YOUNG CONAWAY STARGATT & TAYLOR, LLP
Attorneys at Law

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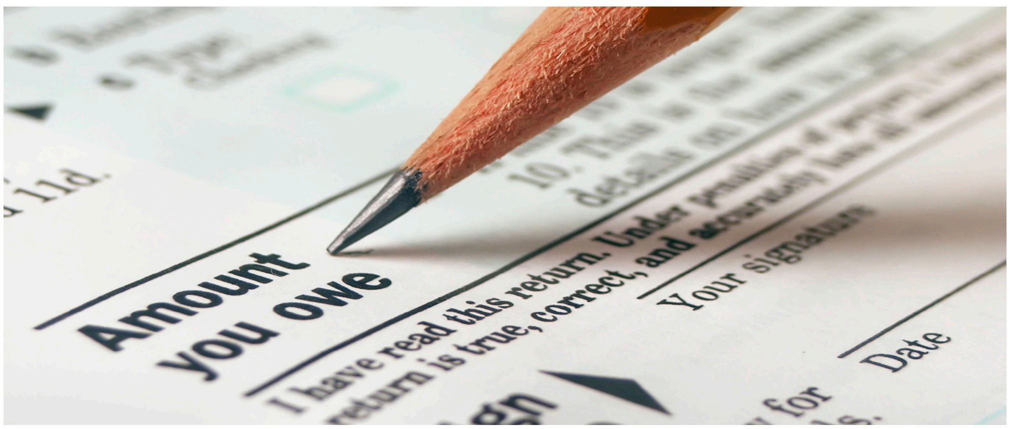
Tax, Benefits, Trusts & Estates Law Update

What The Tax Relief, Unemployment Reauthorization, and Job Creation Act of 2010 Means To You



Introduction. On December 17, 2010, President Obama signed into law the Tax Relief, Unemployment Reauthorization, and Job Creation Act of 2010 (the "Act"). As has been widely publicized, the Act extends the tax rates enacted in 2001 so that these tax cuts now expire on December 31, 2012, instead of on December 31, 2010. The Act also made significant changes to the federal estate, gift, and generation skipping taxes. We will first discuss the estate and gift tax provisions of the Act and then the provisions that affect individuals and businesses.

ESTATE AND GIFT TAX PROVISIONS

For 2011 and 2012, the federal estate and gift tax exemptions have been reunified, with a $5 million per person exemption. In 2009, the federal estate tax exemption was $3.5 million. The federal estate tax was effectively repealed for almost all of 2010, and was scheduled to be reinstated with a $1 million exemption in 2011. The $1 million exemption level now is scheduled to be reinstated for persons dying after December 31, 2012.

In the Act, Congress created a brand new estate planning concept, portability of exemptions. Under the Act, this means that when the first spouse dies, an election can be made on that spouse's estate tax return to allow any of the $5 million exemption not used by the first spouse's estate to be passed on to the surviving spouse. Ostensibly, the enactment of portability of exemptions would allow simplification of many estate plans. Unfortunately, it does not appear to be prudent to utilize the portability of exemptions in estate planning at the present time. Under current law, the unused exemption of the first spouse who dies in 2011 or 2012 can be used only by a surviving spouse who also dies during 2011 or 2012. If the new portability of exemptions rule were to be extended permanently, it would have both potential advantages and disadvantages in estate planning, and would be used in only some estates. Accordingly, making an election to utilize the portability of exemptions rule will likely be recommended in administering those estates in which the first spouse to die did not fully use his/her exemption, which may occur for various reasons, although most significantly, it is most likely to occur in those estates that simply were not large enough to fully use the exemption.

A typical husband/wife estate plan provides for a trust for the benefit of the surviving spouse (or in some cases, the children) up to the amount of the estate tax exemption, with the balance passing to the surviving spouse in the form of a marital deduction gift or trust. If the portability of exemption rule is made permanent, an estate plan could be implemented to provide that all assets will pass to the surviving spouse, outright, without wasting the first spouse's estate tax exemption. The major advantages of such a plan are simplicity, ease of administration of the surviving spouse's assets during the surviving spouse's lifetime, and a full basis step-up for all of the assets of both spouses at the surviving spouse's death.

Conversely, there are a number of potential disadvantages to such planning. First, the appreciation in the value of the assets that would otherwise fund a credit shelter trust will not be removed from the surviving spouse's estate for estate tax purposes. Second, compared to an outright gift, the credit shelter trust provides protection against creditors of the surviving spouse, and also protects the assets from being attached by a new husband or new wife in the event of remarriage by the surviving spouse. Third, the use of a credit shelter trust is important to our clients who are in second marriages and who do not wish the surviving spouse to be able to leave assets exclusively to the surviving spouse's children. Fourth, the portability of exemption rule does not apply to the generation skipping exemption. Those clients who want to optimize use of their now $5 million generation skipping exemption cannot avoid using a credit shelter trust to fully effectuate their estate plans.

The increase in the gift tax exemption will create opportunities for clients who want to make substantial gifts to children or grandchildren to do so, particularly for gifts made in 2011 and 2012.

The Act will have some impact with respect to the estate plans of most of our clients, and we recommend that you contact us to discuss with us in more detail what changes, if any, should be made to your estate plan. Even if clients do not need to make changes to their documents, they may wish to change how assets are titled so as to fully utilize the larger exemption amounts.

Unfortunately, though, because these changes are scheduled to expire on December 31, 2012, absent further legislation, we still cannot achieve certainty in planning.

INDIVIDUAL INCOME TAX PROVISIONS

While the Act made significant changes to the federal estate, gift, and generation skipping transfer taxes, there were also changes to various individual and business income tax provisions. This summary simply touches on those provisions that were adjusted or extended as part of the Act. Because of the complexity of the income tax system, you should consult your tax preparer to determine how the changes made by the Act may affect you.

Individual Income Tax Rates. As has been widely discussed, the Act effectively extended the income tax rates that were enacted in 2001 through December 31, 2012. This means that there will continue to be a 10% rate bracket, and the top bracket will remain at 35% instead of returning to 39.6% as would otherwise have occurred. Additionally, "marriage penalty relief" was extended, meaning that the 15% rate bracket applicable to those taxpayers who are married filing jointly will continue to be twice that of the 15% rate bracket for single taxpayers. Finally, the 2001 reduction to the "kiddie tax" has also been extended.

Capital Gain Tax Rates. Not only did the Act extend the various applicable income tax rates for ordinary income, the Act also extended the capital gain tax rates, that were reduced starting in 2003. As a result, through December 31, 2012, the net capital gains of a taxpayer will be taxed at the maximum rate of 15%, unless the gains would have been subject to the 10% or 15% rates if treated as ordinary income (that is, the individual's taxable income does not fall above the amount of taxable income subject to the 15% rate when adding the net capital gains to ordinary income), in which cases the gains will not be subject to tax. Additionally, the reduced rates applicable to qualified dividends were similarly maintained, such that qualified dividends will be taxed at 15% unless they would have been taxed at 10% or 15% if they were ordinary income, in which case they will not be subject to tax. There were other extensions to the capital gains tax rates, so you should consult a tax advisor to determine if any of these reduced rates can benefit you during the next two years.

Withholding Tax Rates. The Act also extended the withholding rates established in 2001 through December 31, 2012. This includes the backup withholding rate, which remains at 28%, and the supplemental wage withholding rate, which remains at 25% for payments of $1 million or less, and 35% for payments that exceed $1 million in a single year. Other withholding rates, for voluntary withholding from Social Security and other federal payments, as well as unemployment benefits and gambling winnings, remain the same as well.

Social Security Tax Reduction for 2011. While most provisions of the Act simply extended existing tax rates, deductions, and credit, the Act also created a new tax break for individuals by reducing the Social Security tax withholding rate for employees for 2011. As a result, employees will be subject to withholding at 4.2%, instead of 6.2%, for Social Security tax in 2011. There has been no change to the rate employers must pay. Similarly, self-employed individuals are subject to Social Security at an aggregate rate of 10.4%, instead of 12.4%, for 2011. This amounts to a savings of 2% of wage income, up to a maximum savings of $2,136.

Alternative Minimum Tax. Congress also extended a number of provisions relating to the Alternative Minimum Tax in the Act, including increased exemption amounts, reduced AMT capital gains rates, the availability of nonrefundable personal credits and the child tax credit to offset AMT, and the 7% AMT preference for excluded gain resulting from some qualified small business stock.

Tax Credits. Not only were the existing tax rates extended in most instances, many of the tax credits available to individuals were extended and remain available to taxpayers through 2011 or 2012, including the child tax credit, the dependent care credit, the adoption credit, certain energy credits, certain health coverage tax credits, and the earned income tax credit. Similarly, the Act maintained certain deductions at existing levels. As a result, the personal exemption will not phase out for high income taxpayers, the standard deduction for married taxpayers will remain twice that of the standard deduction for single taxpayers, itemized deductions will not be subject to an overall limitation, and it is still allowable to take an itemized deduction for state and local sales taxes paid. The above-the-line deduction for teachers' out-of-pocket classroom expenses also continues to be available.

Many of the education-related tax credits and deductions were also extended. As a result, the American Opportunity Tax Credit remains available as are the qualified tuition deduction and the deduction for interest paid on student loans. Taxpayers are also permitted to contribute additional funds to Coverdell ESAs, and to exclude from income certain educational assistance received from employers or certain federal agencies.

Transit Passes/Adoption Expenses. In terms of benefits offered by employers, employees can also continue to exclude from income the amounts an employer pays for transit passes or vanpooling benefits up to the same amount that an employee can exclude for employer-provided parking benefits ($230 in 2011). Finally, employees can continue to exclude from income certain qualified adoption expenses paid by an employer under an adoption-assistance program, although this benefit is phased out when the employee's adjusted gross income reaches certain levels.

BUSINESS INCOME TAX PROVISIONS

As with the personal income tax provisions briefly outlined above, there were several provisions of the Act that extended or modified business income tax provisions. The following is intended to provide a summary of some of the more significant provisions, but you should consult your tax preparer in order to determine whether any of these apply to your particular tax situation.

Depreciation and Cost Recovery. Many favorable depreciation provisions were extended or increased as part of the Act. Notably, bonus depreciation for certain business property has been generally extended through December 31, 2012, and the amount that may be deducted has increased to 100% for certain property purchased after September 8, 2010 and before January 1, 2012, thus creating a substantial benefit for businesses who invest in qualified property in 2011. Additionally, certain qualified property will be exempt from the AMT depreciation adjustment. There are limitations on the types of property that these provisions apply to, as well as the timing for the purchase of the property.

Section 179 limits, which were scheduled to decrease dramatically in 2012, were increased to $125,000 for 2012, although if a taxpayer purchases equipment for more than $625,000, the Section 179 deduction will completely phase out. Certain other provisions relating to Section 179, including the ability of a taxpayer to revoke a Section 179 election and qualification of certain property as Section 179 property, were also extended through tax years beginning in 2012.

Several other property specific depreciation and depletion provisions were also extended. They are not discussed at length here, but they relate to qualified leasehold improvements and restaurant buildings, cars that are treated as "qualified property", qualified film and television production expenses, qualified remediation expenses, qualified advanced mine safety equipment, motorsports entertainment complexes, and marginal wells.

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REFERENCE GUIDE

TAX BREAKS EXTENDED

In addition to the extensions and changes to the depreciation rules, the following business tax breaks were also extended through 2011:

- The research and development credit.
- The employer wage credit for activated military reservists.
- Look-through treatment of payments between related controlled foreign corporations.
- The Indian employment credit.
- The new markets tax credit.
- The railroad track maintenance credit.
- The mine rescue team training credit.
- The deduction allowable for domestic production activities in Puerto Rico.
- The American Samoa economic development credit.
- The enhanced deduction for contributions of food and book inventories, and computer equipment for educational purposes.
- The rule regarding the reduction in basis of a stockholder in an S corporation that makes charitable donations.
- The special rules for interest, rents, royalties and annuities received by a tax-exempt entity from a controlled entity.
- Empowerment zone tax incentives.
- Renewal community tax incentives.
- Tax incentives for investments in the District of Columbia.
- The work opportunity credit.
- Qualified zone academy bonds.
- Credits for certain costs relating to employer-provided child care.

TAX-RELATED ENERGY PROVISIONS

Additionally, the following energy provisions were also extended by the Act:

- The credit for energy-efficient new homes (available to eligible contractors).
- Incentives for biodiesel and renewable diesel.
- The credit for refined coal facilities.
- Excise tax credits and outlay payments for alternative fuel and alternative fuel mixtures.
- The special rule to implement FERCs and State electric restructuring policy.
- Grants for specified energy property in lieu of tax credits.
- Provisions related to alcohol used as fuel (excluding black alcohol).
- The energy efficient appliance credit (available to manufacturers).
- The credit for energy-efficient improvements to existing homes.
- The 30% investment tax credit for alternative vehicle refueling property.

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About the Update:

The Tax, Benefits, Estates & Trusts Section at Young Conaway Stargatt & Taylor, LLP provides federal and state tax planning for businesses and individuals, as well as assistance for tax-related matters in other areas of the firm's practice.

The Section's attorneys represent and counsel major corporations and their owners in Delaware on a wide range of matters, including entity formation, shareholder agreements, business organization, sales and acquisitions. They also advise business clients as well as governmental agencies on legal issues relating to employee benefits. Members of the Section provide estate administration and representation before the IRS and local taxing authorities and represents individuals in the creation of trusts and wills for intergenerational asset management and planning. They also advise major corporations in Delaware with respect to estate planning for executive employees.

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Members of the Tax, Benefits, Estates & Trusts Section

tsnyder@ycst.com
302.571.6645

Timothy J. Snyder, Partner and Chair of the Section. His primary area of practice is employee benefits which involves both the benefit provisions of the Internal Revenue Code and ERISA. He is a graduate of Widener University School of Law.

jnicholson@ycst.com
302.571.6653

Joseph M. Nicholson, Partner. Mr. Nicholson concentrates his practice on federal and state income and estate tax planning for individuals, corporations and other entities. He is a graduate of Temple University Beasley School of Law.

jgrossman@ycst.com
302.571.6685

Jerome K. Grossman, Partner. Mr. Grossman concentrates his practice on federal and state income and estate tax planning, mergers and acquisitions and representation of closely-held businesses and their principals. He is also a licensed CPA. Mr. Grossman is a graduate of Georgetown University Law Center.

rthomas@ycst.com
302.571.6602

Robert L. Thomas, Partner. Mr. Thomas has focused primarily in the areas of estate planning and estate administration, commercial real estate transactions, business planning and general representation of closely held business entities and their principals. He is a graduate of Georgetown University Law Center.

rpopper@ycst.com
302.571.6652

Richard J.A. Popper, Partner. Mr. Popper focuses on sophisticated estate planning and estate administration for high net worth clients, and on representing both individual clients and corporate trustees in connection with trust administration issues. He is a graduate of the National Law Center, George Washington University and has a Master of Laws in Taxation from Georgetown University Law Center .

cgrear@ycst.com
302.571.6612

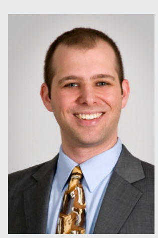
Craig D. Grear, Partner. Mr. Grear has made numerous presentations nationally and internationally on a variety of Delaware business law topics, including alternative entities and Delaware holding companies. He is a graduate of Georgetown University Law Center.

jnoel@ycst.com
302.571.6718

Jennifer R. Noel, Associate. Ms. Noel is well versed in all aspects of the formation and operation of small and emerging growth business enterprises. She has extensive experience with commercial transactions and has assisted clients with a broad variety of tax issues. She also counsels clients regarding the tax-related aspects of bankruptcy proceedings. She is a graduate of Widener University School of Law.

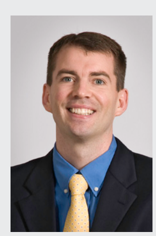
dcoats@ycst.com
302.576.3596

Douglas T. Coats, Associate. Mr. Coats has significant experience in the planning and structuring of sophisticated transactions for both public and privately-held companies involving corporations and flow-through entities (including LLPs, LLCs and S corporations). He is a graduate of the University of Baltimore School of Law.



ekostoulas@ycst.com
302.576.3589

Evangelos ("Andy") Kostoulas, Associate. Mr. Kostoulas practices primarily in the commercial transactions area with a focus on mergers and acquisitions, the structure and use of Delaware entities, and the rendering of legal opinions. He is a graduate of the University of Pennsylvania Law School.



dhansen@ycst.com
302.571.6565

A. David Hansen, Associate. Mr. Hansen counsels clients on the business and tax issues involved in complex transactions. He also counsels clients on benefit and pension issues. He is a graduate of Georgetown University Law Center.