



December 11, 2010

SENATE INTRODUCES COMPROMISE TAX BILL

On December 9th, 2010, the “Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010” was introduced in the Senate (the “Bill”). The Bill incorporates the technical provisions of the tax law compromises reached by the Obama Administration and a group of select Democratic and Republican Senators and Representatives. Despite the stern opposition of several House Democrats, many in Washington expect this Bill to pass. Consequently, its provisions are extremely relevant to year-end tax planning decisions and should be factored into such analyses. Some of the Bill’s most notable income and estate tax provisions for year-end planning purposes are summarized below.

Individual Income Taxes

Effective only *through December 31, 2012*, the Bill extends most of the income-tax cuts and many of the credits provided under the Economic Growth and Tax Relief Reconciliation Act of 2001 (“**EGTRRA**”) and subsequent legislation enacted under both the Bush and Obama Administrations, including the following:

Tax Brackets. The Bill extends the current individual income tax brackets of 10%, 25%, 28%, 33%, and 35% (the top marginal tax bracket). These rates are set to increase to 15%, 28%, 31%, 36%, and 39.6% respectively, as of January 1, 2011.

Dividends & Capital Gains. The Bill extends the current dividend and capital gains rate of 15%. Without passage of the Bill, as of January 1, 2011, dividends will be taxed at ordinary income tax rates and the top long-term capital gains rate will increase to 20%.

AMT Patch. The bill increases the current exemptions for individuals and married couples under the Alternative Minimum Tax (AMT) and allows nonrefundable personal credits against the AMT.

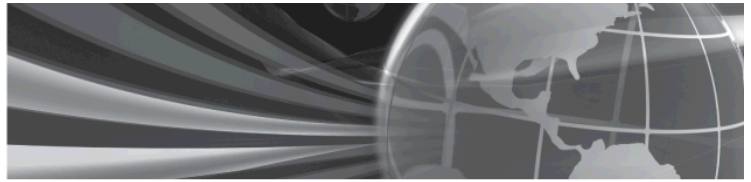
Itemized Deductions and Personal Exemptions. The Bill extends EGTRRA’s repeal of the adjusted gross income limitations on itemized deductions and phase-out of personal exemptions.

Various Family and Education Tax Credits/Exclusions. The Bill extends several tax credits and exclusions targeting middle-class families and education, such as the modified child tax credit, the expanded dependent-care credit, the third-child earned income tax credit, the expanded student loan interest deduction and the American Opportunity Tax Credit (for up to \$2,500 of tuition and related expenses).

Reduction in Payroll Taxes. Currently, employees pay a 6.2% tax and self-employed individuals a 12.4% tax on wages/earned income up to \$106,800. The bill reduces these rates by 2% (4.2% for employees and 10.4% for self-employed individuals).

Estate Taxes

The Bill implements the following provisions regarding the estate, gift, and generation-skipping transfer (“**GST**”) taxes (collectively, “**transfer taxes**”) *through December 31, 2012 only*. Note, however, that *the effective dates of certain provisions vary and may impact year-end tax planning if the Bill is enacted*.



2010 Estate, Gift, and GST Taxation.

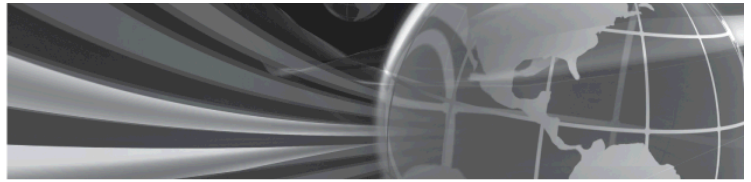
- Estate Tax: The Bill retroactively reinstates the federal estate tax as of January 1, 2010 at a maximum federal estate tax rate of 35% and an estate tax exemption of \$5 million, but provides *estates of decedents dying after December 31, 2009 and before January 1, 2011 with a choice of which estate tax laws they wish to apply*:
 - The federal estate tax laws in effect prior to enactment of the Bill (*i.e.*, no federal estate tax and carry-over basis for inherited assets “**carryover basis regime**”), or
 - The federal estate tax laws enacted under the Bill.
- GST Tax: The Bill also retroactively reinstates the federal GST tax on generation-skipping transfers (*i.e.*, transfers to “skip persons,” such as grandchildren and more remote descendants of the transferor and/or trusts for their benefit) as of January 1, 2010 at a *flat rate of 0% for 2010 transfers only* and a \$5 million GST tax exemption.
 - Note that, even if a decedent’s estate elects to apply the carryover basis regime for estate tax purposes, the decedent still will be deemed a “transferor” of property for purposes of determining whether GST taxes apply to property transfers at death.
- Gift Tax: The Bill does not significantly impact the federal gift tax laws for 2010. The maximum federal gift tax rate remains at 35% and the gift tax exemption at \$1 million through December 31, 2010.

2011 Transfer Tax Rates. Effective as of January 1, 2011, the Bill imposes a 35% top marginal federal estate and gift tax rate and a 35% flat GST tax rate.

2011 Exemption Reunification and Adjustments. As of January 1, 2011, the Bill (1) reunifies the federal estate and gift tax exemptions at \$5 million, (2) ties the federal GST tax exemption amount to the maximum federal estate tax exemption amount, and (3) beginning January 1, 2012, annually adjusts these exemption amounts for inflation.

Exemption Portability. Effective as of January 1, 2011, under the Bill:

- Unified Gift and Estate Tax Exemption. The executor of a decedent dying after December 31, 2010 (“a deceased spouse”) could elect to provide his/her surviving spouse with his/her “deceased spousal unused exclusion amount” (*i.e.*, the deceased spouse’s remaining unified exemption amount after reduction for his or her taxable estate).
 - The executor of a deceased spouse must file a timely estate tax return indicating the “deceased spousal unused exclusion amount” and electing to make it available to the surviving spouse.
 - The surviving spouse can only use the unused exclusion amount of his or her “last such deceased spouse.” Presumably, this limitation prevents the accumulation of the unused exemptions of multiple deceased spouses. It is not entirely clear, however, whether the election of a second deceased spouse would trump the election of a prior deceased spouse, particularly, for example, if the second deceased spouse’s unused exemption



was greater. The IRS is tasked with issuing regulations to implement the portability provisions, if passed, and may address those issues therein.

- **GST Tax Exemption.** Portability between spouses would not apply to the deceased spouse's GST tax exemption, since, under the Bill, an individual's GST tax exemption amount equals the "basic exclusion amount" (\$5 million, as indexed for inflation).

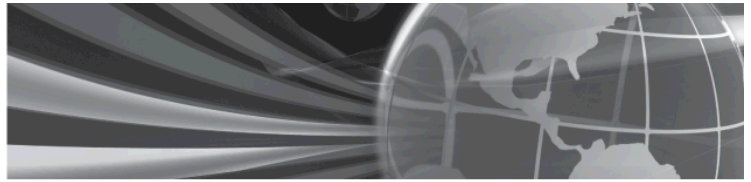
Filing Extensions.

- **Estate Tax:** Estates of decedents dying after December 31, 2009 and before enactment of the Bill would have nine months from the date of enactment to file any required federal estate tax returns, to pay any federal estate tax, and/or to have a beneficiary make a qualified disclaimer of any interest in property passing to him or her by reason of the decedent's death.
- **GST Tax:** The Bill provides a nine-month period from the Bill's enactment to file any GST tax return required for a generation-skipping transfer occurring after December 31, 2009 and before the date of enactment of the Bill.

Sunset. The Bill provides that the above transfer tax law amendments *will not apply to estates of decedents dying, gifts made, or generation skipping transfers after December 31, 2012* and that the Internal Revenue Code will apply as if the amended provisions "had never been enacted."

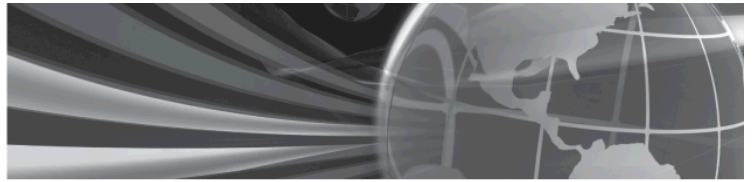
Initial Notes and Planning Comments

- ***Wealth Transfer Planning Implications.*** If this Bill passes, it will provide, at least temporarily, significant wealth transfer planning opportunities through the maximum use of the increased gift and GST tax exemptions. Fully using these exemptions during life can substantially reduce future estate tax exposure. In addition, the Bill does not contain any minimum term requirements on grantor retained annuity trusts or limits on valuation discounts, both of which had previously been considered as possible offsets to the cost of the new tax legislation. The Bill, however, also dramatically reduces, temporarily, the number of households affected by the transfer tax system.
- ***Life Insurance Planning.*** The increased estate, gift, and GST tax exemptions should make it easier to fund irrevocable life insurance trusts ("**ILITs**") with the amounts needed to cover insurance premiums and may lessen the need to implement private split-dollar arrangements, loans, and other planning techniques to fund such premiums on a transfer tax efficient basis.
- ***Estate Planning with Portability.*** Portability between spouses of the reunified gift and estate tax exemptions may minimize the need for complex wills creating trusts to shelter a predeceasing spouse's exemption amount, as well for cumbersome asset divisions between spouses to ensure that each spouse individually owns enough property to take full advantage of his or her exemption. Further, with the reunification of the estate and gift tax exemptions, the surviving spouse could use the deceased spousal unused exclusion amount to shelter lifetime gifts, providing additional opportunities for lifetime wealth transfer planning.
- ***GST Tax Planning in 2010.***
 - The Bill retroactively reinstates the GST tax laws and a \$5 million exemption effective as of January 1, 2010. Thus, 2010 generation-skipping transfers will still be subject to the GST tax provisions of the Code but at a 0% GST tax rate. Accordingly, the Code



sections for determining whether a generation-skipping transfer is exempt, whether and how GST tax exemption can be allocated to the transfer, and the GST tax exempt status of a trust will still apply. Accordingly, individuals making generation-skipping transfers to trusts in 2010 should allocate GST exemption to those transfers, even if they would not otherwise generate a GST tax. Without such an allocation, the trust's receipt of non-GST exempt property may terminate its GST tax exempt status, causing subsequent distributions from that trust to incur a GST tax.

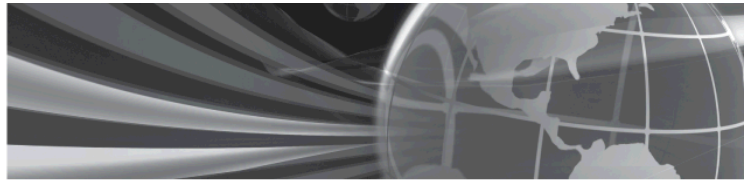
- The availability of the GST tax exemption in 2010 also should resolve questions about whether 2010 generation-skipping transfers to irrevocable trusts structured as GST exempt trusts can be made on a GST tax exempt basis. This resolution may be of particular benefit to individuals who made large gifts to trusts in 2010 in order to take advantage of the low 35% gift tax rate or who made gifts to ILITs in order to enable the payment of insurance premiums. If the Bill passes, these individuals should be able to allocate their GST tax exemptions to such 2010 transfers and thus preserve the GST exempt status of their trusts.
- Individuals making outright gifts to skip persons (*i.e.*, not in trust) in 2010 can rely on the 0% GST tax rate to avoid GST tax without having to allocate any GST tax exemption to the transfer. However, gifts made to skip persons in 2010 that exceed an individual's \$1 million federal gift tax exemption will still be subject to federal gift tax at a maximum rate of 35%. The proposed \$5 million federal gift tax exemption will not become effective until January 1, 2011. Accordingly, the benefits of making outright gifts to skip persons prior to year-end will likely be greatest for those individuals who plan to undertake a significant gifting program in the next few years in excess of the proposed \$5 million gift tax exemption.
- Existing trusts, however, should consider making GST taxable distributions or terminations before year-end if the Bill passes, since they would not incur a GST tax.
- *Dealing with Uncertainty.* This "at the last-minute" legislative proposal may increase the appeal of gifts to "QTIP" marital trusts, where an individual makes a lifetime gift to a trust structured to qualify for the gift tax marital deduction for the benefit of his or her spouse, with the remainder passing to descendants. If a "QTIP" election is timely made, a taxable gift is avoided, since the transfer will qualify for the gift tax marital deduction. The choice to make the QTIP election can be delayed beyond April 15, 2011 by requesting an automatic extension of the time to file the federal gift tax return to October 15, 2011. The beneficiary spouse also can decide to trigger a taxable gift to descendants by making a disclaimer within nine months of the transfer. Either way, an individual will be able to see how the year-end legislative situation unfolds before making any decisions. The individual should be no worse off for transfer tax purposes, as long as he or she is comfortable making the gift for the benefit of his or her spouse.
- *Déjà Vu in 2012?* Unfortunately, the sunset provision contained in the Bill will trigger the same uncertainty at the end of 2012 that we currently are experiencing with EGTRRA's sunset provision, including questions regarding whether gifts and GST transfers made in reliance on the increased exemptions will be respected. This Bill provides only a temporary reprieve, unless Congress can achieve consensus on a more permanent tax policy. With concerns over the growing federal deficit, however, it is unlikely that permanent tax legislation can maintain such favorable terms on all tax fronts, including the estate tax.



Please note that the Bill *is only proposed legislation and currently has no legal effect*. Given the unsettled nature of the tax laws so close to year-end, you may wish to review the impact of these and other potential tax law changes on your current and future estate planning goals. We are available to discuss these issues with you and review solutions that can enhance clarity and help you to achieve your planning objectives in the face of all this uncertainty.

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