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Calamos Wealth Management Wealth Strategies



The 2010 Tax Relief Act:

What is it and what does it mean for taxpayers?

On December 17, 2010, President Obama signed the 2010 Tax Relief Act—or more formally, the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010. The Senate Republicans and President Obama first negotiated the terms on December 6, without the knowledge of the Congressional Democrats, thus beginning a contentious debate between the President and his own party.

The 2010 Tax Relief Act is merely an "extender" which will expire at the end of 2012. In 2012, be prepared for the feeling of déjà vu. As it was in the mid-term elections, I believe the tax debate will again be the centerpiece of the 2012 Presidential election. Politics aside, what does the 2010 Tax Relief Act mean for you? How will it affect income tax, estate tax and wealth planning? Here, we summarize some of the major features of the Act.

Income Tax Rates

The 2010 Tax Relief Act extended the 2010 income tax rates for tax years 2011 and 2012. The lowest tax bracket of 10% will remain. The highest bracket tops out at 35%.

The stakes will be even greater during the 2012 election than they were during the mid-term elections: The top rate in 2013 is set to revert to 39.6%. In addition, the new 3.8% surtax on investment income for high income taxpayers (payment for Obama's health care legislation) is set to come online in 2013. This could result in federal income tax rates of 43.4% on certain types of income, absent any compromising legislation. This should make income tax rates a central focus of the 2012 election season. Expect political rhetoric that is heated, to say the least.

What considerations should you focus on over the next two years? For those of you who made Roth IRA conversions in 2010, you now can take advantage of the two-year deferral of the payment of taxes without worrying about future tax rate increases. The default provisions for the taxation of 2010 Roth conversions is that one half of the income from the conversion will be included in 2011 income and one half of the income from the conversion will be included in 2012 income. Prior to the enactment of the 2010 Tax Relief Act, many taxpayers who did Roth conversions in 2010 planned to pay all of the income taxes from the conversion in 2010, at what were expected to be lower income tax rates. Now with a top bracket of 35% for the next two years, the deferral provision may become the desired strategy.

Capital Gains Rates

The long-term capital gains rates will remain at 15% (0% for taxpayers in the 10% and 15% ordinary income tax brackets). Absent the new legislation, the long-term tax rate would have increased to 20%.

We believe caution should be the course of action over the next 24 months. During the second half of 2010, commentators offered a proliferation of tax planning strategies. Many suggested selling assets and accelerating income to take advantage of lower capital gains tax rates in 2010, in the anticipation of increasing rates. We continue to advise clients that we believe letting the "tax tail" wag the dog isn't a smart investment strategy; and predicting Congressional action (or inaction) is risky business. While there may be certain situations where accelerating transactions to take advantage of lower tax rates makes sense (a deal to sell a business is imminent, a need to reallocate a portfolio or an impending cash need are a few possible examples), these reasons are usually non-tax related where a tax opportunity is a by-product.

We believe tax gain harvesting is a suspect strategy at best and a costly mistake at worst (see articles in popular literature published in November and early December advocating tax gain harvesting), particularly when potential increases in tax rates are expected to be relatively small in a volatile political environment. Like any strategy suggestions, a thorough analysis of all of the facts and circumstances, including the political situation, is an absolute necessity prior to embarking on any tax strategy.

Oualified Dividend Rates

The maximum rate of 15% for qualified dividends will remain in effect through 2012. Qualified dividends would have been taxed as ordinary income if the 2010 Tax Relief Act had not been enacted. It is possible a compromised dividend rate of something higher than 15% but less than ordinary income tax rates could be part of 2012 tax legislation.

Itemized Deduction and Personal Exemption Limitations

Prior to 2010, higher-income taxpayers had portions of both their itemized deductions and personal exemptions phased out. Itemized deductions could be reduced by up to 80% and personal exemptions could be eliminated altogether. These rules were slowly phased out, and in 2010 there was no reduction in itemized deductions and personal exemptions for high-income taxpayers. The 2010 rules will be extended for 2011 and 2012, effectively reducing the "stealth tax" of up to 2% for high-income earners.

Alternative Minimum Tax (AMT)

The annual game of waiting to see if AMT exemptions will be retained or allowed to revert to pre-2001 levels won't be around in 2011. The AMT "patch" was extended retroactively for 2010 and also for 2011. If the "patch" had not been enacted, an estimated 25 million households would have been subject to AMT in 2010. With the patch, an estimated four million taxpayers would pay some amount of AMT in 2010. Extension of the "patch" will be required for 2012. We believe it is likely that a permanent "patch," indexed for inflation, could become a significant part of the tax legislation dialogue during the 2012 Presidential election.

Charitable Contributions Using Individual Retirement Accounts

In 2009, taxpayers over the age of 70½ could transfer up to \$100,000 per year to charitable organizations directly from their IRAs. The distribution would count towards the taxpayer's annual required minimum distribution, but would not be included as taxable income for the taxpayer nor would the contribution be deductible by the taxpayer. The 2010 Tax Relief Act extended this provision for 2010 and 2011 and allowed for taxpayers to make these charitable transfers during January 2011 and treat them as if they had been made on December 31, 2010.

Employee Portion of Social Security Taxes

Each employee is responsible for paying the Social Security taxes ("FICA" taxes) on his or her first \$106,800 of wages in 2011. The 2010 Tax Relief Act has lowered the tax rate from 6.2% to 4.2%, for 2011 only. This is a potential tax savings of \$2,136 per taxpayer (assuming the taxpayer has wages of at least \$106,800). The tax savings can potentially double for married couples where each spouse has at least \$106,800 in wages. Individuals subject to self-employment taxes will also receive the 2% tax reduction (13.3% instead of 15.3%), without a change in their self-employment tax deduction (which will remain at 7.65%).

Estate, Gift and Generation Skipping Taxes

This was the big surprise of the 2010 Tax Relief Act. No one saw this coming and, as late as December 1, commentators were suggesting estate tax discussions were non-existent within the beltway and no legislative activity would occur until 2011. The commentators certainly missed this one.

Below, we provide a breakdown of the Act's estate tax provisions. Please keep in mind these provisions are only valid for 2011 and 2012. Unless legislation is enacted prior to January 1, 2013, the estate tax exclusion amount reverts to \$1,000,000 and the top tax rate increases to 55%.

- Estate tax exclusion amount. \$5,000,000 per person (to be indexed in 2012 for post-2010 inflation). A married couple can now shelter \$10,000,000 of assets from estate taxes.
- > Gift tax exclusion amount. The gift tax exclusion amount and the estate tax exclusion amount are once again united. This means wealthy families can use their entire \$5,000,000 exclusion amount during lifetime, upon death or any combination thereof. This is a windfall for very affluent families who may now make very large gifts, thereby removing assets and the future growth thereon, from their estates. The Bush tax cuts only allowed the use of \$1,000,000 of the exclusion amount during lifetime.
- Seneration-skipping tax (GST) exclusion amount. The GST exclusion amount is the same as the estate and gift tax exclusion amounts, but will not be indexed for inflation.
- Estate and gift tax rates. The maximum rates for the estate tax, gift tax and GST rate, gift tax rates, as well as the maximum GST tax rate, is 35% under the Act.
- > Portability of unused exclusion amount. The 2010

 Tax Relief Act introduced the "deceased spousal unused exclusion amount." When a spouse passes away, any of his or her unused \$5,000,000 estate tax exclusion amount passes to the surviving spouse, who may use it upon his

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or her death (along with his or her original \$5,000,000). Under the current legislation, the deceased spouse must pass between January 1, 2011 and December 31, 2012 and the surviving spouse must pass prior to December 31, 2012. We believe it is likely, however, that these provisions could be included in new estate tax legislation, regardless of what the exclusion amount becomes. There was significant discussion throughout 2010 about portability features, contributed to expectations that these provisions may become permanent.

Date-of-Death Cost Basis. Step-up in basis is back for individuals dying in 2011 and 2012. For descendants dying in 2010, there are modified carryover basis rules, unless the estate elects out of the zero estate tax rules of 2010 (and into the \$5,000,000 estate tax exclusion amount).

Potential Opportunities for the Affluent

The estate and gift tax provisions of the 2010 Tax Relief Act were very generous and create significant planning opportunities for the very wealthy. However, the Act might cause some families to delay planning. Taxes are often a major motivator in creating an estate plan. With no negative tax consequences because of portability, many families may choose to delay planning or wait until the first spouses passes. We believe this is a bad idea. There are many advantages to planning now, even in light of the new tax legislation—and in our view, these advantages far outweigh the expected (but as of yet unknown) simplicity of "porting" exemption amounts to surviving spouses. An educated taxpayer with a well thought out and effectively implemented wealth management plan stands a much better chance of achieving his or her wealth planning goals and objectives during life and after death.

We encourage you to contact us to discuss these and any other topics relating to the accumulation, preservation and transfer of your family's wealth. Please call 888.857.7604 or email cwm@calamos.com.

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