

# TAXOLUTIONS



►► *ideas on taxes*

## 2010 TAX RELIEF ACT PROVIDES OPPORTUNITIES FOR INDIVIDUALS AND BUSINESSES

On December 17, 2010, President Barack Obama signed into law an \$858-billion package that includes a two-year extension of reduced tax rates on individual income and dividends/capital gains. In addition, the law provides extensions of a number of tax breaks for small businesses, a two-year AMT patch, temporary estate tax relief, and a one-year reduction in payroll taxes.

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (2010 Tax Relief Act) was approved by Congress after a prolonged debate over the extension of the income tax reductions passed in 2001 and 2003, which were due to sunset at the end of 2010. In early December, President Obama announced that the White House had struck a deal with Congressional leaders, with both parties agreeing to a two-year extension of the current individual income rates for all taxpayers and estate tax relief. In exchange, President Obama asked Congress to support an extension of unemployment benefits and payroll tax relief.

The new law provides a number of opportunities for individuals and businesses. Among the main provisions are the following:

**Income tax rates extended through 2012.** Under the 2010 Tax Relief

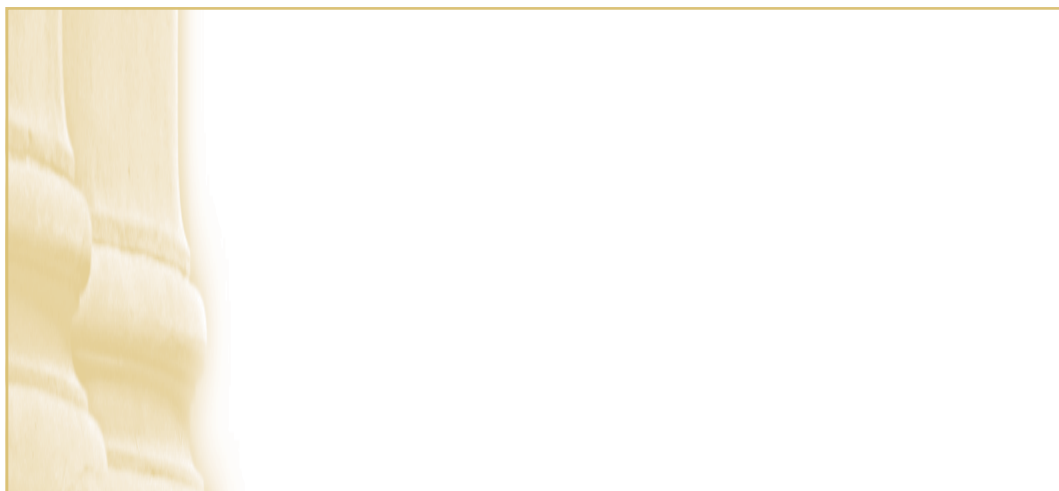
Act, lower individual income tax rates (10%, 15%, 25%, 28%, 33%, and 35%) are extended through 2011 and 2012. These rates went into effect under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), but had been scheduled to revert to their previous levels (15%, 28%, 31%, 36%, and 39.6%) after 2010. The associated changes in itemized deduction and personal exemption rules are also extended for 2011 and 2012, including a two-year continuation of the repeal of the personal exemption phaseout (PEP) and the repeal of the limitation on itemized deductions ("Pease" limitation) for higher-income taxpayers.

**Tax rates on capital gains and dividends extended through 2012.** Under

laws in place in 2010, qualified capital gains and dividends were taxed at a rate of 15%, and taxpayers in the 10% and 15% income tax brackets owed no tax on qualified capital gains and dividends. Under the 2010 Tax Relief Act, these rates are extended through 2012. Had no legislative action been taken, the maximum capital gains rate would have risen to 20%, and qualified dividends would have been taxed at ordinary income tax rates.

**Child tax credit extended through 2012.** Under the 2010 Tax Relief Act, the \$1,000 child tax credit (with enhancements) is continued through December 31, 2012. Under EGTRRA,

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the credit amount had been scheduled to revert to \$500 after 2010.

**Marriage penalty relief continued through 2012.** Under EGTRRA, the basic standard deduction and the 15% income tax rate bracket for married couples filing jointly were increased to twice the amounts for single filers. The new law extends this marriage penalty relief for two years, through December 31, 2012.

**Payroll tax reduced for 2011.** For wages earned in calendar year 2011, the employee share of payroll taxes is lowered from 6.2% to 4.2%, up to the taxable wage base of \$106,800. Self-employed individuals owe 10.4% on self-employment income up to the threshold.

**AMT relief provided for 2010 and 2011.** Under the 2010 Tax Relief Act, the exemption amounts for the Alternative Minimum Tax (AMT) are increased for 2010 and 2011. For 2010, the exemption amounts are raised to \$47,450 for singles, \$72,450 for married couples filing jointly, and \$36,225 for married couples filing separately. For 2011, the equivalent amounts are \$48,450, \$74,450, and \$37,225. Without this "patch," the exemption amounts would have fallen to \$33,750 for individuals, \$45,000 for married couples filing jointly, and \$22,500 for married couples filing separately.

**Education tax breaks extended through 2012.** The 2010 Tax Relief Act extends through 2012 a number of education-related tax incentives at their 2010 levels, including Coverdell Education Savings Accounts, the student loan interest deduction, the Section 127 exclusion from income for employer-provided education assistance, and the American Opportunity Tax Credit for college tuition.

**Tax breaks for families continued through 2012.** Under EGTRRA, the dependent credit available to help pay for care for a child under age 13 or for a disabled dependent or spouse was temporarily increased to up to \$6,000 per family. The 2010 Tax Relief Act extends this increase for two years, through December 31, 2012. Other

breaks for families that are extended through 2012 include the adoption tax credit, the employer-provided adoption assistance program exclusion, the employer-provided child care tax credit, and the earned income tax credit.

**Individual extenders continued through 2011.** Under the 2010 Tax Relief Act, a number of temporary individual tax incentives are extended through 2011, including the state and local sales tax deduction, the higher education tuition deduction, the teacher's classroom expense deduction, and the charitable contributions of IRA proceeds.



**Estate tax returns with a top rate of 35% and an exclusion of \$5 million.** Under EGTRRA, the Federal estate tax was gradually reduced and disappeared altogether in 2010, but it was scheduled to be reinstated in 2011 at pre-2002 levels. Under the 2010 Tax Relief Act, the estate tax returns with a maximum tax of 35% and an exclusion amount of \$5 million for 2011 and 2012 only. The new law also eliminates the modified carryover basis rules that were in effect in 2010 and replaces them with stepped-up basis rules.

Starting in 2011, the gift tax is reunified with the estate tax, with a top tax rate of 35% and exemption of \$5 million. Also starting in 2011, the generation-skipping transfer (GST) tax is equal to the highest estate and gift tax rate in effect for the year (35% for 2011 and 2012).

**Energy tax credits for individuals and businesses extended.** Many of the energy credits and deductions set to expire at the end of 2010 are extended

for one or two years under the new legislation, including business credits for biodiesel and renewable diesel fuel, the credit for refined coal facilities, the new energy-efficient home credit for builders and manufacturers, tax credits for alternative fuel and alternative fuel mixtures, and the credit for the purchase of energy-efficient appliances.

In addition, individuals who make certain energy efficiency improvements to their homes are eligible to claim tax credits worth up to 30% of their investment, up to a total lifetime limit of \$1,500, for products or improvements placed in service through December 31, 2011.

**50% bonus depreciation raised to 100%.** Under recent tax reform, qualified businesses were given the option of depreciating 50% of the adjusted basis of the property for qualifying property bought and placed in service in 2008 through 2010. The 2010 Tax Relief Act increases the 50% bonus depreciation to 100% for qualified investments made after September 8, 2010 through December 31, 2011, and it also makes 50% bonus depreciation available for qualified property placed in service in 2012. In addition, certain long-lived property and transportation property is eligible for 100% expensing if placed in service before January 1, 2013.

**Section 179 expensing extended through 2012.** For 2010 and 2011, businesses are permitted under the Small Business Jobs Act of 2010 to expense up to \$500,000 of Section 179 property, and the amount that may be expensed is reduced only if the cost of the Section 179 property exceeds \$2 million. Under the 2010 Tax Relief Act, a \$125,000 dollar limit (indexed for inflation) and a phase-out beginning at \$500,000 (indexed for inflation) is in effect for 2012. After 2012, the limit reverts to \$25,000, with a phaseout beginning at \$200,000.

**Research tax credit extended through 2011.** The Code Section 41 research tax credit, which had expired at the end of 2009, is continued for two years, through December 31, 2011.

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**Extension of the Work Opportunity Credit (WOTC).** The WOTC, which provides businesses that hire members of certain “targeted groups” with a credit of up to \$2,400 on the qualifying first-year wages paid to each employee, was set to expire after August 31, 2011. Under the 2010 Tax Relief Act, the WOTC is extended for new hires who begin employment after August 31, 2011 and before January 1, 2012, though certain groups who had previously been targeted no longer qualify for this credit.

**Extension of 100% exclusion on sales of small business stock through 2011.** Under the Small Business Jobs

Act of 2010, investors are permitted to exclude 100% of the gain from the sale of certain small business stock acquired and held for more than five years, up from 75% previously, and the excluded gain is not subject to the AMT. To qualify, the stock must have been purchased before January 1, 2011. Under the 2010 Tax Relief Act, this 100% exclusion is extended for one more year to cover stock purchased before January 1, 2012.

**Transit benefits extended one year.** Under the American Recovery and Reinvestment Act of 2009 (ARRA), the amount that may be excluded from the

taxable income of employees used to pay for qualified mass transit, van pools, or parking was raised to \$230 per month through 2010. Under the 2010 Tax Relief Act, this increase is continued for one additional year, through December 31, 2011.

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 offers a number of tax breaks for both individuals and businesses. However, many of the opportunities are temporary. For more information and advice about your unique circumstances, contact one of our qualified tax professionals. ■

## NEW TAX LAW ALTERS ESTATE PLANNING LANDSCAPE

Among the provisions for individuals and businesses, recent tax legislation provides temporary changes to estate and wealth transfer taxes. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (2010 Tax Relief Act) not only lowers the estate tax rate and increases the exemption amount for the next two years, but it also includes an expansion of the gift tax lifetime exclusion amount and a “portability” provision that allows unused estate tax exemption amounts to be transferred to a surviving spouse.

### *Estate Tax Changes*

The estate planning landscape has been marked by change and uncertainty over the past several years. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) provided that the estate tax would become progressively generous in the run-up to 2010, when it would phase out completely for a single year. However, many felt lawmakers would act to prevent a full estate tax repeal, and a number of proposals were heavily debated by Congress.

As the days went by in 2009 and 2010, concern arose that Congress would not act on estate taxes, and the defaults under EGTRRA would come to pass. Under

EGTRRA, after the repeal in 2010, the estate tax was scheduled to be reinstated in 2011, with a maximum tax rate of 55% and an exclusion amount of \$1 million. As a result of the new law, the 2010 Tax Relief Act, the estate tax is reinstated in 2011 with a top tax rate of 35% and an exemption amount of \$5 million, or \$10 million for married couples.

The new estate tax provisions apply to decedents dying after December 31, 2009 and before January 1, 2013. In addition, the modified carryover basis rules that were in effect in 2010 only are eliminated and replaced with stepped-up basis rules. Executors of the estates of individuals who died in 2010 may elect not to come under the revived estate tax rules. These estates may choose to apply the estate tax based on 2011 rates, with stepped-up basis rules, or no estate tax, with modified carryover basis rules.

Under stepped-up basis rules, the value of an inherited asset is “stepped up” from the original purchase price to the potentially higher market value of the asset at the time of inheritance, and heirs do not have to pay capital gains taxes on any increase in the asset’s value over the decedent’s lifetime. By contrast, under modified carryover basis rules, heirs of property from a decedent dying

in 2010 were allowed to step up only \$1.3 million of the decedent’s assets to current market value, and property bequeathed to the spouse of the decedent could be stepped up by an aggregate amount of \$3 million, for a total of \$4.3 million. Assets above this level would be subject to capital gains taxes on the original purchase price of the assets when sold by the heirs. Thus, heirs who inherited less than \$5 million from a decedent in 2010, but who were subject to modified carryover basis rules, may choose to be taxed under the stepped-up basis rules.

### *The Portability Provision*

The 2010 Tax Relief Act also includes a provision that allows the estate tax exemption to be transferred between spouses in 2011 or 2012, so that if one spouse dies in 2011 or 2012 and does not use the full exemption amount, the remainder can be used by the surviving husband or wife, if he or she also dies in 2011 or 2012. To make use of this so-called “portability” option, the executor of the first spouse must actively elect it on the estate tax return, even if no liability is owed. Then, when the remaining spouse dies, the heirs will owe estate tax only on any amount above the combined exemption. For estate planning

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## Taxpayer Advocate Recommends Tax System Reform

According to her 2011 annual report to Congress, National Taxpayer Advocate Nan E. Olson argued that both taxpayers and the U.S. government would benefit from major reforms of the Federal income tax system.

As detailed by the report, tax reform generally focuses on eliminating tax breaks in exchange for lower rates. The report also noted that there is a widespread belief that the influence of “special interests” is the biggest obstacle to tax reform efforts. However, tax breaks, including exclusions from income, tax deductions, or tax credits, benefit the majority of taxpayers. According to the report, tax breaks now total \$1.1 trillion a year, and the average tax liability of each individual who files a Federal tax return is reduced by about \$8,000 annually due to these tax breaks. The most prevalent breaks include the exclusion of employer contributions for health

care, the exclusion for retirement plan contributions and earnings, the mortgage interest deduction, reduced tax rates for dividends and capital gains, exclusions for Medicare benefits, the earned income tax credit, and the deduction for state and local taxes. To improve awareness of the connection between taxation and Federal spending, Olsen recommended that the government provide “taxpayer receipts” that feature a breakdown of how their Federal tax dollars are spent.

Acknowledging that Congress may need to raise tax revenues in the future, the report suggested that Congress first enact structural tax reform on a revenue-neutral basis and keep separate the decision about whether to adjust tax rates. Among the specific simplification proposals are repealing the Alternative Minimum Tax for individuals and consolidating the incentives that encourage saving for education and retirement.

“If tax rates are to be substantially lowered, many existing tax breaks will have to be eliminated immediately and others will be phased out,” Olson said. “But I believe most taxpayers will conclude this is a worthwhile trade-off. If tax reform proceeds on a revenue-neutral basis, the average taxpayer’s liability will not change, and we will end up with a tax system that is simpler, more transparent, and easier and cheaper for taxpayers to navigate.”

The report also outlines the Advocate’s continuing concern that IRS collection practices, especially tax liens, inflict unnecessary harm on financially struggling taxpayers. Finally, the report examines challenges the IRS is facing in administering an increasing number of social benefits programs, including Economic Stimulus payments, the Making Work Pay credit, and health care reform. ■

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purposes, this means that husbands and wives do not have to split assets between them, or be concerned about who holds the title on various assets.

Yet, these changes to the estate tax do not eliminate the need for planning. Because the portability of the estate tax exemption is only in place through 2012, wealthy taxpayers who currently fall within the exemption limits may still want to consider setting up a bypass trust in anticipation of future changes in the rules. In addition, couples with different sets of final beneficiaries, such as children from previous marriages, may wish to set up a bypass trust in order to clarify the beneficiaries of their separate assets.

### Gift Tax Changes

Despite the changes in estate taxes provided by EGTRRA, lifetime gift taxes

remained stable over the last decade, with a maximum tax rate of 35% and a lifetime exclusion amount of \$1 million. Under the 2010 Tax Relief Act, starting in 2011, the gift tax is reunified with the estate tax, with a top tax rate of 35% and exemption of \$5 million, or \$10 million for married couples. While the annual gift tax exclusion remains at \$13,000, this change in the lifetime exclusion amount greatly expands the potential for making tax-free gifts to family members. However, keep in mind that gifts made in excess of the annual exclusion reduce the estate tax exemption.

Under EGTRRA, the generation-skipping transfer (GST) tax had been repealed for 2010. According to the 2010 Tax Relief Act, starting in 2011, the generation-skipping transfer (GST) tax is equal to the highest estate and gift tax rate in effect for the year. Thus,

for transfers to grandchildren made in 2011 and 2012, the exemption amount is \$5 million with a GST tax rate of 35%. While this tax is not portable between spouses, couples can combine their exemptions to give away a total of \$10 million without incurring GST tax.

While the 2010 Tax Relief Act brings a number of changes to the estate planning landscape, it is important to keep in mind that the provisions are temporary. Unresolved questions about the long-term future of estate tax rates and exemptions can create challenges for estate planning. Because it is impossible to predict what laws will be in force at the time of death, it is important to prepare for a number of different scenarios. Regular consultations with one of our qualified tax professionals can help ensure your decisions remain consistent with your objectives, even as tax laws change. ■