The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010: What You Need to Know

By Robert Verzi, Partner

The recently enacted "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010" (Tax Relief Act) 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)
- 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:

Tax Rates

The 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.

Alternative Minimum Tax Patch

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.

Estate Tax

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.

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."

Payroll Tax Cut

The biggest new tax break for individuals in the Tax Relief Act 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. 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 phase-out (i.e., gradual reduction) of the payroll tax reduction for higher income workers. Everyone who works, regardless of income, will receive the reduction in Social Security taxes. 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 workers' wages but was phased out for workers making more than $75,000 ($150,000 for couples).

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.

For now, the tax break only applies for one year, 2011. 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, but it will not affect the worker's future Social Security benefit. Benefits are based on lifetime earnings, not the amount of tax paid by the worker into the Social Security system.

Other Individual Tax Relief

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 Act extends a host of other important tax breaks for businesses and individuals. I'm writing to give you an overview of these key tax breaks that were extended by the new law. Please call our office for details of how the new changes may affect you or your business.

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.

<u>Expensing and Additional First-Year Deprecation</u>

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 **<u>100% additional first-year depreciation.</u>** In other words, the entire cost of qualifying property placed in service during that time frame can be written off, without limit. 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 makes three important changes to the Code Section 179 expense election.

(1) 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 phase-out (i.e., gradual reduction) once capital expenditures exceed $500,000 (indexed for inflation). The new maximum expensing amount and phase-out 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 phase-out level of $2,000,000). For tax years beginning after 2012, the maximum expensing amount will drop to $25,000, and the phase-out level will drop to $200,000.

(2) The rule that treats off-the-shelf computer software as qualifying property is extended through 2012.

(3) 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.

<u>Business tax relief</u>

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 write-offs for qualified leasehold improvements, and restaurant buildings (and certain improvements to such restaurant buildings).
- Seven-year write-offs for certain motorsports racetrack property.
- The employer wage credit for activated military reservists.

- The active financing exception from the Code's 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).
- The 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.

If you would like more details about these provisions or any other aspect of the new law, please do not hesitate to call us.