last year's \$1,500 energy tax credit don't qualify.

### MEDICAL EXPENSES

Workers with Flexible Spending Accounts (FSAs) may no longer use pretax funds to pay for many over-the-counter medicines - aside from insulin - without a prescription. But FSA funds may still be used for other, nonprescription medical items such as crutches, contact-lens solution or a wig after chemotherapy, if the individual plan allows it.

### OTHER

- Renewed \$250 deduction for teacher classroom expenses;
- Renewed deduction for state sales tax in lieu of state income tax deduction;
- Renewed tax-free donation of IRA proceeds to charity;
- Renewed American Opportunity Tax Credit of up to \$2,500 for education expenses.

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## Some of the key ESTATE TAX provisions in effect for 2011

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### PORTABILITY

This is a new concept for estate tax which, in effect, allows each spouse to use any leftover exemption not claimed by the first spouse to pass. However, in order to use this exemption in the surviving spouse's estate at the second death, it is mandatory to make an election on a timely-filed estate tax return within 9 months after the first spouse dies. It is important that this election be made after the first spouse dies because it can't be done later, such as after the second spouse dies. This first election can thus preserve a total of \$5 million of assets from each spouse or a total of \$10 million of family assets being transferred in one family with no federal estate tax.

The election on the estate tax return of the first spouse to pass will keep the statute of limitations on that estate tax return open forever, but only for the purpose of determining the amount of unused exemption, not to make adjustments to the return. As a result of this change, many more estate tax returns will need to be filed after the first death to preserve the balance of the \$5 million dollar exemption for the surviving spouse.

**Example:** Assume that Husband 1 dies in 2011, having made taxable transfers of \$3 million and having no taxable estate. An election is made on Husband 1's estate tax return to permit Wife to use Husband 1's deceased spousal unused exclusion amount. As of Husband 1's death, Wife has made no taxable gifts. Thereafter, Wife's applicable exclusion amount is \$7 million (her \$5 million basic exclusion amount plus \$2 million deceased spousal unused exclusion amount from Husband 1), which she may use for lifetime gifts or for transfers at death.

### The new legislation contains the following:

#### GIFT TAX PROVISIONS

- The gift tax was not changed for 2010 which had a \$1 million exemption and a rate of 35%.
- For 2011 the gift tax exemption per person (donee) is \$5 million.
- The gift tax exemption will be indexed for inflation beginning in 2012.
- The annual exclusion for tax-free gifts remains \$13,000 per donee. A giver may make an unlimited number of \$13,000 gifts, as long as they are to different individuals. Gifts of tuition and payments for medical care also are exempt.

#### ESTATE PLANNING

The current and past estate planning principles still apply. The sheltering of assets into a Family trust at the first death offer the following advantages:

- Providing asset protection and management;
- Protecting the expectancy of children, especially in cases of second marriages and blended families;
- Sheltering growth in value after the first death and sheltering the income from Estate tax at the second death.
- Providing for the use of the Generation-Skipping-Transfer exemption of the first spouse to pass because the portability only applies to estate and gift tax, and not GST.
- Perhaps the most critical to-do items on your 2011 list should include a Will, health-care directive, and power of attorney.

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### **LACK OF PERMANENCE**

The new law is effective for 2011 and 2012 with some provisions expiring at the end of 2011 and the others expiring at the end of 2012. Thus Congress will have to again deal with extending tax cuts or revising these provisions before January 1, 2013. Combining all of these changes in a very temporary way leads us to believe that there will be a renewed debate in 2012 to again reach a consensus and that will not be a simple process.

### **What you should consider doing now:**

This new legislation is complex and contains various timelines, elections, and deadlines. We encourage you to talk with us to review your estate plan and see how these changes may apply to your particular situation.

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