2010

TAX LAW HIGHLIGHTS

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With the scheduled 2011 expiration of the Bush-era tax cuts, many taxpayers were facing a potentially large federal tax increase in the new year. The late-2010 enactment of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act ("2010 TRA") generally extends those tax cuts for two years and provides additional relief for millions of taxpayers.

Following is a summary of the key provisions of the 2010 TRA. Much of the new law simply retains favorable tax rules that applied in prior years. Other provisions modify the old rules or introduce new tax breaks. We urge you to seek professional guidance before acting on anything you see in these highlights.

PROVISIONS AFFECTING INDIVIDUAL TAXPAYERS

Many of the benefits of federal tax laws enacted in the early 2000s were set to be repealed due to "sunset" provisions contained in those laws. Income-tax rates were poised to rise. Income-tax withholding was going to take more out of workers' paychecks. Several tax deductions and credits were going to expire. Bottom line: Most individual taxpayers would have faced a significant tax increase for 2011 and later years. The 2010 TRA generally postpones these "sunset" provisions until after 2011 or 2012.

Income-tax Rates

The federal income-tax rates applicable in 2010 were scheduled to expire for 2011 and after. Taking their place would have been the higher tax rates applicable before July 1, 2001. The 2010 TRA retains the 2010 rates for 2011 and 2012.

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Individual Tax Rates		
2010 Tax Rates	Scheduled Increases in Tax Rates for 2011 and After	Tax Rates for 2011-2012 After 2010 TRA
10%	15%	10%
15%	15%	15%
25%	28%	25%
28%	31%	28%
33%	36%	33%
35%	39.6%	35%

Marriage Penalty Relief

A marriage penalty exists when the income tax on a couple's joint return is more than the combined taxes they would pay if they were unmarried and each filed single returns. The tax legislation of the early 2000s helped reduce the marriage penalty by increasing the size of the 15% tax bracket for joint filers and, for those who do not itemize their deductions, increasing the size of joint filers' standard deduction. These provisions were due to sunset after 2010. Under the 2010 TRA, the marriage penalty relief is extended through 2012.

Capital Gains and Qualified Dividends

When a taxpayer sells or otherwise disposes of an appreciated capital asset — an investment, for example — the difference between the sale price and the tax basis (essentially, the cost) of the asset is generally considered "capital gain." Gains on most assets held longer than one year are considered long-term capital gains.

For several years, individuals and other noncorporate taxpayers have benefited from a maximum rate of 15% on net capital gains (very generally, net long-term gains minus net short-term losses). To the extent the net capital gain would have been taxed at the 10% or 15% tax rate if it had been ordinary income like wages, the net capital gains tax rate has been *zero percent.*

The maximum 0% and 15% net capital gains rates for noncorporate taxpayers were scheduled to sunset after 2010. As a result, net capital gains rates were scheduled to revert to rates ranging as high as 20%, starting in 2011. The 2010 TRA extends the 2010 rates on net capital gains for an additional two years, so they apply to tax years beginning before January 1, 2013.

"Qualified dividends" are those received from domestic corporations and qualified foreign corporations, subject to certain holding period requirements and other special rules. Qualified dividends were subject to the same maximum rates as net capital gains in 2010 — 15% for most taxpayers, 0% if the income would have otherwise been taxed in the 10% or 15% tax brackets. Starting in 2011, qualified dividends were to be treated as ordinary income, subject to tax rates of up to 39.6%. However, as with the net capital gains tax rates, the favorable rates on qualified dividends have been extended by the new law for another two years.

Example: *Sara pays taxes in the highest federal income-tax bracket and she receives qualified dividends of $50,000 during the year.*

When Dividends Received:	Tax Rate:	Income Tax Payable:
2010	15%	$7,500
2011 or Later (Under Prior Law)	39.6%	$19,800
2011 or 2012 (Under 2010 TRA)	15%	$7,500

The 2010 TRA also contains a number of other capital gain and dividend related provisions. For example, the new law extends the 100% capital gain exclusion for

qualified small business stock (QSBS). Subject to a per taxpayer limit and a more-than-five-year holding requirement, prior law provided that no gain from the sale or other disposition of QSBS acquired after September 27, 2010, and before January 1, 2011, is taxed for either regular or alternative minimum tax purposes. The 2010 TRA extends by one year the deadline for acquisition of QSBS subject to the 100% exclusion, to December 31, 2011.

Payroll/Self-employment Tax Relief

In general, two taxes are payable by both employers and employees with respect to wages paid to employees under the Federal Insurance Contributions Act (FICA). The first is the OASDI (Social Security) tax of 6.2% payable on wages up to the $106,800 wage base (in 2010 and 2011; the base amount is subject to adjustments). The second is the 1.45% Medicare tax, payable on all wages. Self-employed individuals pay a 12.4% Social Security tax on the first $106,800 of net earnings from self employment and 2.9% for Medicare tax on all net earnings.

For wages received in 2011, the 2010 TRA reduces the Social Security portion of the FICA tax payable by employees from 6.2% to 4.2%. The employer portion remains 6.2%.

Example: *Kelvin is single and earns more than the Social Security taxable wage base of $106,800 in 2011. Matt and Maria are married and each will make more than the wage base in 2011. Kelvin will see a Social Security tax savings of $2,136, the maximum payroll tax reduction for an individual employee. Matt and Maria will save a total of $4,272, the maximum for a married couple.*

For self-employed persons, the Social Security portion of the self-employment tax drops from 12.4% to 10.4% for tax years that begin in 2011. The maximum tax reduction for a self-employed is the same as for a wage earner ($2,136) or double that amount for a married couple if each has net self-employment earnings of $106,800 or more. In addition, the income-tax deduction allowed to a self-employed person for a portion of the self-employment tax paid increases to 59.6% of the Social Security tax paid in 2011 (from 50% in 2010), plus 50% of the Medicare tax paid (no change).

Personal Exemption Phaseout and Limitation on Itemized Deductions

Before 2010, the personal exemptions of higher income taxpayers were reduced when their adjusted gross income (AGI) exceeded a specified amount. Similarly, higher income taxpayers with AGI that exceeded a certain amount had their allowable itemized deductions for the year reduced or limited.

A 2001 tax law reduced the personal exemption phaseout gradually until it was fully eliminated for 2010. The limitation on itemized deductions was also reduced gradually until it was also eliminated for 2010. Both provisions were to sunset after 2010 so that both the pre-2001 law personal exemption phaseout and the limitation on itemized deductions would have been applicable in 2011 and later. The 2010 TRA delays the sunset provision for two years, until after 2012.

Child Tax Credit and Dependent Care Credit

The tax law allows an individual to claim an income-tax credit (i.e., a direct offset against income taxes) for each qualifying child under age 17. For 2010, the maximum amount of the child tax credit was $1,000 per child (subject to reduction with AGI over certain levels) and the credit was refundable for all taxpayers with qualifying children to the extent of 15% of earned income in excess of a threshold amount, regardless of the number of children.

As of 2011, the child tax credit was scheduled to revert to $500 per qualifying child and the credit's expanded refundability was to be repealed. The 2010 TRA postpones these changes for two years, through 2012.

A taxpayer may claim a dependent care credit for a portion of qualifying child or dependent care expenses

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paid for the purpose of allowing the taxpayer to work. A "qualifying individual" is a qualifying dependent child under age 13 or another dependent or spouse who (1) is incapable of self care and (2) has the same home as the taxpayer for more than half the tax year.

Under a 2001 tax law, the dependent care credit percentage, credit base, and maximum credit amount were increased significantly. These 2001 increases were to sunset after 2010. The new law extends these increases two years by postponing the sunset date until December 31, 2012.

Education Provisions

The new law extends — in some cases, retroactively — several education-related tax benefits.

American Opportunity Tax Credit (AOTC). For 2009 and 2010, the AOTC replaced the former Hope Credit and provided enhanced tax benefits for those paying qualifying post-secondary education expenses, including increasing the maximum credit to $2,500 annually per eligible student. The 2010 TRA extends the AOTC for the 2011 and 2012 tax years.

Coverdell Education Savings Accounts (ESAs). The ESA per beneficiary contribution limit of $2,000 and other enhancements were scheduled to sunset after 2010. The sunset has been extended to the end of 2012.

Qualified Tuition Deduction. At the end of 2009, the "above-the-line" deduction of up to $4,000 for taxpayers below a certain income threshold (up to $2,000 for certain higher income taxpayers) for qualified post-secondary education tuition and related expenses expired. The new law reinstates and extends the deduction for 2010 and 2011.

Student Loan Interest Deduction. Certain favorable features of the up to $2,500 a year deduction for higher education student loan interest, including higher income limits before the deduction is phased out, were to sunset after 2010. The 2010 TRA extends these features through 2012.

Other Credits, Deductions, and Exemptions

Alternative Minimum Tax (AMT) Exemptions. The AMT is an alternate tax originally intended to ensure that high-income individuals pay at least a minimum amount of tax. The 2010 TRA retroactively applies to 2010 and extends through 2011 the "AMT patch," which raised the pre-2001 law exemption amounts that applied before an individual is subject to AMT. Without the patch, an estimated 21 million additional middle-income taxpayers may have been snared by the AMT in 2010.

Adoption Credit. Individuals who adopt an eligible child are entitled to claim an income-tax credit for qualified adoption expenses, up to $13,360 per child for 2011. The credit phases out for higher income taxpayers. Favorable changes to the credit made by legislation in the early 2000s were extended through 2011 by 2010's health care reform law. The 2010 TRA extends these changes an additional year, through 2012.

Itemized Deduction for Sales Tax. Bush-era tax laws allowed taxpayers to elect to claim an itemized deduction for state and local general sales taxes *instead* of a deduction for state and local income taxes. (A number of states have a sales tax but no or a low income tax.) The sales tax deduction election was to expire after 2009, but the 2010 TRA retroactively extends the election for two years, through 2011.

Energy Credits. An individual may claim a non-refundable tax credit for specified energy-efficient property installed in the taxpayer's principal residence. The credit was not to be available for property placed in service after 2010. The new law extends the credit to nonbusiness energy property placed in service on or before December 31, 2011, but the credit rates, dollar limits, and lifetime limits revert back to the less-favorable levels in effect in 2006 and 2007.

Teachers' Expenses. The up to $250 above-the-line deduction available to K-12 teachers and certain other educators for eligible out-of-pocket expenses for

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supplies and equipment used in class expired after 2009. The 2010 TRA retroactively reinstates and extends the deduction for 2010 and 2011.

IRA Charitable Distributions. The new law retroactively reinstates and extends the rule that allows tax-free treatment for up to $100,000 of distributions a year from individual retirement accounts owned by individuals age 70½ or older where the money is donated to charity in 2010 and 2011. A special rule allows IRA distributions to charity made during January 2011 to be considered made on December 31, 2010.

PROVISIONS AFFECTING BUSINESS TAXPAYERS

Incentives for Investment in Business Equipment

The 2010 TRA includes several tax incentives aimed at spurring business investment in machinery, equipment, and other assets.

100% Write-off. The new law allows businesses to deduct 100% of the cost of qualified property acquired and placed in service after September 8, 2010, and before January 1, 2012 (or placed in service before January 1, 2013, for certain longer-lived and transportation property). To qualify for the 100% first-year write-off, several conditions must be met. Among them:

- The property must be otherwise depreciable under the modified accelerated cost recovery system (MACRS) and have an applicable recovery period of 20 years or less. This means that a wide variety of assets can potentially qualify, including most machinery and equipment, computers, office furniture and equipment, etc. Certain water utility property, computer software, and qualified leasehold improvement property also can qualify.
- The original use of the property must begin with the taxpayer after September 8, 2010. (Basically, the property must be new rather than used.)

The new law does not place a dollar limit on the amount of qualified property eligible for the 100% write-off.

50% Depreciation Bonus. Looking ahead to calendar year 2012 (2013 for certain longer-lived and transportation property), the new law allows businesses to make an election to write off 50% of the cost of qualified property placed in service during the year. This 50% first-year depreciation "bonus" is allowed for both regular tax and alternative minimum tax purposes, and it reduces the property's basis for purposes of regular depreciation deductions. Note that the 50% additional first-year depreciation allowance is also available for certain earlier tax years under pre-2010 TRA law.

Section 179 Expensing Limit Increase. The new law sets the dollar limitation on property eligible for the Section 179 expensing election at $125,000, as indexed for inflation, for the 2012 tax year. This is $100,000 more than the $25,000 expensing limit for the 2012 tax year provided under prior law. The $125,000 limit will be reduced dollar for dollar as the cost of Section 179-eligible property placed in service during the 2012 tax year exceeds $500,000, as indexed for inflation (vs. $200,000 under prior law). For tax years beginning after 2012, the expensing limit will decline to $25,000 and the phaseout threshold will drop to $200,000.

Business Credits

The 2010 TRA extends various business tax credits that had been set to expire (or had already expired). Among them:

- Research credit — retroactively extended for two years, 2010 and 2011

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- Work opportunity credit — extended four months, covering qualifying individuals who begin work after August 31, 2011, and before January 1, 2012
- Differential wage credit (for wage payments to employees serving on active duty in the U.S. uniformed services) — retroactively restored and extended two years through 2011
- Credit for employer-provided child care — extended two years through 2012
- Energy-efficient appliance credit with modifications — extended one year, covering appliances manufactured in 2011
- Energy-efficient home credit (available to contractors that construct qualified new energy-efficient homes and to energy-efficient manufactured home producers) — retroactively extended two years for homes acquired in 2010 and 2011
- New markets tax credit for equity investments in a qualified community development entity — retroactively extended for two years through 2011, subject to an annual limitation on the amount of equity investments allowed nationwide

Other Business Provisions

Accumulated Earnings Tax Rate. Under the new law, the penalty tax rate that applies to "excess" earnings and profits retained by a regular C corporation will be 15% instead of 20% for tax years beginning before 2013.

Charitable Contributions. The new law retroactively extends for 2010 and 2011 the rules permitting a regular C corporation to claim an enhanced deduction for contributions of computers and for contributions of book inventory to public schools. The rules permitting corporate farmers and ranchers to deduct contributions of qualified conservation easements up to 100% of taxable income and to carry over any unused deduction for up to 15 years are also retroactively extended through 2011.

Employee Benefits. Under the new law, employers may continue to provide employees up to $5,250 of educational assistance (including assistance for graduate-level courses) free of federal income tax through 2012. Benefits provided under an employer's adoption assistance program are also income-tax free up to $13,170 for the 2010 tax year, $13,360 for 2011, and $12,170 (adjusted for inflation after 2010) for 2012. The adoption assistance exclusion is phased out once an employee's income exceeds a specified level. The monthly income exclusion limit for employer-provided transit pass and vanpooling benefits will continue to be the same as the limit for parking benefits through 2011.

PROVISIONS AFFECTING ESTATE AND GIFT TAXES

In 2010, for the first time in almost 94 years, there was supposed to be no federal estate tax. The reprieve was brief, though. The tax was scheduled to return in 2011, with higher rates and lower exemptions than those in effect from 2002 through 2009. Now, the 2010 Tax Relief Act:

- Reinstates the estate tax for 2010, although executors of decedents dying in 2010 may choose not to have the tax apply if certain steps are taken; and
- For 2010, 2011, and 2012, provides a more favorable tax rate and exemption than those previously scheduled to go into effect for 2011 and beyond.

Rates and Exemptions

Every individual is allowed an exemption (technically, an "applicable exclusion amount") that shelters an aggregate amount of lifetime gifts and transfers at death from estate and gift tax. No federal estate tax will be due on an estate if the total taxable estate and lifetime gifts are less than or equal to this amount.

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Old Law vs. New Law. The exemption amount for 2011 had been scheduled to be $1 million and the top tax rate 55%. The 2010 TRA reduces the impact of estate and gift taxes in 2011 and 2012 by increasing the exemption amount to $5 million (subject to a potential inflation adjustment in 2012) and reducing the top gift- and estate-tax rate to 35%. Due to the $5 million exemption amount, the estate- and gift-tax rate in 2011 and 2012 is effectively a flat 35%.

Estate-tax Rates and Exemption Amounts

	Exemption Amount	Highest Rate
2009	$3.5 million	45%
2010 Prior Law	Repealed	—
2010 New Law*	$5 million	35%
2011-2012 Prior Law	$1 million	55%
2011-2012 New Law	$5 million**	35%

* Unless special opt-out election is made
** May be inflation adjusted for 2012

Moreover, the new law also subjects the estates of individuals who died in 2010 to estate tax (with a $5 million exemption amount and a 35% rate) *unless* the estate's executor elects to have certain "carryover basis" rules apply (see *A Special Option for 2010 Estates* on the next page).

Property Basis

For lifetime gifts, the donor's tax basis (or in some cases the fair market value of the property, if less) on the gift date is "carried over" and becomes the recipient's basis. If the recipient later sells the gift property, he or she is liable for capital gains tax on the property's appreciation both before and after the gift was made.

For estates of decedents dying in 2010, prior tax law dictated that an estate's beneficiaries' tax basis in the estate assets be figured using a modified carryover basis rule. Under that rule, estate assets received the same basis treatment applied to gifts. However, an estate generally could increase the basis of the transferred property to reflect the property's fair market value at the time of death up to a total of $1.3 million — plus an additional $3 million for assets transferred to a surviving spouse. (So the total basis step-up for assets transferred to a surviving spouse could be as much as $4.3 million.)

With the reinstatement of the estate tax for 2010, the basis step-up is not limited to $1.3 million/$4.3 million. An estate's executor (or personal representative) may value the estate's assets at their fair market value on the date of the owner's death (or an alternate valuation date up to six months after death). Under the basis step-up rule, a beneficiary of an estate who sells the property can avoid capital gains tax on any appreciation in the value of the property that occurred before the decedent's death.

A Special Option for 2010 Estates. The 2010 TRA provides that, for property of a decedent who died in 2010, an executor can elect to opt out of the estate tax by using the modified carryover basis rule that previously applied for 2010 instead of the basis step-up rule. As a result, executors of estates of decedents who died in 2010 should seek professional guidance as to the estate-tax and basis options available and select the one that best suits the situation.

Portability of Exemption

The new law allows a deceased spouse's executor to elect to transfer any unused estate-tax exemption to the surviving spouse. This provision is effective for 2011 and 2012.

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__Example:__ Husband dies in 2011, having made lifetime taxable gifts of $3 million and having no taxable estate. Husband's executor elects to permit Wife to use Husband's unused exemption amount. As of Husband's death, Wife has made no taxable gifts. Husband's remaining $2 million exemption is added to Wife's $5 million exemption to give her a total exemption of $7 million that she can use for lifetime gifts or for transfers at her death.

If an individual outlives more than one spouse, the amount of the unused exemption that can be carried over is limited to the lesser of $5 million or the unused exemption amount of the *last* deceased spouse — even if that amount is zero. Also, for individuals dying after December 31, 2010, an estate-tax return must be filed if the value of the gross estate exceeds $5 million (as adjusted for inflation after 2011), even if the individual's exemption amount is greater than $5 million because of a deceased spouse's unused exemption amount.

Generation-skipping Transfer Tax

Transfers of property to grandchildren or other people more than a generation younger than the person making the transfer can trigger another tax — the generation-skipping transfer (GST) tax. The GST-tax rate is equal to the highest federal gift- and estate-tax rate of 35% in 2011 and 2012. Where applicable, GST tax is paid in addition to estate and gift tax.

Higher Exemption. Like the estate tax, the GST tax was repealed for 2010. It was scheduled to return in 2011 with a $1 million exemption (as adjusted for inflation). The 2010 TRA reinstated the GST tax, effective for 2010, and set the exemption to equal the $5 million estate- and gift-tax exemption amount for 2010, 2011, and 2012 (subject to inflation adjustment in 2012). (Special rules apply if an individual claimed some of the GST-tax exemption available prior to 2010.) However, for generation-skipping transfers made in 2010 *only*, the applicable GST-tax rate is 0%, effectively keeping the repeal of the GST tax in place. In 2011 and later, the GST-tax rate returns to the highest federal estate-tax rate.

No Exemption Portability. Unlike the estate-tax exemption amount, the unused portion of a decedent's GST-tax exemption cannot be carried forward and used by his or her surviving spouse.

Time Extension for 2010 Returns

An estate's executor must file a federal estate-tax return and pay any estate tax due within nine months of a decedent's death. Certain GST-tax returns and payments are due on the same date as the estate-tax return. These dates are extended for most 2010 returns. For estates of individuals dying after December 31, 2009, and before December 17, 2010, the due date for filing a federal estate-tax return and paying the estate tax is nine months after December 17, 2010. The due date is the same for filing any required GST-tax return relating to transfers between those dates.

Other Estate- and Gift-tax Provisions

The 2010 TRA also extends through 2012 several other estate- and gift-tax provisions:

- The deduction for state death taxes paid
- Repeal of the estate-tax deduction for qualified family-owned business interests
- Expanded availability of the estate-tax exclusion for qualified conservation easements
- Certain requirements allowing more estates to qualify for installment payment of estate tax attributable to a closely held business

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CAN WE HELP?

The 2010 Tax Relief Act was enacted to avoid tax increases due to the sunsetting of many favorable provisions of the tax legislation of the early to mid-2000s. The highlights presented here are intended to make you aware of the changes so you can plan for them, with the guidance of your professional advisor. We can help you with your planning. Let our professionals be of service to you.

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