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The Tax Act of 2010

INTRODUCTION

The passage of tax legislation often creates planning opportunities for many taxpayers and this is true even when the changes are only effective for a relatively short period of time. The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (hereinafter referred to as the Act) is no exception and most of the changes contained in the Act will sunset on or before December 31, 2012. The short term nature of these changes fails to eliminate the uncertainty that has made estate planning difficult for the last ten years and has resulted in many taxpayers taking a wait-and-see approach to estate planning. The new Act presents tremendous planning opportunities and the limited two-year window should prompt clients to act and to begin to take control of their estates.

This issue of *Legal & Tax Trends* will highlight some of the key income, estate, gift and generation skipping transfer tax provisions of the Act and will discuss how taxpayers will be affected by these changes. In this article we will also focus on some of the planning opportunities created by the Act. A second companion issue of *Legal & Tax Trends* will be released later this month and will review how life insurance will continue to play a prominent role in meeting our client's needs in business planning, executive benefits, retirement planning, estate planning and funding income replacement.

II. A Review of the Provisions of The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010

A. Estate, Gift, and Generation Skipping Changes

Reinstatement of Estate Tax for 2010

While the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) repealed the estate tax for the year 2010, the Act retroactively reinstates the estate tax for decedents dying after December 31, 2009. However, the reinstatement of the estate tax comes with a much higher exemption amount and a far lower maximum estate tax rate. In 2010 through 2012, this exemption amount - referred to as the "basic exclusion amount" - will be $5 million. This exclusion had previously been called the "applicable exclusion amount".

Under the Act a new building block was required to address the concept of "portability" (which will be discussed in detail later) of a deceased spouse's unused exclusion amount passing to the surviving spouse. Under the Act the new "applicable exclusion amount" for a surviving spouse is equal to his or her basic exclusion amount plus any unused exclusion amount which passed to him or her from the predeceased spouse. The basic exclusion amount is indexed for inflation for decedents dying after 2011. The maximum estate tax rate is 35% which is significantly lower that the 45% rate for those dying in 2009.

Comment: For most individuals, the $5 million ($10 million if married) basic exclusion amount is more than enough to ensure that no federal estate taxes are due. The increase in the basic exclusion amount does not eliminate the need for planning one's estate and many of the traditional estate planning ideas (e.g., grantor retained annuity trusts, family limited partnerships, irrevocable life insurance trusts, charitable lead trusts) will still be useful. For example, a credit shelter trust can still be used to provide income to a surviving spouse and to protect a beneficiary's inheritance from creditors and divorce. Furthermore, state death taxes and income tax considerations will remain an important consideration for many clients.

- ***Option for Decedents who Die in 2010***

Even though the estate tax has been reinstated for 2010, the Act permits executors of estates of decedents who died in 2010 to make an election to apply the law under EGTRRA which eliminated the estate tax. The Act provides these executors the option of being taxed either under the Act's estate tax extension (i.e., 35% rate, $5 million exemption and a full step-up in basis) or under EGTRRA's provision for 2010, in which the estate tax was repealed but with modified carryover basis.[1] The presumption under the law is that the estate tax applies to all estates. Thus, the executor will need to affirmatively elect out of the

[1] The IRS has provided online an official draft of Form 8939, "Allocation of Increase in Basis for Property Acquired from a Decedent."

estate tax. Under the EGTRRA system for 2010, an executor who elects out of the estate tax is required to use the modified carryover basis rules. The executor may allocate basis to estate assets within certain limits: the basis of property passing to a non-spouse may be increased by $1.3 million and the basis of property passing to a spouse may be increased by an additional $3 million.[2]

The executor's options are illustrated by the following example:

> *Tom, who was happily unmarried, died in November of 2010 with an estate valued at $8 million. His assets are to be divided equally among his four nieces. His estate includes: a $2 million traditional IRA; a $2 million residence (basis $1,500,000), and $4 million of business stock (basis $2 million).*
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> *Option 1. If Tom's executor so elects, the estate will avoid estate tax but will be subject to the limited carryover basis provisions of §1022. Because Tom was unmarried, his executor may allocate up to $1,300,000 of basis to the estate property. Tom's executor chooses to allocate $500,000 of basis to the residence, resulting in its basis being equal to its fair market value. The executor allocates the remaining $800,000 of increase to the stock, after which its basis is $2,800,000. Assuming that the residence and stock are then sold by the nieces in 2011, only the stock sale will generate capital gains tax. The capital gains tax will be $180,000 (equal to 15% multiplied by gain of $1,200,000). The estate pays no estate tax under this option.*
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> *Option 2. If Tom's executor does not make such an election, by default the estate will be subject to estate tax. Assuming Tom had never made any taxable gifts, his federal estate tax payable will be calculated based on an $8 million estate and a $5 million estate tax exemption. The estate tax will be equal to $1,050,000 (Tentative Tax of $2,780,800 less the unified credit of $1,730,800). Because of the full basis increase available under this election, Tom's heirs will not recognize any capital gains tax if they sell the residence and stock at $2 million and $4 million respectively.*

Several considerations should be kept in mind. First, Tom's executor was not required to allocate all of the available $1.3 million basis increase. If some property had passed to a charity, for example, the allocation of basis to that property would not have been necessary.[3] Second, the executor has the discretion to allocate the basis disproportionately. For example, Tom's executor does not have to prorate the $1.3 million by value or by the relative amount of gain. Third, items of income in respect of a decedent (IRD) are not eligible for increased basis, so the executor could not allocate any of the $1.3 million increase to Tom's IRA. Fourth, property may only receive a basis increase up to the property's fair market value as of the estate's valuation date. Stated another

[2] Both the $1.3 million basis increase and the $3 million spousal property basis increase may be used for property passing to a surviving spouse. Thus, up to $4.3 million of basis increase may be allocated to the decedent's property that passes to his or her surviving spouse. IRC §1022(b) and (c).

[3] Assuming the charity was a qualified §501(c)(3) organization it would not pay income tax on the sale of appreciated property.

way, the allocation of basis by the executor cannot be used to create a loss. For example, Tom's executor could allocate no more than $500,000 of basis increase to the residence since it had only $500,000 of gain. Fifth, where property is not simply divided among beneficiaries pro rata, the executor's decision to allocate basis to some property and not others may create disparities in the value of property each beneficiary receives. Finally, the allocation decision can affect the net (i.e., after-tax) value of property, which may put some beneficiaries in a better position than others.

Consider the issues of fairness raised in this example if niece A receives the IRA, niece B the residence and nieces C and D share the stock. While each beneficiary will receive assets of nominally equal value, only B could liquidate her inheritance without recognizing some taxable income. Each executor should consult with his or her tax and legal advisors before deciding whether to make this election.

Comment: While the executor's decision to elect out of the estate tax and into modified carryover basis regime depends upon a number of factors, the single most important issue will be the total tax incurred under each scenario. Generally, the executor will elect out of the estate tax if the current estate tax liability will exceed the present value of the future income tax liability. In determining the present value of the future income tax liability, it will be necessary to project when the capital assets will be sold, the appreciation rate on the assets until sale, and the future capital gains rate (and if there is recapture property, what the ordinary income tax rate will be as well).

Generally, as the gross estate grows beyond $5 million, the cost of the estate tax (at a 35% rate) begins to overtake the benefit that the step-up in basis provides in the form of reduced capital gains tax exposure. Choosing to stay within the estate tax regime and even pay some amount of estate tax may appeal to those executors of taxable estates over $5 million with a large amount of property which has a very low basis. Also, paying a relatively small amount of estate tax with a full-step up in basis may be better than not paying an estate tax and being subject to the complexity of the modified carryover basis rules.

Other factors which will need to be considered include the following:

- The ability to shelter future income by using the new higher depreciation schedules available with the step-up in the basis assets. (One will need to calculate the present value of the future benefit of these income tax deductions.)
- The impact of state and local income taxes; and
- The impact of deprecation recapture under §1245 and 1250.

- ***Extension of Certain Filing Deadlines***

For those decedents who died in 2010 but before the date of enactment of the Act, the due date is extended until no earlier than nine months after the date of enactment of the Act (December 17, 2010) for: (1) filing an estate tax return, (2)

paying the estate tax, and (3) making a disclaimer of an interest passing by reason of the death of a decedent.

Comment: This provision of the Act is not surprising given the retroactive reinstatement of the estate tax for 2010. The extension gives these estates and transferors time to evaluate the effect of the new law and to make needed adjustments, including disclaimers. One question that arises as a result of the extension for a qualified disclaimer is whether the disclaimer will be a valid under state law.

Portability of Unused Exemption

The Act creates a new concept called "portability" which attempts to simplify estate tax planning by avoiding the need for married couples to undertake trust planning to fully utilize the basic exclusion amount at the first death. Unfortunately, portability is not simple, nor does it always assure the intended results. For a spouse who dies after December 31, 2010, the Act allows the surviving spouse to use the deceased spouse's unused exclusion amount in addition to the surviving spouse's own basic exclusion amount. The executor of the deceased spouse's estate can elect to transfer this remaining amount to the surviving spouse. If the decision is made to transfer any remaining amount, the election must be made on a timely filed estate tax return for the deceased spouse. This carryover amount is being referred to as the Deceased Spousal Unused Exclusion Amount (DSUEA).[4] If the surviving spouse has more than one pre-deceased spouse, then the surviving spouse may only use the lesser of $5 million or unused exclusion amount of the last deceased spouse.

The following examples will illustrate how portability works.

> ***Example: 1:*** *Josephine dies in January of 2011 having previously made taxable gifts totaling $1 million. The entire estate is left to Napoleon and the executor files an election to allow Napoleon to use Josephine's deceased spousal unused exclusion amount (DSUEA) of $4 million. Napoleon can now use his basic exclusion amount of $5 million plus Josephine's DSUEA of $4 million for a total of $9 million in transfers during his lifetime, or his executor can use the $9 million at his death.*
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> ***Example: 2****: Same facts as above except Napoleon marries again. His second wife, Marie Louise, predeceases Napoleon having made taxable gifts totaling $3 million and does not have a taxable estate. An election is made on Marie Louise's estate tax return to permit Napoleon to use Marie Louise's deceased spousal unused exclusion amount. Napoleon cannot combine the deceased spousal unused exclusion amount for each of his deceased wives. Instead, he may only use Marie Louise's $2 million deceased spousal unused exclusion amount since she was the last*

[4] This does not include any unused generation skipping transfer tax amounts. Under the Act, "Applicable Exclusion Amount" is now defined as the "Basic Exclusion Amount" (e.g., $5,000,000) plus the "Deceased Spousal Unused Exclusion Amount."

spouse to die, along with his own $5 million basic exclusion amount for a total of $7 million. This amount may be used during lifetime or at death.

Suppose Napoleon had predeceased Marie Louise, his executor could have used Napoleon's $5 million basic exclusion amount and Josephine's deceased spousal unused exclusion amount of $4 million because Josephine was the last deceased spouse of Napoleon. If an election was made on his estate tax return, Marie Louise would be able to use Napoleon's deceased spousal unused exclusion amount of $5 million.

Comment: This provision may prove beneficial to those individuals who failed to create an estate plan to take advantage of the basic exclusion amount at the death of the first spouse to die. However, there are still substantial tax and non-tax benefits to be derived from using the basic exclusion amount to make lifetime transfers or at death to fund a credit shelter trust.

In addition to the tax certainty of using a credit shelter trust, there are spendthrift and creditor protection benefits of using a trust. Furthermore, relying on portability may result in unnecessary state death taxes being paid at the second death because of the failure to take advantage of the state death tax exclusion of the first spouse to die. In addition, the appreciation of the property after it is placed in the credit shelter trust will not be included in the surviving spouse's estate. Contrast this with the fact that the portable portion of the exclusion amount is frozen at its date of death value and does not receive the benefit of future inflation indexing. However, the assets which pass to the surviving spouse outright (and which benefit from this portability provision) will receive a step up in basis at the surviving spouse's death, while assets passing to a credit shelter trust will not. Finally, a credit shelter trust is attractive in that a person can use a portion, or all, of their exemption amount at his or her death to benefit children from a previous marriage by leaving assets in trust. Similarly, use of a trust can ensure what happens to the property after the death of the surviving spouse. In other words Mother does not have to worry about Father remarrying and leaving the property to his new family and thereby, disinheriting her own children.

Portability will be helpful where one spouse has an unusually large asset and it cannot be easily divided (e.g., a client who has a large IRA and few other assets to fund the credit shelter trust), In this situation there is a tension between the leaving the IRA directly to the surviving spouse to benefit from income tax deferral and foregoing the estate tax benefits of utilizing the exemption versus leaving the IRA to a credit shelter trust to realize the estate tax benefits but consequently losing the income tax benefits. Portability largely solves this problem. The portability provision is set to expire on December 31, 2012, and at that time the exemption amount is scheduled to revert to $1 million. Carrying an unused exemption beyond 2012 could prove detrimental if future legislation curtails portability of the DSUEA.

State Death Tax Deduction Reinstated

The state death tax deduction is reinstated for decedents dying after December 31, 2010. The Act extends the deduction for state estate and inheritance taxes rather than the credit provided under earlier law. Until 2013 the state death tax deduction is still available when filing ones's federal estate tax return as it was in 2005 through 2009. In 2013, the credit for state death tax returns and the deduction will no longer apply. Federal estate tax calculations will have to be adjusted accordingly.

Increased $5 Million Gift & GST Exemption / Reunified Gift & Estate Tax

The applicable exclusion amount for gifts and generation skipping transfers made after December 31, 2010 is $5 million and the top gift and GST tax rate is 35%. Beginning January 1, 2011, the gift tax is reunified with the estate tax which means the $5 million exemption can be used during life or at death. Just as before passage of the Act, any portion of the federal gift tax exemption used during life will reduce the federal estate tax exemption at death.

Comment: The reunification of the estate and gift tax applicable exclusion amount along with the $5 million GST exemption will provide taxpayers with a tremendous planning opportunity. Every family with significant wealth will now need to take the time to consider what actions should be taken. It is expected that trust and estate planning attorneys will be busier than they have been for many years. Increased planning will mean that life insurance with its unique ability to provide solutions to estate and business problems will continue to be on the table.

The two-year window creates a sense that action needs to be taken or this opportunity may be lost. While the $5 million gift and GST exemptions for 2011 and 2012 are substantial, no one knows what 2013 will bring. We have learned over the past decade that the political process is unpredictable. It is expected that many clients who have substantial assets will use these large gift and GST exemptions to try to lock in these benefits before they are scheduled to expire in 2013. Unfortunately, as estate and gift tax rates are unified, there is a possibility that gifts made during those years may be added back to the base on which the estate tax is computed after 2012. Thus, there is a potential to subject those tax-exempt 2011 and 2012 gifts to the estate tax if the donor dies in a year with a lower estate tax exemption. This possibility is referred to as the "claw back". It will be important to disclose this possibility to clients when discussing making large gifts.

While it may not be possible to lock in the increased gift tax exemption, the use of valuation discounts, the removal of future appreciation from both estates and the income tax benefits of using a grantor trust mean that there is little likelihood that the grantor would be hurt by making these large gifts. However, if the claw back applies, there may be issues raised (i) if the gifted assets would have otherwise qualified for the marital deduction at the donor's death; (ii) if the gifted assets were to decline in value after the gift was made; or (iii) if the recipients of the large gifts were different than the recipients of the taxable estate.

The increased gift tax and generation skipping tax exemption amount in 2011 and 2012 will facilitate planning in many ways. The impact, however, will differ markedly depending upon the size of one's estate. For purposes of our analysis, we will offer planning suggestions and ideas for (i) Estates under $3 million, (ii) Estates between $3 million and $10 million, and (iii) Estates over $10 million.

- ***Estates Under $3 Million***
  - For these estates, planning will still be needed to make sure the "right" people get the "right" assets with the "right" amount of supervision. Everyone will need to have their existing estate planning documents reviewed as the new law's impact on formula clauses may skew the amount of property passing to the spouse and children in unintended ways.
  - Taxpayers at all levels still need planning for insurance ownership, beneficiary designations, asset protection, guardianships, powers of attorney, children with special needs, medical directives, business succession, income tax issues, state death taxes and many other matters.
  - A married couple with under a $3 million estate may wish to consider using disclaimer wills to retain flexibility. At the death of the first spouse, all of the decedent's property would pass to the surviving spouse (who with full knowledge of any future tax changes) would have an opportunity to disclaim all or a portion of the bequest with any disclaimed property passing to a credit shelter trust for the benefit of the family.
  - The higher exemptions will permit clients with under $3 million to own their own life insurance policies. This will enable them to have ready access to the cash values and to rely on the higher exemptions instead of the irrevocable trust to shelter the death proceeds from estate tax. Clients should be prepared to have a standby strategy available that will permit the transfer of the insurance policy from the taxable estate (without subjecting the death proceeds to the three year rule) should the exemptions revert back to their lower levels.
  - Clients may decide to use the higher gift tax exemption to simplify their estate planning (e.g., revisit the use of Crummey powers to fund an existing life insurance trust).

- Estates of less than $3 million will still need liquidity for any one or more of the following:
  - To create survivor income,
  - To meet educational expenses for the children and grandchildren,
  - To pay probate fees and possible state death taxes,
  - To provide for estate equalization,
  - To pay income taxes on income in respect of a decedent assets (e.g., IRAs, 401(k) plans, nonqualified deferred compensation),
  - To better assure the tax benefits of a "stretch",
  - To provide a legacy for family members or for a favorite charity ("live better and leave more"), and
  - To fund a business succession plan.

- ***Estates Between $3 million and $10 Million (Married Couple)***
  - All of the strategies and opportunities for estates under $3 million will still be applicable to these larger estates.
  - While state death taxes and income taxes may be a more immediate concern, future growth of these estates and the possible return of lower federal gift and estate tax exemptions may still necessitate tax planning that is both flexible and economical. Otherwise, "wait and see" may translate into "wait and pay".
  - Clients may wish to "insure" against the "risk" that exemption "portability" may not be available or the risk that they may die in a year when the estate tax exemption is low enough to cause their estates to pay federal estate tax.
  - Clients may also wish to consider creating and funding a life insurance trust with specially designed flexibility to distribute principal and income to the spouse during grantor's life – a so-called spousal lifetime access trust (SLAT). Large gifts of income-producing assets which, depending upon on circumstances, may possibly be discounted for both lack of control and lack of marketability can now be made to fund these trusts. The trust income could then be used to (i) fund life insurance premiums, (ii) pay interest on an installment note under a sale to a defective trust, (iii) and distribute excess income to the spouse or children, if needed**.**
    - To the extent that each spouse establishes a SLAT, there is a concern that the Service may apply the Reciprocal Trust Doctrine and not respect the gifts, treating the transfers as if no gifts were made. Working with counsel, it may be possible to avoid the Reciprocal Trust Doctrine by creating the trusts at different times and with substantially different terms.

- Consider leveraging the gift to the SLAT with an individual life insurance policy. Gifts to a SLAT or the income from assets placed in the SLAT can be used to purchase insurance on the grantor's life.
- This insurance will be helpful in offsetting the cost of losing the step-up in basis on the property transferred to the SLAT.
- If the SLAT is respected, the life insurance proceeds may generally be received both income tax -free and estate tax-free.
- Provided the trust is properly established and operated, all post-transfer appreciation on the gifted assets will be removed from both spouses' estates.

- ***Estates over $10 Million (Married Couple)***
  - All of the strategies and opportunities that may apply to an under $3 million estate or an estate of between $3 million and $10 million could also apply to these larger estates.
  - The next two years present a tremendous opportunity for wealthy individuals to make gifts (i.e., relatively low asset values, no state gift tax except for Tennessee and Connecticut, available valuation discounts, low interest rates, and a limited time to act). This predicted increase in planning will inevitably lead to increased opportunities to use life insurance to solve estate and business planning problems.
  - All of the traditional estate planning ideas (e.g., grantor retained annuity trusts, family limited partnerships, irrevocable life insurance trusts, charitable remainder trusts) will still be useful. Since the new law did not restrict use of discounts for lack of control and lack of marketability, these discounts will still be available at least in the near term.
  - Clients should consider using the $5 million gift tax exemption to simplify their planning. For example, the increased exemption could be used:
    - to give a high cash value life insurance policy to an irrevocable trust; (This gift may have been previously impractical due to the $1 million gift tax exemption.)
    - to forgive a family loan;
    - to exit from an economically inefficient split dollar arrangement;
    - to give assets to a non U.S. citizen spouse;
    - to transfer assets between same sex partners where the gift or estate tax marital deduction is not available; and
    - to exit a failed estate planning transaction. [5]

[5] This may be applicable, for example, in an asset sale to an irrevocable trust where the asset has substantially declined in value, leaving little probability of successfully transferring wealth.

- The Act presents a unique opportunity to review your client's business succession plan and to consider using some or all of his or her $5 million gift tax exemption to transfer an interest in the family business (or family real estate) to his or her children who are active in the business:
  - Gifting can permit the client to take advantage of the discount for lack of control and the discount for lack of marketability;
  - By recapitalizing into voting and non-voting interests and gifting the non-voting interests, your client can still retain control of the business;
  - Gifting removes the future appreciation from both spouse's estates and shifts the income to the next generation;
  - A grantor trust can maximize the tax benefits (i.e., the grantor can pay the taxes on the trust income so that the trust property grows free of tax).
- Qualified Personal Residence Trusts (QPRTs) will become more attractive under the Act as the increased gift tax exemption will permit very valuable residences to be transferred at a substantial discount. Clients may elect to purchase life insurance on the life of the grantor in order to insure against the possibility of death during the term.
- With the higher gift tax exemption and the ability to increase the "seed money", the sale to a grantor trust will become more attractive. The ability to exempt the property given to the trust (as well as its future growth) from the generation-skipping tax is an important benefit which favors use of this technique. The sale to a defective trust is also attractive as it removes all appreciation after the sale regardless of when death occurs.
- While GRATs may not be as favored as sales to a defective grantor trusts under the Act, GRATs remain a viable strategy, especially longer term GRATs which can leverage today's low interest rates. GRATs will also remain attractive for clients who wish to make a gift and still retain an income interest. Clients can purchase insurance on the grantor's life in order to insure against the possibility of death during the term.

> ***Example:*** *Ken, age 55, is the sole shareholder of Acme Widgets, Inc., an S Corp. Ken's two children, Michele and Tom, are both active in the business. Ken would like to transfer some interest in the business to the children yet still retain control of the business. Ken could create voting and non-voting stock and transfer the non-voting stock to a 10-year GRAT. Assume the non-voting shares have a value of $2 million and a discounted value of $1.5 million. With a 5% payout rate and a 7520 rate of 2.40% the value of the gift of non-voting stock is approximately $840,000.*

- By leveraging the $5 million exemption, GRATs can help facilitate the rollout from split dollar arrangements, as the trust can be the remainder beneficiary of the GRAT.
- The ability to make taxable lifetime gifts and generation skipping transfers of up to $5 million ($10 million for a married couple who gift splits) will make it easier and simpler to fund a dynasty insurance trust. For example, a married couple can use their combined $10 million exemption to fund a generation-skipping trust, depositing $2 million into a secondary guaranteed $20 million second-to-die life insurance policy. Clients with illiquid estates will now be able to solve their liquidity problem by making one substantial gift to an irrevocable trust, assuming the trustee then elects to purchase life insurance with the gift.
- The increased applicable exclusion amount may, in many instances, reduce the need for a split dollar arrangement to minimize the value of the gift. A large outright gift can now be made to an insurance trust to enable the trust to "roll out" or exit from economically inefficient split dollar arrangements (e.g., one with high economic benefit costs or high interest rate costs).

Generation Skipping Transfer Tax Applies in 2010

EGTRRA had repealed the generation skipping transfer tax for 2010 but the Act reinstates the generation skipping transfer tax for decedents dying after December 31, 2009. However, the tax rate on a generation skipping transfer in 2010 is 0%. In tax years 2011 and 2012, the tax rate on a generation skipping transfer is the highest estate and gift tax rate in effect for such year (35% for tax years 2011 and 2012).

There is also a generation skipping transfer tax exemption of $5 million for 2010 which is equal to the applicable exclusion amount for estate tax purposes. The reinstatement of the transfer tax exemption will enable taxpayers to utilize part or all of the exemption for transfers in trust that are not direct skips. This eliminates some of the uncertainty pertaining to planning for transfers in trust that are not direct skips resulting from EGTRRA's repeal of the generation skipping transfer tax and the generation skipping transfer tax exemption.

Comment: The zero tax rate for generation skipping transfers made in 2010 provided an opportunity to make distributions to skip beneficiaries from non-exempt GST trusts without incurring a GST tax. Unfortunately, because the Act was not signed into law until the middle of December, it did not afford trustees with much of an opportunity to determine whether the trust document permitted such a distribution and whether or not a distribution was in the best interests of the trust beneficiaries.

B. Summary of the Income Tax Provisions of the Act

The Act extends temporarily many income tax provisions, both for individuals and businesses. Some of the changes only apply to 2010 and 2011, while others also include 2012.

1. Income Tax Provisions for Individuals

Rate Changes applicable through 2012

- Individual income tax rates will remain at the 2010 levels for 2011 and 2012. Rates are scheduled to increase in 2013. In addition, as part of the health care legislation passed prior to the Act, a portion of earned income (amounts in excess of $250,000 for joint filers or $200,000 for single filers) will be subject to an additional 0.9% tax, beginning in 2013.
- Long term capital gains rates of 15% (and 0% for taxpayers in the 10% and 15% brackets) will continue through the end of 2012. Qualified dividends will be taxed at the long term capital gains rate. In 2013 the long term capital gains tax rate is scheduled to return to a maximum of 20% (18% for assets held more than five years). In 2013 dividends are scheduled to be treated as ordinary income. In addition, beginning in 2013, taxpayers with income in excess of $250,000 (for joint filers) or $200,000 (for single filers) will face an additional 3.8% tax on their net investment income.
- Under the Act, in 2011 and 2012 taxpayers will be able to use full itemized deductions and personal exemptions without limitation. This so-called "haircut" provision returns in 2013.

Other Individual Income Tax Provisions applicable through 2012

- Marriage penalty relief is extended through 2012 (i.e., an increased standard deduction for married couples filing jointly and an increase in the income subject to the 15% tax bracket).
- The dependent care credit and the child tax credit were extended for an additional two years at 2010 levels.
- Both the Earned Income Tax Credit and the Adoption Credit were extended at 2010 levels.
- Education incentives:
  - The Coverdell account contribution limit of $2,000 is restored.
  - The exclusion from income of up to $5,250 in employer-provided tuition is extended for an additional two years.
  - The above-the-line student loan interest deduction is also extended.

- The American Opportunity tax credit of up to $2,500 of the cost of tuition and related expenses paid during the tax year is extended.

Other Individual Income Tax Provisions applicable through 2011 only

- The Act features a two-year "patch" that essentially keeps the alternative minimum tax (AMT) exemption at 2010 levels. Without this patch, more than 21 million Americans would otherwise have been subjected to the AMT.
- The itemized federal deduction for state and local general sales taxes in lieu of the itemized deduction for state and local income taxes is extended for 2010 and 2011.
- Certain ordinary income tax credits (e.g., child tax credit, dependent care credit, education credit, *et al*.) may be used to offset a taxpayer's AMT liability for 2010 and 2011.
- Retroactively reinstates for 2010 and extends for 2011 the ability of individuals 70 ½ or older to make income tax-free distributions of up to $100,000 directly from their IRA to a public charity.
- Payroll tax reduction for the OASDI portion of FICA. The rate is reduced to 4.2% (from 6.2%) on the employee portion only. Since this rate applies only to the first $106,800 of wages, the maximum tax savings for this in 2011 will be $2,136 ($4,272 if married).
- The federal unemployment insurance benefits have been extended for 13 months in those states with high unemployment. This means that in those states, the unemployed may get benefits for a total of 99 weeks.
- The itemized deduction of mortgage insurance premiums for qualified residences is extended.
- The lifetime credit ($500) for energy efficiency home improvements is extended.

2. Income Tax Provisions for Businesses

- The Act provides for a reduction in 2011 in the combined self-employment tax rate from 15.3% to 13.3%. This provision corresponds to the similar payroll tax reduction available for employees.
- The Act provides an exclusion from income of 100% of the gain from the sale of "qualified small business stock." The qualified stock must have been acquired at the original issuance, been acquired between September 27, 2010 and before January 1, 2012, and must have been held for at least five years prior to sale. A discount of 75% is available for similarly qualifying sales of stock acquired between February 17 and September 26, 2010.

Business Changes applicable through 2012

- The Act provides bonus depreciation (available to businesses of all sizes) equal to 100% of qualified capital purchases of assets placed into service after September 8, 2010 and before December 31, 2011. The bonus depreciation for such assets placed into service in 2012 is 50%.
- Section 179 of the Code is extended and continues to allow businesses to write off the full amount of qualifying equipment or computer software purchased in 2010 and 2011, up to $500,000 per business per year. The phase out amount of $2,000,000 is also extended for these two years. In 2012 the amount that can be written off is reduced to the 2007 limits - $125,000 and the phase out begins at $500,000.

Business Changes applicable through 2011 only

- A charitable deduction for contributions of computer equipment used for education, for books to public schools, and for contributions of food inventory was extended.
- The Work Opportunity Tax Credit was extended for four months (through all of 2011).
- The Research Tax Credit available for qualified expenditures made in 2011 was extended.
- The 15-year straight line cost recovery for qualified leasehold improvements was extended.
- Certain credits related to energy use incentives were extended.

3. Strategies and Opportunities – Income Tax Provisions

- With the lower income tax rates, clients may consider converting to a Roth IRA in 2011 or 2012. Note that the income tax resulting from the conversion must be paid in the year of the conversion. The special provision to spread the tax across two years (2011 and 2012) applied only to conversions made in 2010.
- Clients may also consider using the savings from the 2% payroll tax reduction in 2011 (up to $2,136) to increase their 401(k) contributions or fund other tax-advantaged vehicles.
- Client may also wish to consider harvesting long-term capital gains over the next two years while the rate is generally 15%.
- Clients should also consider whether exercising stock options while the AMT is patched makes sense.
- If the client is over age 70 ½, he or she may wish to consider fulfilling charitable commitments in 2011 by transferring up to $100,000 from his or her IRA to a public charity.

- Inquire whether the family business can benefit from tax incentives to spur investment (e.g., bonus depreciation, Section 179 expensing). Any cash savings can be redirected to meet personal goals.

III. CONCLUSION

The passage of tax legislation often creates opportunities and the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 is no exception. The new 2010 Act has created a favorable planning environment for lifetime gift and insurance planning for a number of reasons. First, the cloud of doubt and uncertainty finally has been lifted after years of not knowing what to expect, even if relief is assured only for two years. The next couple of years present tremendous opportunities to make large gifts, especially to generation skipping trusts. Secondly, the period of "certainty" is limited to only two years and so, clients will be motivated to act now to take advantage of these opportunities. Finally, the essential tax provisions are easy to understand -- $5 million gift and GST exemptions in 2011 and 2012. Clients can act with confidence.

Even for those estates that might now be excluded from the estate tax, the wealth accumulation and retirement issues using qualified and nonqualified plans still apply. In addition, the survivor income, legacy, estate equalization and the business continuation issues will still apply for many clients. The proper approach to the estate and business planning process will not change. The process still needs to be driven by the client's objectives.

- Does the client have sufficient wealth to live comfortably for the rest of his or her life?
- Will the surviving spouse be able to maintain that standard of living if the client dies?
- How much of a legacy does the client want to leave to children and grandchildren? When? How?
- Who should inherit or take over the business?
- How much of a legacy does the client want to leave to charity?

These are the questions that will still need to be answered. The answers to these questions will largely determine the extent life insurance will play a role. The attention given in the media to the increased estate and gift tax exemptions provides an opportunity to discuss with your clients the proper uses of life insurance as part of the estate and business planning process. Proper planning should not cease just because the estate tax laws change for a limited period of time. Planning today will need to focus on the client's many planning objectives for which life insurance is often the ideal funding vehicle. Only life insurance permits the client to take back control and assure completion of his or her estate planning objectives.

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Please note that the state income tax treatment of your Roth IRA conversion and subsequent distributions from your Roth IRA may vary depending upon your state of residence.

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