CORDASCO
& COMPANY P.C.
Certified Public Accountants

2010

TAX RELIEF ACT

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TAX RELIEF, UNEMPLOYMENT INSURANCE RE-AUTHORIZATION, AND JOB CREATION ACT OF 2010

INTRODUCTION

On December 17, 2010, President Obama signed the much-anticipated ***"Tax Relief, Unemployment Insurance Re-Authorization, and Job Creation Act of 2010"*** (Tax Relief Act) extending all current income tax rates for two years (through 2012), and providing temporary estate tax relief through 2012. The legislation also contains other tax breaks for businesses and individuals, including: the extension of tax breaks that expired after 2009, and others that were scheduled to expire after 2010; a temporary increase of the bonus depreciation deduction from 50% to 100%; a Social Security tax cut of two percentage points for 2011; a two-year alternative minimum tax (AMT) "patch," and more. This letter provides a summary of the key provisions of this sweeping tax legislation.

> **Planning Alert!** We highlight only *selected* provisions of the new tax legislation. If you have questions about any provision not discussed in this letter, please call our office for details.

ALL CURRENT INCOME TAX RATES EXTENDED THROUGH 2012

Beginning in 2011 the lowest individual income tax rate was scheduled to increase by 5 percentage points (from 10% to 15%), the maximum individual income tax rate was scheduled to increase by 4.6 percentage points (from 35% to 39.6%), and most other individual income tax rates were to increase by 3 percentage points. In addition, the maximum tax rate on long-term capital gains was to increase from 15% to 20%, while the top tax rate on dividends was to jump from 15% to 39.6%. The *Tax Relief Act* extends the current individual income tax rates for all income levels for two years, **through 2012.** Consequently, the current 10% through 35% tax brackets are retained for ordinary income, and the maximum tax rate for long-term capital gains and qualified dividends remains at 15% (zero percent if the dividends or capital gains would otherwise fall in the 10% or 15% tax brackets).

> **Caution!** Starting in 2013, absent Congressional action, the top individual income tax rates will increase to: **1)** 39.6% for ordinary income; **2)** 39.6% for qualified dividends; and **3)** 20% for long-term capital gains.

- **Personal Exemption And Itemized Deduction Phase-Out Relief Extended.** For the past two decades, high-income individuals have been subject to phase-out provisions that reduced their personal exemptions and itemized deductions as their income exceeded certain amounts. These phase-outs were eliminated for **2010,** but were scheduled to return in 2011. The *Tax Relief Act* provides that these phase outs will not apply for **2011 and 2012.**

- **Marriage Penalty Relief Extended.** Several tax provisions were enacted in 2001 to reduce the so-called "marriage penalty" (i.e., provisions in the tax law causing married individuals filing jointly to pay more tax than if they were single filing separate returns). However, these relief provisions were scheduled to expire after 2010. The *Tax Relief Act* extends these *marriage penalty relief* provisions (e.g., an enhanced standard deduction and larger 10% and 15% brackets for married taxpayers filing jointly) **through 2012.**

ALTERNATIVE MINIMUM TAX "PATCH' EXTENDED FOR 2010 AND 2011

For the past several years, Congress has enacted a series of temporary increases in the alternative minimum tax (AMT) exemption amounts to ensure that most lower and middle income taxpayers were not subject to this tax. The higher AMT exemption amounts expired after 2009. The *Tax Relief Act* extends the increased AMT exemption amounts **to 2010 and 2011.** The *Act* also allows non-refundable personal income tax credits to offset the AMT, **through 2011.**

ESTATE, GENERATION SKIPPING, AND GIFT TAX RELIEF FOR 2010 THROUGH 2012

Over the years, the estate tax has generally been imposed only on estates exceeding certain dollar amounts ("exemption amounts"). In 2001, Congress passed the 2001 Act which increased the estate tax *exemption amount* in stages and also reduced the top estate tax rate. For example, in 2009, an estate tax rate of 45% applied to taxable estates in excess of $3.5 million. The 2001 Act also repealed the estate tax for *2010* and provided that the estate tax would return in 2011 with an *exemption amount* of only $1 million and generally with a maximum estate tax rate of 55%.

The *Tax Relief Act generally* reinstates the estate tax ***retroactive to January 1, 2010***. However, under the Act, for 2010 through 2012, the estate tax exemption amount is increased to $5 million (indexed for inflation for 2012), and the tax rate on the amount of the estate in excess of $5 million is 35%. In addition, if an **individual died in 2010**, the Act provides that the executor may ***elect*** to use the estate tax rules **in effect prior to enactment** of these changes (i.e., no estate tax), or the *new* rules (i.e., a $5 million exemption amount). Although this election to use the *Pre-Act* estate tax rules for 2010 could save "estate" taxes for larger estates (e.g., those over $5 million), it could have a negative "income" tax impact on the beneficiaries who receive appreciated property from the estate. This is because, under the *Pre-Act* estate tax rules for 2010, an individual who inherits an asset *generally* acquires a basis for income tax purposes equal to the *lesser of* the decedent's basis or the *value* of the asset on the date of the decedent's death (commonly referred to as "modified carryover basis"). However, under the *modified carryover basis* rule, there is a limited amount of basis increase for certain appreciated properties (e.g., up to a $1.3 million in general and an additional $3 million for assets passing to the surviving spouse). By contrast, under the *Tax Relief Act*, heirs generally acquire an income tax basis in assets received from the estate equal to the asset's value on the decedent's date of death (even if this value exceeds the decedent's tax basis). This latter rule allows the beneficiary a so-called *stepped-up* basis in *all* assets that are valued in excess of the decedent's basis. Thus, if an estate with appreciated assets elects to use the *Pre-Act* estate tax rules for 2010, beneficiaries who later sell the inherited property might be taxed on gains that would have been avoided under the "stepped-up" basis provisions of the Tax Relief Act.

Tax Alert! For individuals dying after 2012, the *exemption amount* is scheduled to be $1 million, and the top rate is scheduled to be 55%.

- **Tax Tip.** For many estates valued at $5 million or less, using the new $5 million exemption amount will probably be preferable since there will be no estate tax and the heirs of the estate will have a basis in appreciated assets received from the estate equal to the fair market value of the assets at the date of the decedent's death. For estates valued at more than $5 million, the election to use the *Pre-Act* rules for 2010 may be prudent. However, for some estates in excess of $5 million, it may still be preferable to pay some estate tax using the new rules (i.e., the $5 million exemption and 35% rate) where the estate has highly-appreciated assets. This may be the case where the estate tax is small compared to the income tax savings resulting from the unlimited "step up" in basis of the appreciated assets received by the heirs.

- **Elections And Due Dates.** According to the *Tax Relief Act*, an election to use the *Pre-Act* estate tax rules will **not be due earlier than nine months following December 17, 2010.** In addition, for estates of decedents dying **after December 31, 2009, and before December 17, 2010,** the due date for **1)** filing an estate tax return, **2)** paying the estate tax, and **3)** making a "qualified" disclaimer will be no earlier than **September 17, 2011.** A similar rule applies for generation-skipping transfers.

- **Unused Estate Tax Exemption Amount Of First Spouse To Die Available To Estate Of Surviving Spouse.** Historically, *each* spouse's estate has been entitled to a full estate tax *exemption amount* (e.g., $3.5 million for 2009 and $5 million for 2010 through 2012). However, technical estate tax planning structures and strategies (e.g. credit shelter trusts) were often necessary to ensure that the estate tax *exemption amount* of the first spouse to die was not partially or completely wasted. For **individuals dying in 2011 or 2012,** the *Tax Relief Act* provides that the personal representative of a deceased spouse's estate may elect for any of the $5 million exemption amount not used by the estate of the first spouse to die to be available to the estate of the surviving spouse. Thus, this new "portability" feature should make it much easier for couples to shelter up to $10 million of their combined assets from the estate tax even where credit shelter trusts are not established.

  Planning Alert! This provision will particularly benefit estates where the taxable estate of the first spouse to die is less than the $5 million exemption amount and the taxable estate of the surviving spouse is more than the $5 million exemption amount.

- **Gift Tax Changes.** Although the 2001 Act repealed the estate tax for 2010, the 2001 Act did not repeal the gift tax. The gift tax exemption amount for 2010 is $1 million and the maximum gift tax rate for 2010 is 35%. The *Tax Relief Act* does not change the $1 million exemption amount and 35% top rate for gifts made in 2010. However, for gifts made in **2011 and 2012,** the *Act* unifies the "estate" and "gift" tax exemption amount at a single $5 million with any excess gift or estate amounts taxed at 35%.

- **Generation-Skipping Tax. In addition to the gift tax,** there is also imposed a generation-skipping tax on gifts which skip a generation (e.g., gifts to grandchildren). The 2001 Act repealed the generation-skipping tax for generation-skipping gifts in 2010. However, the *Tax Relief Act* reinstates the generation-skipping tax as of January 1, 2010 with a $5 million *exemption amount.* However, the **generation-skipping tax rate for 2010 is zero percent.** The generation-skipping exemption amount will continue at $5 million for **2011 and 2012**. However, the generation-skipping tax rate on gifts in excess of this exemption amount will be **35% for 2011 and 2012.**

TWO PERCENT SOCIAL SECURITY TAX HOLIDAY FOR 2011

The *Tax Relief Act* provides *a* ***2%*** reduction in Social Security taxes for employees and self-employed individuals. Here's how this one-year Social Security tax reduction works. **If you are an employee,** then **for 2011,** the normal 6.2% "employee" portion of your Social Security tax rate will be reduced to 4.2%. Thus, your take-home pay for 2011 will generally be increased by 2% of each dollar of compensation that you earn. However, since Social Security taxes apply only to the first $106,800 of compensation in 2011, your maximum savings will generally be $2,136 (i.e., $106,800 x 2%).

Tax Tip! This temporary Social Security tax reduction will not impact your future Social Security benefits.

- **If you are self-employed,** you are generally required to pay Social Security taxes at a rate of 12.4% on your self-employment income, up to $106,800. In addition, you are generally allowed to deduct 50% of your Social Security taxes from your taxable income. **For 2011**, self-employed individuals will pay Social Security taxes of only 10.4% on their self-employment income. In addition, self employed individuals will be allowed to deduct 59.6% (instead of the normal 50%) of their Social Security taxes from their taxable income for 2011.

FIRST-YEAR BONUS DEPRECIATION TEMPORARILY INCREASED FROM 50% TO 100%

Prior to the *Tax Relief Act*, businesses were allowed a 50% up-front bonus depreciation deduction for qualifying new business property placed in service during 2008, 2009, or 2010. For "qualifying business property" ***acquired*** and ***placed-in-service*** after **September 8, 2010 and through December 31, 2011** (through December 31, 2012 for certain long-production-period property and transportation property), the *Tax Relief Act* increases the 50% up-front bonus depreciation to 100%! In other words, the *entire cost* of qualifying property can be fully deducted.

Tax Tip. *Qualifying business property* that is "acquired" *after* September 8, 2010 pursuant to a binding contract entered into *before* September 9, 2010 will still qualify for the 100% bonus depreciation, provided that the binding contract was entered into after 2007 and the property is placed in service by December 31, 2011.

- **Qualifying 50%/100% bonus depreciation property** is generally *new* property that has a depreciable life for tax purposes of *20 years or less* (e.g., machinery and equipment, furniture and fixtures, cars and light general purpose trucks, sidewalks, roads, landscaping, depreciable computer software, farm buildings, qualified motor fuels facilities and "qualified leasehold improvements").

SELECTED **EXPIRING (OR EXPIRED) TAX BREAKS THAT WERE EXTENDED**

In addition to extending the current tax rates, the *Tax Relief Act* extended a host of other expiring tax breaks. The following are some of the more popular tax breaks that were extended –

- ***Selected*** **"Individual" Tax Breaks Extended Through 2011:** **1)** school teachers' deduction (up to $250) for certain school supplies; **2)** election to deduct state and local sales tax; **3)** deduction (up to $4,000) for qualified higher education expenses; **4)** expanded deduction and carry over limits for charitable contributions of conservation easements; **5)** deduction for home mortgage insurance premiums; **6)** "District of Columbia" first-time homebuyer's credit; **7)** tax-free transfers from IRAs to charities for those at least age 70½

  Planning Alert! individuals may make these qualifying charitable IRA transfers during **January of 2011,** and elect to treat them as if made during 2010);

  and **8)** credit for energy-efficient improvements to your principal residence

  Planning Alert! this 30% credit of up to $1,500 cumulative for 2009 and 2010 drops to 10% with a life-time cap of $500 for installations after 2010.

- ***Selected*** **"Business" Tax Breaks Extended Through 2011:** **1)** 15-year (instead of 39-year) depreciation period for "qualified" leasehold improvements, restaurant improvement property, and retail improvement property; **2)** 7-year depreciation period for certain motor sports racetrack property; **3)** research and development credit; **4)** employer differential wage credit for payments to military personnel; **5)** various tax incentives for investing in the District of Columbia; **6)** favorable S corporation charitable contribution provisions; **7)** temporary exclusion of 100% of gain on the sale of certain small business stock; **8)** a host of tax benefits for qualified energy-efficient expenditures; **9)** enhanced charitable contribution rules for qualifying business entities contributing computer equipment, book, and food inventory; and **10)** work opportunity tax credit for qualified employees.

- ***Selected*** **"Individual" Tax Breaks Extended Through 2012:** **1)** enhanced rules for Coverdell education savings accounts; **2)** enhanced student loan interest deduction; **3)** enhanced earned income tax credit; **4)** expanded and enhanced $1,000 child credit; **5)** expanded child and dependent care credit; **6)** expanded and enhanced American Opportunity Tax credit (formerly the "Hope" credit); and **7)** expanded rules for tax-free treatment of scholarships under the NHSC Scholarship Program and the Armed Forces Scholarship Program.

- ***Selected* "Business" Tax Breaks Extended Through 2012:** **1)** election for C corps to exchange bonus depreciation for refundable AMT credits; **2)** up to $5,250 tax free employer-provided education assistance; and **3)** credit for employer-provided child-care facilities.

FINAL COMMENTS

Feel free to contact us if you are interested in a tax topic that we did not discuss. Please call us before implementing any planning ideas that may be addressed in this letter, or if you need additional information. **Note:** The information contained in this letter represents a general overview of *selected* provisions in the *Tax Relief Act* and should not be relied upon without an independent, professional analysis of how any of these provisions may apply to a specific situation.

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