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ANALYSIS OF 2010 TAX ACT

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Dear Clients and Friends:

After much anticipation, President Obama signed the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the "Act") on December 17, 2010. The Act provides a reprieve for taxpayers by extending the Bush-era tax cuts for the next two years. In addition, the Act provides for temporary certainty over that period in the areas of estate, gift and generation-skipping transfer tax. Postponed for another day is the looming decision on long-term tax policy. In the meantime, we have taken this opportunity to summarize some of the major aspects of the new law and discuss certain planning concerns and opportunities that will require attention in the near term.

Federal Estate, Gift and Generation Skipping Transfer ("GST") Taxes. For deaths occurring in 2011 and 2012, there will be an estate tax exemption amount of $5 million per individual ($10 million per married couple) and a maximum estate tax rate of 35%. Beginning in 2012, the exemption amount will be indexed for inflation. In addition, a decedent's assets will generally qualify for a step-up in basis to fair market value at date of death, as they had prior to 2010.

The Act applies the estate tax retroactively to individuals dying in 2010. However, the Act allows the executors of such estates to "opt out" of the federal estate tax. If this election is made, a decedent's assets would receive a limited step-up in basis. For estates under the $5 million exemption amount, most executors would prefer that the federal estate tax apply to the estate. A federal estate tax will not be due, and the decedent's assets will receive a full step-up in basis. For 2010 estates that exceed $5 million, an analysis of the estate tax currently payable versus the future capital gain tax must be performed. In addition, the executor would need to determine how to allocate any modified basis step-up in the event that he or she opted out of the federal estate tax.

The Act also provides that for decedents dying in 2011 and 2012, any estate tax exemption that goes unused in the first spouse's estate is "portable," meaning that it may be added to the surviving spouse's exemption amount, which could be available to the surviving spouse during his or her lifetime or later death. A surviving spouse, therefore, could use his or her own base exemption of $5 million plus the unused exemption of his or her most recent deceased spouse. Although no pre-mortem planning is necessary to take advantage of the new portability rules, there are a number of planning limitations that make the portability option less attractive, including the lack of asset protection planning, the inability to shelter appreciation on the exemption amount from future estate tax, and the loss of unused GST exemption.

The gift tax rate will remain at 35%, as it was in 2010. However, the exemption amount in 2011 and 2012 will be $5 million (up from $1 million). Therefore, as of January 1, 2011, the federal estate and gift tax exemption amounts have become re-unified. The increased gift tax exemption will provide additional lifetime planning opportunities, particularly for those individuals who have fully used their $1 million federal estate tax exemption.

The GST tax is reinstated for transfers made after December 31, 2009, with a $5 million exemption. The tax rate in effect for generation-skipping transfers made in 2010 will, however, remain at zero percent. The GST-tax exemption in 2011 and 2012 is $5 million and the tax rate is 35%.

Please note that, unlike the federal estate tax exemption amount, an individual's unused GST exemption is not portable and cannot be carried over to a surviving spouse.

State Estate Tax Complexities. Although the federal estate tax exemption amount has been substantially increased, the Act does not alter state estate tax exemptions. As a result, for clients in such states as Connecticut, New York, New Jersey and Massachusetts, the state estate tax exemption will be much less generous than the new federal exemption, thereby potentially triggering a state estate tax. The difference in amounts will only grow as the federal amount is adjusted for inflation in 2012. Estate plans must be drafted flexibly to address the differing state exemption amounts.

In addition to the potential consequences of the decoupled federal and state tax systems, it should be noted that the state estate tax exemption is not portable between spouses. Therefore, it will be critical for many couples to ensure that the exemption amount of the first spouse to die is properly preserved for both federal and state estate tax purposes.

Income Tax Rules. For 2011 and 2012, the six individual income tax rates, ranging from 10% to 35%, will remain in place for all taxpayers. In addition, capital gains and qualified dividends will continue to be taxed at a maximum rate of 15%.

For 2010 and 2011, charitable gifts that originate from an IRA distribution may be excluded from taxable income. Please note that in order to qualify, the taxpayer must be age 70½ or older. A maximum of $100,000 per donor per tax year can qualify so long as the distribution is made directly from the plan custodian to the qualified charity. Because the Act was passed so close to the end of 2010, it permits charitable gifts made in January 2011 to be reported by donors as if made in 2010. Further, January 2011 distributions that are claimed in 2010 will not impinge upon the 2011 limit of $100,000.

Payroll Tax Holiday. For 2011, there will be a temporary reduction of the Social Security payroll tax. As a result, the current rates of 6.2% and 12.4% to wage earners and self-employed individuals, respectively, will be reduced to 4.2% and 10.4%. Employees will receive the benefit of this reduction through reduced withholdings and self-employed individuals will benefit from the reduced rates in their estimated tax payments. The reduction will apply to the first $106,800 of wages for 2011.

Planning Opportunities. Fortunately, the Act does not limit the use of certain attractive planning techniques, such as Grantor Retained Annuity Trusts ("GRATs"), Qualified Personal

Residence Trusts ("QPRTs") and Family Limited Partnerships ("FLPs"). These techniques, which allow for leveraging of the gift tax exemption, were targeted in earlier legislative proposals. However, even though Congress did not place limitations on the use of these techniques, it is very possible that they will be targeted in future legislation.

In addition to the planning opportunities made available as a result of the new exemption amounts, it is worth noting that we continue to operate in a time of historically low interest rates. A number of techniques benefit from low rates, including Intra-Family Loans, GRATs, Installment Sales and Charitable Lead Trusts. Now might be the time to explore these opportunities.

Plans will need to be flexible enough to address the recent changes in the law and also be ready to deal with a possible return to prior law at the end of the two-year extension period. Flexibility is particularly critical where state estate laws are in place that call for differing exemption amounts. In any case, you might wish to explore a number of planning techniques that excel in low-interest rate environments. Whatever your goals and objectives, we would welcome the opportunity to discuss how the new law and current environment might impact your estate plan.

We look forward to hearing from you.

Sincerely,

Blair & Potts