

Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010

Tax Update

Income tax extensions	3
Temporary estate and gift tax relief	4
Temporary payroll tax holiday	5

The Tax Relief, Unemployment Insurance Reauthorization, and Jobs Creation Act (the Act) is now law. Enacted December 17, 2010, the Act extends the current income tax rate structure to all income earners for two years and establishes a two-year estate and gift tax regime which provides a \$5 million estate, gift, and generation-skipping transfer tax exemption per person, with a top rate of 35%, indexed for inflation beginning in 2012.

The following are some highlights from the Act along with planning ideas that you may wish to consider and discuss with your tax, legal and financial advisors.

Income tax extensions

Extension of individual income tax brackets.

The Act extends current income tax rates for all taxpayers through 2012. The brackets are 10%, 15%, 25%, 28%, 33% and 35%.

- **Planning note:** In anticipation of higher income tax rates, some clients were considering triggering and accelerating income in 2010 to capture the lower rates. This strategy should be reevaluated with your financial advisor.
- **Planning note:** For those who converted a traditional IRA to a Roth IRA in 2010, you have the option to (1) recognize 100% of the IRA account as income for 2010, or (2) recognize 50% of the income in 2011 and 50% in 2012. Because the income tax rates are extended under the Act, you should consider taking advantage of the ability to defer the recognition of the income into 2011 and 2012 (this option is available only for Roth conversions made in 2010). However, clients who converted in 2010 and whose accounts have gone down in value may wish to recharacterize (or undo) the conversion prior to year end and re-convert as soon as possible in 2011 in order to pay tax on a lower amount and preserve the ability to monitor investment performance through October 15, 2012 to determine whether to recharacterize again (compared to a deadline of October 15, 2011 if you converted in 2010). For those who are still considering a Roth IRA conversion, you should consider waiting to convert until 2011; you would lose some of the income tax deferral noted above, but, you will have until October 15, 2012 to decide whether to recharacterize the Roth conversion. You should discuss with your tax advisors the benefit of the longer "look back" period for recharacterization purposes if you wait to convert in 2011 versus the ability to spread the tax liability over two years if you convert in 2010.

Taxation of capital gains and dividends. The capital gains and qualified dividend rates will remain at 15% for two years for those in the 25% income tax bracket and above. The rates for taxpayers below the 25% bracket will remain at zero percent.

AMT patch. The Act extends the AMT patch for two years, increasing the exemption amounts for 2010 to \$47,450 for individuals and \$72,450 for married couples filing jointly. For 2011, the exemption amount will be \$48,450 for individuals and \$74,450 for married couples filing jointly.

IRA charitable contributions. The Act extends the ability for individuals to contribute up to \$100,000 tax-free from an IRA to charity for 2010 and 2011. The Act also allows charitable donations made in January 2011 from an IRA to count toward the 2010 minimum distribution requirement.

Itemized deduction limitation. Prior to 2010, the amount of itemized deductions a taxpayer could claim was reduced for taxpayers with AGI over a certain amount. This limitation on itemized deductions was repealed in 2010, and the Act extends this repeal for two years through 2012.

- **Planning note:** Because the phase-out rules for itemized deductions will not apply for 2011 and 2012, many income tax deductions, including charitable deductions, may be more valuable in 2011 and 2012 than in future years.

Personal exemption phase-out. In 2010, the personal exemption phase-out was repealed for one year, meaning that personal exemptions would not be phased out for taxpayers with AGI above a certain level. The Act extends the repeal of the phase-out through 2012.

Extension of bonus depreciation. The Act extends and increases for two years the depreciation deduction for businesses. Beginning in 2008, businesses could take an additional depreciation deduction equal to 50% of the depreciable property placed in service in a taxable year. The Act provides for 100% bonus depreciation for qualified property placed in service between September 8, 2010 and December 31, 2011. For qualified property placed in service in 2012, businesses can take a 50% bonus depreciation. The Act also allows businesses to accelerate some AMT credits in lieu of bonus depreciation for 2011 and 2012.

Temporary estate and gift tax relief

Estate tax exemption. The Act sets the estate tax exemption amount at \$5 million per person and a top rate of 35% for 2011 and 2012. Accordingly, a married couple can transfer up to \$10 million of wealth without generating a federal estate tax. The estate tax exemption will be indexed for inflation beginning in 2012.

- **Planning note:** You should review your estate planning documents to ensure that any formulas contained in your documents which transfer certain amounts to certain individuals or trusts based on the estate tax exemption still make sense for you given this significant increase in the estate tax exemption. For those clients who live in a state with an independent state death tax, they should also review formula allocations in their estate planning documents which take into account state death taxes to assess the affect of the federal estate tax exemption, which is now significantly greater than most state death tax exemptions.

Calendar year	Estate tax exemption	GST tax exemption	Gift tax exemption	Top estate, GST and gift tax rates
2009	\$3.5 million	\$3.5 million	\$1 million	45%
2010	n/a (repealed)	n/a (repealed)	\$1 million	35% (gift tax only)
2011	\$5 million	\$5 million	\$5 million	35%
2012	\$5 million*	\$5 million*	\$5 million*	35%

*Indexed for inflation

Gift tax. The Act reunifies the estate and gift tax. The gift tax exemption will be set at \$5 million per person with a top rate of 35% for 2011 and 2012. The gift tax exemption will be indexed for inflation beginning in 2012.

- **Planning note:** For those who have previously used their \$1 million gift tax exemption (the maximum lifetime exemption in 2010), they will now have an additional \$4 million of exemption to use during their lifetimes.
- **Planning note:** Clients may want to consider utilizing a substantial portion (or even all) of their \$5 million gift and GST tax exemption by making a gift to an irrevocable trust for the benefit of their family members, in order to

remove the gift, plus future appreciation, from their estates. The trust could use all or a portion of the contribution to fund premiums for large life insurance policies it owns on the person who created the trust, if liquidity is needed for potential estate tax liability.

- **Planning note:** Those taxpayers who are considering making taxable gifts in 2010 (meaning that they have used their entire \$1 million lifetime exemption and intend to make gifts in excess of that amount, thereby triggering the 35% tax) should discuss with their tax advisors whether it still makes sense to make those gifts.

Generation skipping transfer (GST) tax. As of January 1, 2010, the generation-skipping transfer tax (as well as the estate tax) was repealed for one year. The Act retroactively reinstates the GST exemption at an exemption level of \$5 million per person as of January 1, 2010 with a zero percent rate for 2010.

- **Planning note:** For those taxpayers considering making direct taxable gifts to grandchildren in 2010, they should be aware that the gifts will not incur GST tax or use any GST exemption.

- **Planning note:** Because the GST exemption has been reinstated for 2010, taxpayers will be able to allocate GST exemption to transfers to trusts made in 2010. In addition, clients who have created trusts solely for the benefit of grandchildren (which therefore qualify as "skip persons") may be able to make gifts to those trusts in 2010 without any GST tax or use of their GST exemption. You should discuss with your tax advisors the merits of making such gifts, however, since future distributions from such trusts to more remote descendants than grandchildren may still be subject to GST tax.

- **Planning note:** The Act provides for a 0% rate for generation skipping transfers that occur in 2010. Therefore, trustees of GST non-exempt trusts should consider making distributions to "skip person" beneficiaries before the end of the year.

For decedents in 2010. Under prior law, the estate tax was repealed for 2010 only, so estates, no matter the size, were not subject to estate tax. However, the unlimited basis step-up was replaced with modified carryover basis, meaning that the executor of an estate could allocate \$1.3 million of basis step-up among assets passing to any beneficiary or beneficiaries and an additional \$3 million of basis step-up among assets passing to a surviving spouse. The basis of remaining assets passing to beneficiaries would receive the decedent's carryover basis. The Act allows estates of decedents who died between January 1, 2010 and January 1, 2011 to elect to apply 2010 law (no estate tax but modified carryover basis) or 2011 law (\$5 million estate tax exemption and unlimited step-up in basis).

Portability of unused estate tax exemption.

The Act allows the executor of a deceased spouse's estate to transfer any unused estate tax exemption to the surviving spouse (for decedents dying after 2010).

- **Planning note:** Although the new portability means that a decedent's unused estate tax exemption will not have to go to waste (if the decedent hadn't titled sufficient assets in his own name, for example), married clients should still consider splitting up assets so that each spouse owns at least the estate tax exemption amount. In this way, the exemption amount of the first spouse to die can be allocated to a trust to which GST exemption can be applied and the future growth in the assets will escape tax in the survivor's estate. Also, the portability feature of this legislation may not be re-enacted in future legislation, so any estate plan that relies on it may need to be altered in the future.

No GRAT provision. Previous proposals in 2010 included legislation that would restrict the use of grantor retained annuity trusts (GRATs), requiring a ten year minimum term and a remainder interest greater than zero. The Act does not include any provisions relating to GRATs.

Temporary payroll tax holiday

The Act cuts payroll taxes by 2% for 2011. As a result, the 6.2% and 12.4% rates for the Social Security tax for employees and self-employed individuals will be reduced to 4.2% and 10.4%, respectively. (The employer share remains at 6.2%, even for self-employed individuals.)

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