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Lane Gorman Trubitt, PLLC
Accountants & Advisors

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Overview of the Tax Provisions in the 2010 Tax Relief Act

The newly enacted “Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010” signed into law on December 17, 2010 is a sweeping tax package that includes, among many other items, an extension of the Bush-era tax cuts for two years, estate tax relief, a two-year “patch” of the alternative minimum tax (AMT), a two-percentage-point cut in employee-paid payroll taxes and in self-employment tax for 2011, new incentives to invest in machinery and equipment, and a host of retroactively resuscitated and extended tax breaks for individuals and businesses. Here’s a look at the key elements of the package:

- Current income tax rates will be retained for two years (2011 and 2012), with a top rate of 35% on ordinary income and 15% on qualified dividends and long-term capital gains.
- Employees and self-employed workers will receive a reduction of two percentage points in Social Security payroll tax in 2011, bringing the rate down from 6.2% to 4.2% for employees, and from 12.4% to 10.4% for the self-employed.
- A two-year AMT “patch” for 2010 and 2011 will keep the AMT exemption near current levels and allow personal credits to offset AMT. Without the patch, an estimated 21 million additional taxpayers would have owed AMT for 2010.
- Key tax credits for working families that were enacted or expanded in the American Recovery and Reinvestment Act of 2009 will be retained. Specifically, the new law extends the \$1,000 child tax credit and maintains its expanded refundability for two years, extends rules expanding the earned income credit for larger families and married couples, and extends the higher education tax credit (the American Opportunity tax credit) and its partial refundability for two years.
- Businesses can write off 100% of their equipment and machinery purchases, effective for property placed in service after September 8, 2010 and through December 31, 2011. For property placed in service in 2012, the new law provides for 50% additional first-year depreciation.
- Many of the “traditional” tax extenders are extended for two years, retroactively to 2010 and through

the end of 2011. Among many others, the extended provisions include the election to take an itemized deduction for state and local general sales taxes in lieu of the itemized deduction for state and local income taxes; the \$250 above-the-line deduction for certain expenses of elementary and secondary school teachers; and the research credit.

- After a one-year hiatus, the estate tax will be reinstated for 2011 and 2012, with a top rate of 35%. The exemption amount will be \$5 million per individual in 2011 and will be indexed to inflation in following years. Estates of people who died in 2010 can choose to follow either 2010's or 2011's rules.
- Omitted from the new law: Repeal of a controversial expansion of Form 1099 reporting requirements.
- Also not included: Extension of the Build America Bonds program, which permits state and localities to issue federally-subsidized municipal bonds.

Individual and business extenders in the 2010 Tax Relief Act

In addition to extending the Bush tax cuts, providing relief from the AMT, and cutting the payroll tax by two percentage points, the recently enacted "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010" (Tax Relief Act) extends a host of other important tax breaks for businesses and individuals.

Individual tax relief - The following tax breaks for individuals that expired at the end of 2009 have been retroactively reinstated by the Tax Relief Act and extended through 2011:

- The election to take an itemized deduction for State and local general sales taxes instead of the itemized deduction permitted for State and local income taxes.
- The above-the-line deduction for qualified higher education expenses.
- The \$250 above-the-line tax deduction for teachers and other school professionals for expenses paid or incurred for books, certain supplies, equipment, and supplementary materials used by the educator in the classroom.
- The increased contribution limits and carryforward period for contributions of appreciated real property (including partial interests in real property) for conservation purposes.
- The provision that permits tax-free distributions to charity from an Individual Retirement Account (IRA) of up to \$100,000 per taxpayer, per tax year. Individuals also will be allowed to make charitable transfers during January of 2011 and treat them as if made during 2010.
- The look-thru rule for certain regulated investment company (RIC) stock in determining the gross estate of nonresidents.
- The increase in the monthly exclusion for employer-provided transit and vanpool benefits to equal that of the exclusion for employer-provided parking benefits.

In addition, the new law extends for an additional year (i.e., through 2011) the rule allowing premiums for mortgage insurance to be deductible as qualified residence interest.

Business tax relief - On the business side, the following business tax breaks that expired at the end of 2009 have been retroactively reinstated and extended through 2011 by the Tax Relief Act:

- The research and development credit.
- 15-year writeoffs for qualified leasehold improvements, and restaurant buildings (and certain improvements to such restaurant buildings).
- 7-year writeoffs for certain motorsports racetrack property.
- The employer wage credit for activated military reservists.
- Active financing exception from the Subpart F rules for a controlled foreign corporation predominantly engaged in the conduct of a banking, financing, or similar business.
- Look-through treatment of payments between related controlled foreign corporations.
- The Indian employment credit.
- The new markets tax credit.
- Accelerated depreciation for business property on an Indian reservation.
- The railroad track maintenance credit.
- The special expensing rules for certain film and television productions.
- The mine rescue team training credit.
- The election to expense advanced mine safety equipment.
- Expensing of environmental remediation costs.
- The deduction allowable for domestic production activities in Puerto Rico.
- The American Samoa economic development credit.
- The rules exempting from gross basis tax and from withholding tax the interest-related dividends and short-term capital gain dividends received from a RIC by certain foreign persons (extended to apply to tax years of a RIC beginning before 2012).
- Inclusion of a RIC within the definition of a “qualified investment entity” under the provisions of the Foreign Investment in Real Property Tax Act as codified in Code Sec. 897.
- The enhanced deduction for contributions of food and book inventories, and computer equipment for educational purposes.
- A liberal rule for S corporations making 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 (extended for four months (through the end of 2011)).
- Qualified zone academy bonds.

In addition, the new law extends for an additional year (i.e., through 2011) the temporary exclusion of 100% of gain on the sale of certain small business stock.

Energy provisions - The following energy provisions were extended by the Act (through 2011):

- The credit for manufacturers of energy-efficient new homes.
- 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.
- Suspension of the limitation on percentage depletion for oil and gas from marginal wells.
- Grants for specified energy property in lieu of tax credits.
- Provisions related to alcohol used as fuel.
- The energy efficient appliance credit.
- The credit for energy-efficient improvements to existing homes.
- The 30% investment tax credit for alternative vehicle refueling property.

Disaster relief provisions - The following disaster relief provisions are extended through 2011:

- New York Liberty Zone tax-exempt bond financing.
- Increased rehabilitation credit for structures in the Gulf Opportunity Zone.
- Low-income housing credit rules for buildings in Gulf Opportunity Zones.
- Tax-exempt bond financing for the Gulf Opportunity Zones.
- Bonus depreciation deduction applicable to specified Gulf Opportunity Zone extension property.

Extension of Bush tax cuts in the 2010 Tax Relief Act

The heart of the recently enacted “Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010” is a two-year extension of the Bush tax cuts. But what, exactly, are the Bush tax cuts? Here’s a primer:

Bush tax-cut legislation - The Bush tax cuts refer primarily to tax changes in two major pieces of legislation back in 2001 and 2003: the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA).

The 2001 legislation (EGTRRA) was a 10-year \$1.35 billion tax cut package that was the largest tax cut since 1981. Key elements of EGTRRA included:

- A lowering of individual income tax rates from 15%, 28%, 31%, 36%, and 39.6% to 10%, 15%, 25%, 28%, 33%, and 35%.
- A doubling of the child tax credit from \$500 to \$1,000.

- A gradual reduction in estate taxes, culminating in a one-year repeal in 2010 (but reinstatement in 2011).

But the crucial element of the 2001 tax cuts, at least for current purposes, is that they were temporary, set to expire at the end of 2010 unless Congress acted to extend them.

The 2003 legislation (JGTRRA) accelerated certain tax changes passed in EGTRRA, but the centerpiece of the law was a cut in the top capital gains rate from 20% to 15% and a cut in the top individual rate on dividends from 35% to 15%. Under the 2003 legislation, the capital gains and dividends cuts were set to expire after 2008, but they were later extended for two additional years (until 2010).

So when people talk about the “Bush tax cuts,” they are referring, for the most part, to the provisions in the 2001 and 2003 Acts that lowered individual income tax rates and cut the top rates on capital gains and dividends.

New law extends lower rates for all taxpayers for two years - Over the past several years, a lot of political energy has been expended on the issue of whether the favorable individual income tax rates, which were set to expire at the end of 2010, should be extended for everyone, or for everyone except the “rich.”

The new law settles the issue by extending the lower rates for all taxpayers. Under the new law, the rates that have been in effect in recent years—10%, 15%, 25%, 28%, 33%, and 35%—will remain in place. However, the extension is only for two years—through 2012.

New law extends lower capital gains rates for two years - Capital gains, generally speaking, refers to the profits realized on sales of non-inventory assets. For individuals, capital gains are generally taxed at a preferential rate in comparison to ordinary income.

The amount of tax depends on both the investor’s tax bracket and how long the investment was held before being sold. Short-term capital gains on investments held for a year or less are taxed at the investor’s ordinary income tax rate. Long-term capital gains, which apply to assets held for more than one year, are taxed at a lower rate than short-term gains.

Since 2008, the tax rate on long-term capital gains has been 0% for individuals in the 10% and 15% income tax brackets, and 15% for everyone else. However, those rates were scheduled to expire at the end of 2010, as explained above, with the result that in 2011 the long-term capital gains tax rate would have risen to 20% (10% for taxpayers in the 15% tax bracket) if Congress had not acted.

The new legislation forestalls these increases by extending the 0% and 15% long-term capital gains tax rates for two years (through 2012).

New law extends lower rates for qualified dividends for two years - Since 2003, “qualified dividends” have been taxed at the same low tax rates that apply to long-term capital gains. For dividend income falling in the higher tax brackets, the rate is 15%. In the first two brackets (where ordinary income is taxed at 10% and 15% rates), the dividend rate is 0%

To count as “qualified,” dividend-paying common stocks must be held for at least 61 continuous days before the ex-dividend date—the last purchase day for collecting the dividend. For preferred stock, the required holding period is 91 days before the ex-dividend date.

The low rates for qualified dividends, like the other Bush tax cuts, were scheduled to expire at the end of 2010. If Congress had not acted, beginning in 2011 taxes on dividends would have returned to the rates that were in effect before 2001, and all dividend income received in 2011 would have been taxed as ordinary income. Since the top income tax rate was scheduled to return to 39.6%, individuals could have paid as much as a 39.6% tax on dividends.

The new legislation prevents that from happening by continuing the tax regime in effect for qualified dividends (i.e., treatment as long-term capital gains, subject to a 0% tax rate for individuals in the 10% and 15% tax brackets and a 15% tax rate for other taxpayers) for two years—through 2012.

Reduced Tax Rates Extended for Two Years

For tax years beginning in 2010, the income tax rates for individuals are 10%, 15%, 25%, 28%, 33% and 35%. In addition, the size of the 15% tax bracket for joint filers and qualified surviving spouses is 200% of the 15% tax bracket for individual filers (in the so-called marriage penalty relief).

Under pre-Act law, for tax years beginning after Dec. 31, 2010, the rates were scheduled to rise to 15%, 28%, 31%, 36% and 39.6%; and the 15% tax bracket for joint filers and qualified surviving spouses was scheduled to drop to 167% of the 15% tax bracket for individual filers.

New law - Under Sec. 101 of the 2010 Tax Relief Act, the tax rate schedules for individuals will remain at 10%, 15%, 25%, 28%, 33% and 35% for two additional years, through 2012. In addition, the size of the 15% tax bracket for joint filers and qualified surviving spouses will remain at 200% of the 15% tax bracket for individual filers through 2012.

Thus, the 2011 individual tax rates will be: (Committee Report)

**FOR MARRIED INDIVIDUALS FILING JOINT RETURNS
AND SURVIVING SPOUSES, THE 2011 RATE BRACKETS WILL BE:**

If taxable income is:	The tax will be:
Not over \$17,000	10% of taxable income
Over \$17,000 but not over \$69,000	\$1,700.00 plus 15% of the excess over \$17,000
Over \$69,000 but not over \$139,350	\$9,500.00 plus 25% of the excess over \$69,000
Over \$139,350 but not over \$212,300	\$27,087.50 plus 28% of the excess over \$139,350
Over \$212,300 but not over \$379,150	\$47,513.50 plus 33% of the excess over \$212,300
Over \$379,150	\$102,574.00 plus 35% of the excess over \$379,150

**FOR SINGLE INDIVIDUALS (OTHER THAN HEADS OF HOUSEHOLDS AND
SURVIVING SPOUSES), THE 2011 RATE BRACKETS WILL BE:**

If taxable income is:	The tax will be:
Not over \$8,500	10% of taxable income
Over \$8,500 but not over \$34,500	\$850.00 plus 15% of the excess over \$8,500
Over \$34,500 but not over \$83,600	\$4,750.00 plus 25% of the excess over \$34,500
Over \$83,600 but not over \$174,400	\$17,025.00 plus 28% of the excess over \$83,600
Over \$174,400 but not over \$379,150	\$42,449.00 plus 33% of the excess over \$174,400
Over \$379,150	\$110,016.50 plus 35% of the excess over \$379,150

**FOR HEADS OF HOUSEHOLDS, THE 2011 RATE
BRACKETS WILL BE:**

If taxable income is:	The tax will be:
Not over \$12,150	10% of taxable income
Over \$12,150 but not over \$46,250	\$1,215.00 plus 15% of the excess over \$12,150
Over \$46,250 but not over \$119,400	\$6,330.00 plus 25% of the excess over \$46,250
Over \$119,400 but not over \$193,350	\$24,617.50 plus 28% of the excess over \$119,400
Over \$193,350 but not over \$379,150	\$45,323.50 plus 33% of the excess over \$193,350
Over \$379,150	\$106,637.50 plus 35% of the excess over \$379,150

**FOR MARRIEDS FILING SEPARATE RETURNS, THE 2011 RATE
BRACKETS WILL BE:**

If taxable income is:	The tax will be:
Not over \$8,500	10% of taxable income
Over \$8,500 but not over \$34,500	\$850.50 plus 15% of the excess over \$8,500
Over \$34,500 but not over \$69,675	\$4,750.00 plus 25% of the excess over \$34,500
Over \$69,675 but not over \$106,150	\$13,543.75 plus 28% of the excess over \$69,675
Over \$106,150 but not over \$189,575	\$23,756.75 plus 33% of the excess over \$106,150
Over \$189,575	\$51,287.00 plus 35% of the excess over \$189,575

Observation: The 2011 tax rate schedules for individuals as reflected in the 2010 Tax Reform Act were previously calculated by RIA based on Consumer Price Index (CPI) figures, (see Federal Taxes Weekly Alert 12/09/2010).

Observation: Under Sec. 101 of the 2010 Tax Relief Act, the top four income tax rates that apply to estates and trusts under pre-Act law (25%, 28%, 33%, and 35%) are extended two additional years through 2012 (rather than rising to 28%, 31%, 36%, and 39.6% for tax years beginning after Dec. 31, 2010).

**FOR ESTATES AND TRUSTS, THE 2011 RATE
BRACKETS WILL BE:**

If taxable income is:	The tax will be:
Not over \$2,300	15% of taxable income
Over \$2,300 but not over \$5,450	\$345.00 plus 25% of the excess over \$2,300
Over \$5,450 but not over \$8,300	\$1,132.50 plus 28% of the excess over \$5,450
Over \$8,300 but not over \$11,350	\$1,930.50 plus 33% of the excess over \$8,300
Over \$11,350	\$2,937.00 plus 35% of the excess over \$11,350

Observation: The 2011 tax rate schedules for estates and trusts as reflected in the 2010 Tax Reform Act were previously calculated by RIA based on Consumer Price Index (CPI) figures (see Federal Taxes Weekly Alert 12/09/2010).

AMT relief in the 2010 Tax Relief Act

The provisions extend partial relief to individual taxpayers from the alternative minimum tax, or AMT. Earlier temporary measures to deal with the unintended creep of the AMT's reach expired at the end of 2009, meaning that more than 20 million additional taxpayers would have faced paying the tax on their 2010 returns without the new relief.

Brief overview of the AMT - The AMT is a parallel tax system which does not permit several of the deductions permissible under the regular tax system, such as property tax. Taxpayers who may be subject to the AMT must calculate their tax liability under the regular federal tax system and under the AMT system taking into account certain “preferences” and “adjustments.” If their liability is found to be greater under the AMT system, that’s what they owe the federal government. Originally enacted to make sure that wealthy Americans did not escape paying taxes, the AMT has started to apply to more middle-income taxpayers, due in part to the fact that the AMT parameters are not indexed for inflation.

In recent years, Congress has provided a measure of relief from the AMT by raising the AMT “exemption amounts”—allowances that reduce the amount of alternative minimum taxable income (AMTI), reducing or eliminating AMT liability. (However, these exemption amounts are phased out for taxpayers whose AMTI exceeds specified amounts.) For 2009, the AMT exemption amounts were \$70,950 for married couples filing jointly and surviving spouses; \$46,700 for single taxpayers; and \$35,475 for married filing separately. However, for 2010, those amounts were scheduled to fall back to the amounts that applied in 2000: \$45,000, \$33,750, and \$22,500, respectively. This would have brought millions of additional middle-income Americans under the AMT system, resulting in higher federal tax bills for many of them, along with higher compliance costs associated with filling out and filing the complicated AMT tax form.

New law provides two-year stopgap fix - To prevent the unintended result of having millions of middle-income taxpayers fall prey to the AMT, Congress has once again relied on a temporary “patch” to the problem, this time a two-year extension of the 2009 exemption amounts, increased slightly. Under the new law, for tax years beginning in 2010, the AMT exemption amounts are increased to: (1) \$72,450 in the case of married individuals filing a joint return and surviving spouses; (2) \$47,450 in the case of unmarried individuals other than surviving spouses; and (3) \$36,225 in the case of married individuals filing a separate return. For tax years beginning in 2011, the AMT exemption amounts are increased to: (1) \$74,450 in the case of married individuals filing a joint return and surviving spouses; (2) \$48,450 in the case of unmarried individuals other than surviving spouses; and (3) \$37,225 in the case of married individuals filing a separate return.

Personal credits may be used to offset AMT through 2011 - Another provision in the new law provides AMT relief for taxpayers claiming personal tax credits. The tax liability limitation rules generally provide that certain nonrefundable personal credits (including the dependent care credit and the elderly and disabled credit) are allowed only to the extent that a taxpayer has regular income tax liability in excess of the tentative minimum tax, which has the effect of disallowing these credits against the AMT. Temporary provisions had been enacted which permitted these credits to offset the entire regular and AMT liability through the end of 2009. The new law extends this temporary provision to 2010 and 2011.

Payroll tax cut in the 2010 Tax Relief Act

The biggest new tax break for individuals in the recently enacted “Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010” is the one-year payroll tax reduction. Under this new provision, which is intended to supplement income and boost economic growth, the payroll tax—which funds Social Security—will be cut by two percentage points during 2011. Here are the details:

- The Social Security payroll tax on individual wages will be lowered to 4.2% in 2011, from the usual 6.2% rate. For an individual with wages of \$60,000, that amounts to a \$1,200 savings for individuals with an income of \$60,000. If the individual gets paid twice a month, it will mean an extra \$50 in his or her paycheck starting in January.
- Self-employed workers will also get the tax break. Their self-employment taxes will be cut from 12.4% to 10.4%.
- There is no phaseout (i.e., gradual reduction) of the payroll tax reduction for higher income workers. It goes to everyone who works, regardless of income. However, since Social Security taxes apply only to the first \$106,800 in earnings in 2011, the benefit for high earners tops out at \$2,136.
- The payroll tax reduction in effect replaces the \$400-per-worker tax break included in the 2009 stimulus bill. That break, called the Making Work Pay tax credit, provided a tax credit of 6.2% on the first \$6,450 of a worker’s wages but was phased out for workers making more than \$75,000 (\$150,000 for couples). The Making Work Pay credit, which was billed as a way to stimulate the stalled economy, is widely thought to have had little if any success in that regard, in part because of the small amounts involved—\$400 for individuals, \$800 for couples. The new law’s payroll tax reduction, by contrast, provides a potentially much bigger tax break for taxpayers (up to \$2,136 for individuals, \$4,272 for couples). In addition, the benefits of the payroll tax reduction are distributed far differently than they were under the Making Work Pay credit, which was aimed primarily at low and moderate-income workers. For example, an individual making \$100,000 in 2011 will be able to keep an extra \$2,000 under the payroll tax reduction, but under the Making Work Pay credit (which was phased out for earnings over \$75,000), the individual’s tax break would have been zero.
- The employer’s share of Social Security tax is not affected; it stays at 6.2%. Thus, the cost of hiring new workers isn’t directly affected by the payroll tax reduction.
- The tax break only applies for one year, 2011—for now anyway. There will almost certainly be efforts to extend it beyond 2011, and I will keep you apprised of any developments in that regard.
- The payroll tax reduction will cost the government an estimated \$120 billion.
- The payroll tax reduction will not affect the worker’s future Social Security benefit, because benefits are based on lifetime earnings, not the amount of tax paid by the worker into the Social Security system.

Expensing and additional first-year depreciation in the 2010 Tax Relief Act

The recently enacted 2010 Tax Relief Act includes a wide-ranging assortment of tax changes affecting both individuals and business. On the business side, two of the most significant changes provide incentives for businesses to invest in machinery and equipment by allowing for faster cost recovery of business property. Here are the details.

Expansion and extension of additional first-year depreciation - Businesses are allowed to deduct the cost of capital expenditures over time according to depreciation schedules. In previous legislation, Congress allowed businesses to more rapidly deduct capital expenditures of most new tangible personal property, and certain other new property, placed in service in 2008, 2009, or 2010 (2011 for certain property), by permitting the first-year write-off of 50% of the cost. The new law extends and temporarily increases this additional first-year depreciation provision for investment in new business equipment. For investments placed in service after September 8, 2010 and through December 31, 2011 (through December 31, 2012 for certain longer-lived and transportation property), the new law provides for 100% additional first-year depreciation. In other words, the entire cost of qualifying property placed in service during that time frame can be written off, without limit. Note that even though the legislation did not take shape in Congress until mid-December of 2010, the effective date of this provision was made retroactive, to include qualifying property placed in service after September 8, 2010.

Fifty percent additional first-year depreciation will apply again in 2012.

The Act extends through 2012 the election to accelerate the AMT credit instead of claiming additional first-year depreciation.

The new law leaves in place the existing rules as to what kinds of property qualify for additional first-year depreciation. Generally, the property must be (1) depreciable property with a recovery period of 20 years or less; (2) water utility property; (3) computer software; or (4) qualified leasehold improvements. Also the original use of the property must commence with the taxpayer – used machinery doesn't qualify.

Enhanced small business expensing (Section 179 expensing) - Generally, the cost of property placed in service in a trade or business can't be deducted in the year it's placed in service if the property will be useful beyond the year. Instead, the cost is "capitalized" and depreciation deductions are allowed for most property (other than land), but are spread out over a period of years. However, to help small businesses quickly recover the cost of capital outlays for qualifying personal property, small business taxpayers can elect to write off these expenditures in the year of acquisition instead of recovering the costs over time through depreciation. The expense election is made available, on a tax year by tax year

basis, under Section 179 of the Internal Revenue Code, and is often referred to as the “Section 179 election” or the “Code Section 179 election.” The new law makes three important changes to the Code Section 179 expense election.

First, the new law provides that for tax years beginning in 2012, a small business taxpayer will be allowed to write off up to \$125,000 (indexed for inflation) of capital expenditures subject to a phaseout (i.e., gradual reduction) once capital expenditures exceed \$500,000 (indexed for inflation). The new maximum expensing amount and phaseout level for tax years beginning in 2012 is actually lower than the levels in effect for tax years beginning in 2010 or 2011 (maximum expensing amount of \$500,000, and a phaseout level of \$2,000,000). For tax years beginning after 2012, the maximum expensing amount will drop to \$25,000 and the phaseout level will drop to \$200,000.

Second, the rule which treats off-the-shelf computer software as qualifying property is extended through 2012.

Finally, the new law extends, through 2012, the provision permitting a taxpayer to amend or irrevocably revoke a Code Sec. 179 expense election for a tax year without IRS’s consent.

Return of the estate tax in the 2010 Tax Relief Act

The estates of wealthy individuals who died in 2010 didn’t pay any federal estate tax, but that situation is about to change. Under the recently enacted “Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010,” the federal estate tax, which disappeared for 2010, springs back to life in 2011 and is imposed at the top rate of 35% of the estate’s value after the first \$5 million.

Background - The modern estate tax dates back to 1916, when it was imposed at a rate of 10% on the portion of estates above \$50,000. Over the following years, the rates and exemption amounts have varied, reaching a high of 77% from 1941 to 1976 with a \$60,000 exemption amount.

In 2001, Congress passed the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), the first of the two large legislative packages that contain most of what are now commonly referred to as the “Bush tax cuts.” EGTRRA gradually lowered the maximum estate tax rate and substantially raised the applicable exclusion amount over the years 2002 through 2009. The maximum tax rate fell from 60% under prior law in 2001 (a 55% marginal rate on taxable estate values over \$3 million plus a 5% surtax from \$10 million to \$17 million) to 45% in 2007-2009. EGTRRA repealed the estate tax completely for decedents dying in 2010. That led to several well-publicized instances in which famous people died in 2010 leaving multibillion-dollar estates that will pass to their heirs without paying so much as a penny in federal estate tax. However, all of those provisions were scheduled to sunset on December 31, 2010,

meaning that if Congress had not acted, starting January 1, 2011, the estate tax would have sprung back at a level that no one seemed to want. Where the exclusion was \$3.5 million (\$7 million for couples) in 2009 – a level at which it affected relatively few households – it would have been \$1 million (\$2 million for couples) in 2011. The tax rate would also have risen, from a top rate of 45% in 2009, to a top rate of 55% in 2011.

New law - The new law brings back the estate tax, for 2011 and 2012 anyway. During 2011 and 2012, the top rate will be 35%. For 2011, the exemption amount will be \$5 million per individual (indexed for inflation after 2011). At those levels, the vast majority of estates (all but an estimated 3,500 nationwide in 2011) will not be subject to any federal estate tax, and the tax will raise about \$11.4 billion for the government. By way of comparison, the 55% tax with a \$1 million exemption would have resulted in about 43,540 taxable estates in 2011, and raised about \$34.4 billion. Tax historians would also note that except for the temporary repeal of the estate tax in 2010, the estate tax rate has not been less than 45% since 1931.

The new law also gives heirs of decedents dying in 2010 a choice of which estate-tax rules to apply – 2010's or 2011's. That's important because although there is no estate tax in 2010, some inherited assets are subject to higher capital gains tax under the 2010 rules, a situation that actually raises the tax burden for some heirs. Inherited assets under the 2010 rules have a tax basis equal to the price when they were purchased (referred to in tax parlance as "carryover basis") rather than the price at death. That could lead to a significant tax burden for heirs who sell assets such as stocks that had been held for many years and have greatly appreciated in value. Under the 2011 rules, by contrast, heirs will be allowed to inherit assets with a "stepped-up basis." While most heirs would choose the 2011 regime (\$5 million exemption from both estate and generation-skipping tax and an unlimited step-up in the basis of assets to their current market value), the heirs of superrich decedents could find it more advantageous to elect the 2010 law (limited step-up in the basis of assets and no estate tax). If the executor makes the election to have the 2010 rules apply, the estate tax return's due date will not be earlier than the date that's nine months after the new law's enactment date.

For gifts made after December 31, 2010, the gift tax will be reunified with the estate tax. Under the new law, the estate and gift tax exemptions will be reunified starting in 2011, which means that the \$5 million estate tax exemption will also be available for gifts. The law in effect prior to 2010 provided a \$3.5 million lifetime exemption for estates, but only \$1 million for gifts. The gift tax rate, starting in 2011, will be 35%. The exemption from the generation-skipping tax (GST) – the additional tax on gifts and bequests to grandchildren when their parents are still alive – will also rise to \$5 million from the \$1 million it would have been without the new law. The GST tax rate for transfers made in 2011 and 2012 will be 35%.

From a planning standpoint, a nice feature of the new law is that it makes it easier to transfer the \$5 million exemption to a surviving spouse, so married couples can shield \$10 million of their assets from taxes. In the language of tax professionals, the estate tax exemption will be “portable.”

Extension of expanded child tax credit in the 2010 Tax Relief Act

\$1,000 maximum child tax credit is extended for two years - Under pre-Act law the maximum amount of the credit per child was \$1,000 through 2010, but was scheduled to drop to \$500 after 2010. The Act extends the \$1,000 child tax credit through 2012.

Phaseout amounts are left unchanged - The aggregate amount of child credits that may be claimed is phased out (i.e., gradually reduced) for individuals with income over certain threshold amounts. Specifically, the otherwise allowable aggregate child tax credit amount is reduced by \$50 for each \$1,000 (or fraction thereof) of modified adjusted gross income over \$75,000 for single individuals or heads of households, \$110,000 for married individuals filing joint returns, and \$55,000 for married individuals filing separate returns. The new law leaves these phaseout levels in place.

Allowance of the credit against the alternative minimum tax (AMT) is extended for two years - The credit is allowable against the regular tax and, under pre-Act law, it was also allowable against the AMT, although this provision was scheduled to expire after 2010. The Act provides a two-year extension (through 2012) of the allowance of the child tax credit against the AMT.

Expanded rules for the additional child tax credit are extended for two years - To the extent the child tax credit exceeds the taxpayer’s tax liability, the taxpayer is eligible for a refundable credit (the additional child tax credit) equal to 15 percent of earned income in excess of a threshold dollar amount (the “earned income” formula). For 2009 and 2010, the threshold was set at \$3,000, but under pre-Act law the ability to determine the refundable child credit based on earned income in excess of the threshold dollar amount was set to expire after 2010. The new law extends the earned income formula for determining the refundable child credit for two years (through 2012), with the earned income threshold of \$3,000.

Treatment of refundable portion of child tax credit not as income is extended for two years - The new law extends for two years (through 2012) the rule that the refundable portion of the child tax credit does not constitute income and will not be treated as resources for purposes of determining eligibility or the amount or nature of benefits or assistance under any federal program or any state or local program financed with federal funds.

Extension of the American Opportunity Credit in the 2010 Tax Relief Act

The recently enacted “Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010” includes a two-year extension of the American Opportunity tax credit for college costs. Added to the tax code in 2009 as a temporary replacement of the previous Hope tax credit, the American Opportunity credit both increased the tax relief available for students from middle-income families and extended relief for the first time to students from lower-income families.

Now that the American Opportunity credit has been extended for two years, it might be a good time to review the tax benefits available under that credit, with an eye to how it compares with the Hope credit, which would have been in effect over the next two years had the American Opportunity credit not been extended.

- Families with a family member in college can benefit from a tax credit for tuition and fees. From a taxpayer’s point of view, a credit is almost always preferable to a deduction, because a credit reduces taxes owed, while a deduction only reduces taxable income. The maximum amount of the American Opportunity credit is \$2,500 (up from a maximum of \$1,800 under the Hope credit). The credit is 100% of the first \$2,000 of qualifying expenses and 25% of the next \$2,000. The maximum credit of \$2,500 is reached when a student has qualifying expenses of \$4,000 or more.
- While the Hope credit was only available for the first two years of undergraduate education, the American Opportunity credit is available for up to four years.
- Under the Hope credit, qualifying expenses included just tuition and fees required for the student’s enrollment. Textbooks were excluded, despite their escalating cost. The American Opportunity credit expands the list of qualifying expenses to include textbooks.
- The Hope credit was nonrefundable. It could reduce your regular tax bill to zero but could not result in a refund. This meant that if a family didn’t owe any tax it couldn’t benefit from the credit, prompting critics to argue that the credit was unavailable to the families who needed it most. The American Opportunity credit addresses this criticism by providing that 40% of the credit is refundable. This means that someone who would qualify for the maximum credit of \$2,500, but has no tax liability to offset that credit, would qualify for a refund of \$1,000 (40% of \$2,500).
- The Hope credit wasn’t available to someone with more than moderate income. Under the credit’s “phaseout” provision, taxpayers with adjusted gross income (AGI) over \$50,000 (for 2009) saw their credits reduced, and the credit was completely eliminated for AGIs over \$60,000 (twice those amounts for joint filers). Taxpayers with somewhat higher incomes can qualify for the American Opportunity credit, as the phaseout of the credit begins at AGI in excess of \$80,000 (\$160,000 for joint filers).

If you have any questions on how these tax law changes will affect you or your business, please contact your Lane Gorman Trubitt, PLLC tax professional at (214) 871-7500.