The 2010 Tax Relief Act

What you need to know

BST

BST ADVISORS, LLC
Tax and Management Consultants
800-724-6700
www.bstco.com

The extension of the lower income and capital gains tax rates set to expire Dec. 31, along with significant reductions to the estate tax, has probably received the most media coverage. But the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, signed into law Dec. 17, extends and expands — temporarily — a wide variety of valuable tax breaks.

Many of the breaks were scheduled to end after 2010 under the "sunset" provision of the Economic Growth and Tax Relief Reconciliation Act of 2001 and have now been extended through 2012. Other breaks expired after 2009 and have been extended only through 2011. The act also provides a few new tax breaks, most notably a payroll tax reduction for 2011. (See below.)

Here is a closer look at the most important changes affecting individuals, businesses and estate planning, along with the implications for your 2010 tax return and your planning for 2011 and beyond. Many breaks are subject to a variety of rules and limitations, so it's important to discuss them with your tax advisor to determine exactly how they'll affect you.

New payroll tax break for 2011

For 2011 only, the 2010 Tax Relief act reduces the employee portion of the Social Security tax on earned income from 6.2% to 4.2%. The self-employed pay both the employee and employer portions of Social Security tax, and the Tax Relief act also reduces their rate by two percentage points for 2011, from 12.4% to 10.4%. (This doesn't reduce a self-employed individual's deduction for the employer's share of these taxes, however.)

For 2011, the maximum taxable wage base for Social Security taxes is $106,800 (the same as for 2010). So the maximum tax savings from this break is $2,136. Unlike last year's Making Work Pay credit (which the payroll tax break essentially replaces), no other income-based limit applies. So even high-income taxpayers can enjoy the maximum benefit.

Chart 1
Income tax increase deferred to 2013

2003–2012	2013
10%	15%
15%	15%
25%	28%
28%	31%
33%	36%
35%	39.6%

Individuals

Many of the Tax Relief act's provisions benefit individual taxpayers through extensions of lower tax rates, enhanced deductions and credits, and more.

Ordinary income tax rates

Because of the 2001 tax act sunset, ordinary income tax rates (except for the 15% rate) were scheduled to increase for 2011. There was much talk about extending the lower rates for only the lower and middle tax brackets, for only married couples making $250,000 or more ($200,000 or more for singles), or for only those making $1 million or more — or for only one year. But the 2010 Tax Relief act extends the 2001 act rates for everyone for two years. So income tax rate increases now aren't scheduled to occur until 2013. (See Chart 1 above.)

This means that for 2011 you can employ the traditional income-timing strategy of deferring income to the next year, where possible, to defer tax (assuming you don't expect to be in a higher tax bracket in 2012).

Long-term capital gains rates

Under the 2001 tax act, the 15% long-term capital gains rate was scheduled to increase to 20% in 2011. The 2010 Tax Relief act extends the 15% rate through 2012. (See Chart 2 below.)

So, for the time being, taxes on your investments may be less of a concern. But in your investment planning you'll want to keep in mind that the extension of the lower rates is for only two years. There may be actions you'll want to take to lock in lower rates while they're still available.

The 2010 Tax Relief act also extends the 0% rate for taxpayers in the bottom two brackets. If you have children or other loved ones in these brackets, consider transferring appreciated assets to them. They can sell the assets this year or next and pay no tax on the capital gain. But beware of the "kiddie tax."

Qualified dividend tax rates

The 2010 Tax Relief act extends taxation of qualified dividends at the 15% long-term capital gains tax rate through 2012 (0% for those in the bottom two brackets). Without Congressional action, dividends would have gone back to being taxed at ordinary income rates in 2011, with a top rate as high as 39.6%.

If you hold dividend-producing investments and have been considering whether you should make adjustments to your portfolio in light of their potentially higher tax cost, you now can put off that decision until 2012.

Chart 2
What's the maximum capital gains tax rate?

		2010–2012	2013[1]
Maximum tax rate for assets held			
12 months or less (*short term*)		35%	39.6%
More than 12 months (*long term*)		15%	20%
Some key exceptions			
	Long-term gain on collectibles, such as artwork and antiques	28%	28%
	Long-term gain attributable to certain recapture of prior depreciation on real property	25%	25%
	Gain on qualified small business stock held more than 5 years	14%[2]	14%[2]
	Long-term gain that would be taxed at 15% or less based on the taxpayer's ordinary-income rate	0%	10%

[1] *If Congress doesn't take action.*
[2] *Effective rate based on 50% exclusion rules.*

Source: *U.S. Internal Revenue Code*

Increased exclusion on small business stock gains

To make investing in certain small businesses more attractive, the Small Business Jobs Act of 2010 (SBJA), signed into law in September, temporarily increased the qualified small business (QSB) stock gain exclusion to 100% for stock acquired after Sept. 27, 2010, and before Jan. 1, 2011, that's held for at least five years. (The exclusion normally is 50%; 75% in some cases.) Additionally, the SBJA eliminated the alternative minimum tax (AMT) preference item on such gain, making it tax free for AMT purposes as well.

The 2010 Tax Relief act extends the acquisition deadline for 100% gain exclusion and elimination of the AMT preference item to Dec. 31, 2011.

QSB stock can help diversify your portfolio while providing additional potential tax benefits. So purchasing it by the end of 2011 may be worth considering. (To be a QSB, the company can't hold gross assets exceeding $50 million at the time the stock is issued and must be engaged in an active trade or business.)

AMT

The AMT is a separate tax system that limits some deductions and credits, doesn't permit others and treats certain income items differently. If your AMT liability is greater than your regular tax liability, you must pay the AMT.

Chart 3

Exemption "patches" provide temporary AMT relief

	AMT exemption		
	Single or Head of household	**Married filing jointly or surviving spouse**	**Married filing separately**
Without patch	$33,750	$45,000	$22,500
2010 patch	$47,450	$72,450	$36,225
2011 patch	$48,450	$74,450	$37,225

Note: *Consult your tax advisor for AMT exemptions for children subject to the "kiddie tax."*

Unlike the regular tax system, the AMT system isn't regularly adjusted for inflation. Instead, Congress must legislate any adjustments. Typically, it has done so in the form of a "patch" — an increase in the AMT exemption. The 2010 Tax Relief act establishes patches for 2010 and 2011. (See Chart 3 above.)

For 2010 and 2011, the Tax Relief act also allows you to offset your AMT liability with certain nonrefundable personal credits (such as the dependent care credit and certain energy-related credits) you're otherwise eligible for.

You may be able to time income and deductions to avoid the AMT or reduce its impact. Unfortunately, planning for the AMT will continue to be a challenge until it's known whether Congress will provide patches beyond 2011 (or provide longer term relief). Talk to your tax advisor to determine the best strategy for your situation.

Itemized deduction and personal exemption phaseouts

The 2001 tax act reduced the adjusted gross income (AGI)-based reductions on itemized deductions and personal exemptions for 2006 through 2009 and eliminated them for 2010. The 2010 Tax Relief act extends this elimination through 2012.

Accelerating deductible expenses into the current tax year is often a smart strategy, because it defers tax. And it's even more powerful when you're not subject to the AGI-based reduction. So you may want to consider it for 2011. But beware of the AMT.

If you're normally subject to the personal exemption limit and in recent years have forgone the partial exemption available to you so that one or more of your children could take advantage of an education-related tax credit, consider revisiting this strategy to see if it will still provide the most tax savings overall for your family.

Deduction for state and local sales taxes

For the last several years, taxpayers have been allowed to take an itemized deduction for state and local *sales* taxes in lieu of state and local *income* taxes. This break can be valuable to those residing in states with no or low income tax rates or who purchase major items, such as a car or boat. But this break expired after 2009.

Now the 2010 Tax Relief act has extended it for 2010 and 2011 (but not for 2012). If you're contemplating a major purchase, you may want to make it in 2011 to ensure the sales tax deduction is available.

Charitable giving breaks extended

The 2010 Tax Relief act extends some valuable charitable giving breaks through 2011:

1. Tax-free IRA distributions for charitable purposes. If you're age 70½ or older, you can make a direct contribution from your IRA to a qualified charitable organization without owing any income tax on the distribution. The contribution can be used to satisfy the required minimum distribution requirement. The maximum allowable distribution for charitable contribution purposes is $100,000 per tax year.

2. Contributions of capital gains real property for conservation purposes. You can make such a contribution and take a larger deduction than is allowed for most other capital gains property contributions. Specifically, your deduction for a contribution of capital gains real property for conservation purposes generally can be up to 50% of your adjusted gross income (AGI) rather than the 30% of AGI limit that normally applies to contributions of capital gains property.

3. Inventory donations. Enhanced deductions are available for certain inventory donations:

- Food inventory,
- Book inventory to public schools, and
- Computer inventory for educational purposes.

The rules are complex and vary for each type of donation, so talk to your tax advisor to determine whether you're eligible for an enhanced deduction.

Breaks related to children and education

Several breaks have been extended, but be aware that the benefit of many of them is phased out if a taxpayer's income exceeds certain limits:

- Extension of the $1,000 child credit and other enhancements of the credit through 2012.
- Extension of the higher adoption credit and the higher income exclusion for employer-provided adoption assistance through 2012.
- Extension of the higher dependent care credit through 2012.
- Extension of the American Opportunity education credit (an enhanced version of the Hope credit) through 2012.
- Extension of the above-the-line tuition and fees deduction — through 2011 only.
- Extension of the enhancements to the student loan interest deduction through 2012.
- Extension of the income exclusion for employer-provided education assistance through 2012.
- Extension of the $2,000 Coverdell Education Savings Account contribution limit and other enhancements through 2012.

Your tax advisor can help you determine which breaks you or your children may qualify for.

Businesses

The Tax Relief act also extends and enhances many breaks for businesses. In particular, it provides incentives for businesses to invest in assets, research and people.

Bonus depreciation

The Tax Relief act significantly enhances bonus depreciation — temporarily — by increasing this additional first-year depreciation allowance to 100% and providing a 50% allowance for 2012. The SBJA had previously extended 50% bonus depreciation to 2010. (See Chart 4 on page 5 for an overview of bonus depreciation amounts.)

Qualified assets include *new* tangible property with a recovery period of 20 years or less (such as office furniture and equipment), off-the-shelf computer software, water utility property and qualified leasehold-improvement property.

The Tax Relief act also extends the provision allowing corporations to accelerate certain credits in lieu of claiming bonus depreciation for qualified assets placed in service through Dec. 31, 2012 (Dec. 31, 2013, for certain long-lived and transportation property).

If you made asset purchases that might qualify for 100% bonus depreciation on your 2010 tax return, be sure to discuss them with your tax advisor. And if you're anticipating major asset purchases in the next year or two, you may want to time them so you can benefit from 100% bonus depreciation.

Chart 4
Bonus depreciation's rise and fall

Qualified assets placed in service	Bonus depreciation
Jan. 1, 2010, through Sept. 8, 2010	50%
Sept. 9, 2010, through Dec. 31, 2011	100%
Jan. 1, 2012, through Dec. 31, 2012	50%
After Dec. 31, 2012	none

Note: *Later deadlines apply to certain long-lived and transportation property.*

Sec. 179 expensing

Section 179 is another tax law provision that encourages investment. It allows smaller businesses to immediately write off the full price of qualifying asset purchases rather than depreciating them over several years. The deduction is reduced by $1 for every $1 of expenses in excess of a phaseout threshold, which is why the break primarily benefits smaller businesses. The expensing election can be claimed only to offset net income, not to reduce net income below zero.

Before the 2010 Tax Relief act, the Sec. 179 expensing limit was scheduled to drop to $25,000 in 2012, with a phaseout threshold of $200,000. The act increases the 2012 limits to $125,000 and $500,000, respectively, and both amounts will be indexed for inflation.

It's important to note, however, that these higher limits will be a significant drop from the 2010 and 2011 limits. Under the SBJA, the limits for assets placed in service in those years are $500,000 and $2 million, respectively.

Sec. 179 may be less important while 100% bonus depreciation is available. Depending on the type of asset, 100% bonus depreciation may provide the same tax savings — with no limit on asset purchases. But you'll also want to consider state tax consequences.

Leasehold-improvement, restaurant and retail-improvement property

For 2009, accelerated depreciation was available for qualified leasehold-improvement, restaurant and retail-improvement property. The 2010 Tax Relief act extends accelerated depreciation to 2010 and 2011. Specifically, the provision allows a shortened recovery period of 15 years — rather than 39 years — for such property.

If you made asset purchases that might qualify for accelerated depreciation on your 2010 tax return, be sure to discuss them with your tax advisor. And if you're considering making such investments, you may want to do so in 2011 to ensure you can take advantage of this break if it's not extended again.

Research credit

For many years, the research credit (also commonly referred to as the "research and development" or "research and experimentation" credit) has provided an incentive for businesses to invest in research. But the credit expired at the end of 2009.

The 2010 Tax Relief act extends the credit to 2010 and 2011. The credit is generally equal to a portion of qualified research expenses. It's complicated to calculate, but the tax savings can be substantial. So consult your tax advisor.

Energy-related breaks extended

The 2010 Tax Relief act extends certain energy-related incentives. While most are typically applicable to either home builders or manufacturers of energy-efficient appliances, there are some that are more generally applicable.

Nonbusiness energy credits that were set to expire at the end of 2010 have been extended — and modified — through 2011. So if, for example, you weren't able to install energy-efficient windows and doors by the Dec. 31, 2010, deadline you may still be able to get a tax credit.

Further, certain qualified energy-saving projects may be eligible for government grants in lieu of tax credits. This will allow you to recoup the cost of such an investment more quickly than if you had to wait until filing your income tax return for the year.

Work Opportunity credit

The Work Opportunity credit, designed to encourage hiring from certain disadvantaged groups, was scheduled to expire after Aug. 31, 2011. The 2010 Tax Relief act extends the credit to qualifying hires made through Dec. 31, 2011.

Examples of disadvantaged groups for purposes of the credit include food stamp recipients, disabled veterans and ex-felons. The credit generally equals 40% of the first $6,000 of wages paid to qualifying employees ($12,000 for wages paid to qualified veterans).

If you're considering making new hires, and workers from one or more of these disadvantaged groups might meet your needs, making the hires before the end of 2011 may be beneficial from a tax perspective.

Transit benefits

Some fringe benefits aren't included in an employee's wages for income and payroll tax purposes, yet the employer is still allowed to deduct them. Until recently, the maximum transit benefit that could receive such treatment was higher for parking than for van-pooling and mass transit. Tax legislation in 2009, however, provided for the limits to be equal through 2010.

The 2010 Tax Relief act extends this parity through 2011. For 2011, the limit is $230 per month, the same as for 2010. If you offer transit benefits, keep this in mind for your 2011 program.

Other business breaks

The act also extends through 2011 many other breaks for businesses that had expired after 2009. These breaks generally are too limited in applicability to cover here, but they can provide significant benefits to the taxpayers that qualify for them.

Estate planning

There's been much speculation as to what Congress would do about the 2010 estate tax repeal and the scheduled 2011 return of the tax at higher rates and a lower exemption. The Tax Relief act has finally given us our answer.

Rather than simply extending the 2009 rates and exemptions, as many expected Congress would do, the act reduces rates and increases exemptions. (See Chart 5 on page 7.) It also provides some flexibility for the families of people who died in 2010. But the outlook isn't completely rosy. The act provides only temporary relief, so we again face the prospect of higher rates and lower exemptions in the near future.

Here's a closer look at some of the specifics.

Estate tax

The act retroactively brings back the estate tax for 2010, but with a $1.5 million exemption increase (to $5 million) and a 10 percentage point rate reduction (to 35%) compared to 2009.

It extends these levels to 2011 and 2012, with an inflation adjustment on the exemption for the latter year. Then in 2013 the exemption and top rate will return to levels prescribed by pre-2001 tax law — the levels that would have gone into effect in 2011 without the 2010 Tax Relief act.

While what for 2010 is essentially a repeal of the estate tax repeal may sound unattractive, it actually may prove beneficial to many families with loved ones who died in 2010. This is because the estate tax repeal was accompanied by a limit on the step-up in basis, which could have caused many heirs to face significant income tax liability on the sale of the inherited assets.

Still, for some families the step-up in basis is less of an issue than the estate tax. So the Tax Relief act provides an option to elect the pre-act estate tax regime for 2010. (See "Election for 2010" on page 7.)

Chart 5

Transfer tax exemptions and rates for 2009–2013

	2009	2010	2011	2012	2013
Gift tax exemption	$ 1 million	$ 1 million	$ 5 million	$ 5 million[2]	$ 1 million
Estate tax exemption[1]	$3.5 million	$ 5 million[3]	$ 5 million	$ 5 million[2]	$ 1 million
GST tax exemption	$3.5 million	$ 5 million	$ 5 million	$ 5 million[2]	$ 1 million[2]
Highest estate and gift tax rates and GST rate	45%	35%[3] (0% GST tax)	35%	35%	55%[4]

[1] *Less any gift tax exemption already used during life. For 2011 and 2012, these amounts are "portable" between spouses.*
[2] *Indexed for inflation.*
[3] *Estates can elect to follow the pre–Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 regime (estate tax repeal + limited step-up in basis).*
[4] *The benefits of the graduated gift and estate tax rates and exemptions are phased out for gifts/estates over $10 million.*
Source: *U.S. Internal Revenue Code*

GST tax

The generation-skipping transfer (GST) tax was also repealed for 2010, and the Tax Relief act brings it back for 2010 as well, with the same exemption amounts as the estate tax through 2012. However, the act sets the GST tax rate for 2010 at 0%.

This is probably because, unlike the estate tax, where the elimination of the step-up in basis limitation could be provided to essentially offset liability from the return of the estate tax, there was no such offset that could make up for tax liability due to the return of the GST tax in 2010. Such a retroactive tax would likely have brought lawsuits.

That's not an issue after 2010, so the GST tax rate goes back up to 35% to match the top estate tax rate in 2011 and 2012.

If you can afford to do so without compromising your own financial well-being, you may want to consider maxing out your GST exemption by the end of 2012 to take full advantage of the $5 million exemption while it's available.

Gift tax

The gift tax was never repealed for 2010, so the 2010 Tax Relief act provides no change to the gift tax regime for 2010. The exemption remains at $1 million and the top rate at 35%.

But, like the GST tax, the gift tax will follow the estate tax exemptions and top rates for 2011 and 2012.

As with the GST tax exemption, you may want to consider maxing out your gift tax exemption by the end of 2012 to take full advantage of the $5 million exemption while it's available — again, if you can afford to do so without compromising your own financial well-being. An added advantage is that this also removes from your taxable estate any future appreciation on the transferred assets.

Time to review your estate plan

With the many changes going into effect and the uncertainty about what will happen with the estate, generation-skipping transfer and gift taxes in 2013, it's critical to revisit your estate plan. If you don't, the changes could result in your assets not being distributed according to your wishes or your family paying unnecessary taxes.

Election for 2010

As already mentioned, for anyone who died in 2010, the estate may either follow the new rules under the 2010 Tax Relief act or elect to follow the pre-act regime.

First some background on step-up in basis:

- Generally, the income tax basis of most inherited property is "stepped up" to its date-of-death fair market value. This means that recipients of the property can sell it immediately without triggering capital gains tax. Even if they hold on to it, they typically will pay less capital gains tax whenever they do sell it than they would have if the basis hadn't been stepped up.
- Under the estate tax repeal, the automatic step-up in basis is eliminated. Instead, estates can generally allocate only up to $1.3 million to increase the basis of certain assets plus up to $3 million to increase the assets inherited by a surviving spouse.

So, if the estate of someone who died in 2010 doesn't exceed the new $5 million exemption (less any gift tax exemption used during life), then following the new rules will likely be more beneficial: No estate tax will be due anyway, and the deceased's heirs don't have to worry about any limits on the step-up in basis.

If the estate exceeds the deceased's available estate tax exemption, the decision becomes more complicated. Factors such as the extent of the possible estate tax liability, the extent to which assets have appreciated beyond the deceased's basis and the extent to which the assets are going to a surviving spouse vs. other heirs will need to be considered.

Fortunately, the Tax Relief act does give families some time to make this decision. It extends the estate tax filing deadline for estates of those dying after Dec. 31, 2009, but before Dec. 17, 2010, generally to nine months after Dec. 17, 2010.

Portability for married couples

The 2010 Tax Relief act includes a provision that will — temporarily — provide significant estate planning flexibility to married couples. If one spouse dies in 2011 or 2012 and part (or all) of his or her estate tax exemption is unused at his or her death, the estate can elect to permit the surviving spouse to use the deceased spouse's remaining estate tax exemption.

Similar results can be achieved by making asset transfers between spouses during life and/or setting up certain trusts. But making this election will be much simpler and, if proper planning hasn't been done before the first spouse's death, the election may provide needed flexibility.

Still, this election is currently available for only two years unless Congress extends it. So married couples can't depend on the election being available to ensure that they take full advantage of both spouses' exemptions.

Also be aware that the provision doesn't allow the deceased spouse's remaining GST tax exemption to be used by the surviving spouse.

Ongoing change requires ongoing planning

The changes under the 2010 Tax Relief act affect many areas of planning. Complicating matters is the fact that most of the breaks expire after 2011 or 2012. Because many strategies require considering not just the current year but future years as well, this means planning will continue to be a challenge.

There also are recently expired or soon-to-expire tax breaks that the act didn't address — see "What the act *didn't* extend," below. Congress may extend one or more of these provisions in 2011. In addition, tax reform is on the agenda for 2011.

Changes in your personal situation may also require a change in tax planning strategies. Births, deaths, marriages and divorces can all have an impact. So can changes in your personal finances or your business.

So to ensure that you minimize your tax liability, your tax planning needs to be an ongoing activity, not just a year-end one. Consult your tax advisor about how the Tax Relief act and other changes affect your planning. ◆

What the act *didn't* extend

Here are a few expired or expiring tax breaks that the Tax Relief act *didn't* extend:

The homebuyers credit. If you purchased a home before May 1, 2010 (Oct. 1, 2010, if a binding contract was in place before May 1), you may be eligible for a credit as a "first-time" homebuyer or "long-time" homeowner. But income-based phaseouts apply. (For certain active military and other foreign service personnel, the deadline is a year later.)

The expanded definition of "qualified expenses" for Section 529 college savings plans. Plan distributions used to pay qualified expenses — such as tuition, mandatory fees, books, equipment, supplies and, generally, room and board — are income-tax free for federal purposes and may be tax free for state purposes. Through 2010, the definition also includes computers, computer technology and Internet service.

The payroll tax forgiveness provided under the Hiring Incentives to Restore Employment (HIRE) Act of 2010. This break expired Dec. 31, 2010. But remember that, if you hired workers in 2010 who qualified for payroll tax forgiveness, you may be eligible for a retention credit of up to $1,000 per retained worker on your 2011 tax return.

The Small Business Jobs Act of 2010 (SBJA) provision that expanded the types of assets that qualify for Section 179 expensing. Under the SBJA, up to $250,000 of certain leasehold-improvement, restaurant and retail-improvement property placed in service in 2010 or 2011 is eligible for Sec. 179 expensing.