Congress Has Gifts for Everyone

Bipartisan Compromise Prevents 2011 Tax Hike

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After months of political inaction, countless hours of debate, threats, cajoling and a special post-election Congressional session, the Senate and the House of Representatives have approved, and the President has signed, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010.

The new act provides an $801 billion package of tax cuts and $57 billion for extended unemployment insurance.

To garner the votes necessary to secure passage, this late-year legislative creation became the epitome of a “Christmas tree bill.” December negotiations between the President and Congressional leaders resulted in the addition of several provisions that were added to secure the votes necessary for passage.

One of the major benefits of the act is that it gives taxpayers and their advisers a degree of certainty, at least for the next two years.

While the vast majority of the tax changes are discussed here, not everything is covered. Many of the new rules are complex, and this description is necessarily brief. Consult your tax adviser before acting on any of these new provisions.

The various provisions of the act can be divided into four major themes:

1. Extension of tax provisions set to expire Dec. 31, 2010 (or in some cases, provisions that expired Dec. 31, 2009)
2. Reinstatement of the estate tax
3. Individual and business tax incentives
4. Extension of unemployment benefits for an additional 13 months for the long-term unemployed

This issue of *Strategies*™ covers the first three items.

EXTENSION OF EXPIRING PROVISIONS

Tax rate brackets

Since 2001, individual income tax rate brackets have been set at 10 percent, 15 percent, 25 percent, 28 percent, 33 percent and 35 percent. Effective Jan. 1, 2011, these brackets were scheduled to change to 15, 28, 31, 36 and 39.6 percent. The new law keeps the existing brackets in place through Dec. 31, 2012.

The tax rate schedules for 2011, adjusted for inflation, will be as follows:

2011	SCHEDULE X: Single Individuals						
Taxable Income							
Over	But not over		Pay	+	Percent on excess		Of amount over
$ 0	$ 8,500		$ 0		10%		$ 0
8,500	34,500		850.00		15		8,500
34,500	83,600		4,750.00		25		34,500
83,600	174,400		17,025.00		28		83,600
174,400	379,150		42,449.00		33		174,400
379,150	. . . .		110,016.50		35		379,150

2011	SCHEDULE Y: Married Filing Jointly and Surviving Spouses						
Taxable Income							
Over	But not over		Pay	+	Percent on excess		Of amount over
$ 0	$17,000		$ 0		10%		$ 0
17,000	69,000		1,700.00		15		17,000
69,000	139,350		9,500.00		25		69,000
139,350	212,300		27,087.50		28		139,350
212,300	379,150		47,513.50		33		212,300
379,150	. . . .		102,574.00		35		379,150

Standard deduction

The standard deduction amounts for 2011 will be:

Filing Status	Standard Deduction
Unmarried	$ 5,800
Married filing jointly	11,600
Surviving spouse	11,600
Married filing separately	5,800
Head of household	8,500

Those who are age 65 or older by Dec. 31, 2011, or are legally blind, are entitled to an additional standard deduction of $1,100 ($1,400 for single individuals and heads of household). Those who are both age 65 and blind are entitled to two additional amounts. Note that on a joint return, both spouses may qualify for the additional amounts.

The standard deduction may also be increased by the following:

- The amount of state and local real estate taxes, up to a maximum increase of $500 ($1,000 on a joint return)
- The amount of a net disaster loss incurred in a federally declared disaster area

No loss of exemption or itemized deduction for high-income taxpayers

The limitations that reduced itemized deductions and reduced or eliminated the exemption deduction for higher-income individuals ceased to apply in 2010 but were scheduled to return in 2011. Now these limitations will not apply for 2011 and 2012.

The personal exemption amount for 2010 is $3,650 and is expected to rise to $3,700 for 2011.

Capital gains and qualified dividends

For 2011 and 2012, most long-term capital gains will continue to be taxed at a maximum rate of 15 percent. The 0 percent rate continues for those in the 10 and 15 percent brackets, and the 25 and 28 percent rates continue to apply to certain types of capital gains.

During 2011 and 2012, qualified dividends paid to individuals will continue to be taxed at the same 15 percent (or 0 percent) tax rate that applies to capital gains.

The 100 percent exclusion for gains realized from the sale of small business stock – other than stock in S corporations – acquired after Sept. 27, 2010, and held for more than five years is extended to stock acquired before Jan. 1, 2012.

The act also extends the following provisions for two years:

- Qualified dividend status for dividends from regulated investment companies (mutual funds, or RICs)
- Qualified dividend status for dividends from real estate investment trusts (REITs)

AMT 'patched' for 2010 and 2011

The Alternative Minimum Tax (AMT) exemption amounts for 2010 and 2011 will be as follows:

Filing Status	2010 Exemption Amount	Zero Exemption Income Level
Married filing joint and surviving spouse	$72,450, less 25% of AMTI over $150,000	$ 439,800
Unmarried	$47,450, less 25% of AMTI over $112,500	$ 302,300
Married filing separately	$36,225, less 25% of AMTI over $75,000	$ 219,900

Filing Status	**2011 Exemption Amount**	**Zero Exemption Income Level**
Married filing joint and surviving spouse	$74,450, less 25% of AMTI over $150,000	$ 447,800
Unmarried	$48,450, less 25% of AMTI over $112,500	$ 306,300
Married filing separately	$37,225, less 25% of AMTI over $75,000	$ 223,900

Also for 2010 and 2011, many nonrefundable personal tax credits will be allowed to offset the AMT.

Charitable contributions from IRAs

For 2010 and 2011, those over age 70½ will be able to make charitable contributions from their IRA without the need to include the distribution in income and claiming a charitable contribution deduction. This popular provision had expired Dec. 31, 2009.

Since the reinstatement took place so late in the year, a special provision allows contributions made during January 2011 to be treated as having been made on Dec. 31, 2010.

Credit for energy-efficient improvements to existing homes

This credit, which was scheduled to expire after 2010, was available to individuals who made energy-efficient improvements to their residences by, for example, replacing furnaces, water heaters, windows and doors, or adding insulation. The maximum credit for 2009 and 2010 combined was $1,500.

The act extends the credit through 2011 but without a number of enhancements added in earlier legislation. The 2009 recovery act tripled what was a $500 credit and provided that previous sub-caps would not apply. These enhancements are not renewed for 2011.

Adoption credit

Those who incur qualified adoption expenses may be eligible for the adoption credit or, in the case of employer-provided assistance, an exclusion from income. The act extends the provisions raising the credit/exclusion amount to $10,000 adjusted for inflation through Dec. 31, 2012.

However, the provision of the Patient Protection and Affordable Care Act that increased the amount by another $1,000 adjusted for inflation and made the credit refundable was not extended by the act. The patient protection act enhancements will expire Dec. 31, 2011.

For 2010, the maximum credit/exclusion is $13,170. That amount will be adjusted for inflation for 2011. And the credit will not be refundable after 2011.

Other provisions affecting individuals

The following provisions, which expired Dec. 31, 2009, are reinstated for 2010 and 2011:

- The $250 above-the-line deduction for certain expenses of elementary and secondary school teachers
- The election to claim an itemized deduction for state and local sales taxes in lieu of the itemized deduction for state and local income taxes
- Increased contribution limits and carryforward period for contributions of appreciated real property (including partial interests) for conservation purposes
- Above-the-line deduction for qualified tuition and related expenses
- Increased monthly exclusion for employer-provided transit and van pool benefits to the amount of the exclusion for employer-provided parking benefits

The following provisions, which were scheduled to expire Dec. 31, 2010, are extended through 2012:

- American Opportunity Tax Credit that allows a credit for qualified education expenses paid during all four years of postsecondary education
- Various enhancements made to Coverdell Education Savings Accounts, formerly called education IRAs
- Exclusion of up to $5,250 for employer-provided education assistance, including tuition assistance for graduate school
- Exemption from the payments-in-services rule for amounts received under certain government health professions scholarship programs
- Various enhancements made to the $2,500 above-the-line student loan interest deduction
- Credit for employer-provided child care facilities
- Various enhancements made to the earned income tax credit in recent years
- Enhancements allowing a credit of up to $2,100 for household and dependent care expenses for children under the age of 13 and incapacitated dependents and spouses
- Tax credit of $1,000 per child under the age of 17

The following provision, which was scheduled to expire Dec. 31, 2010, is extended through 2011:

- Rule allowing premiums for mortgage insurance to be deductible as interest that is qualified residence interest

Extension of expiring business provisions

A number of business tax breaks expired at the end of 2009. The following are reinstated and extended through 2011:

- The research credit
- The new markets tax credit
- The employer wage credit for activated reservists

- The 15-year write-off for qualified leasehold improvements, restaurant buildings and improvements and retail improvements
- The 7-year write-off for motorsports entertainment facilities
- The enhanced charitable deductions for contributions of food inventory and book inventories to public schools and corporate contributions of computer equipment for educational purposes
- The expense election for environmental remediation costs
- The availability of the domestic production activities deduction for activities in Puerto Rico

The Work Opportunity Tax Credit was scheduled to expire Aug. 31, 2011. The act extends the credit to employees who begin employment before Jan. 1, 2012. However, the extension does not apply to employees in the two new targeted groups added in 2009 – unemployed veterans and disconnected youth.

Extension of expiring energy-related provisions

The list of energy-related provisions extended through 2011 includes:

- $1 per gallon production tax credit for biodiesel
- Small agri-biodiesel producer credit of 10 cents per gallon
- $1 per gallon production tax credit for diesel fuel created from biomass
- Placed-in-service deadline for qualifying refined coal facilities
- Credit for manufacturers of energy-efficient residential homes
- 50-cent-per-gallon alternative fuel tax credit, although not extended for any liquid fuel derived from a pulp or paper manufacturing process
- Suspension of the taxable income limit for purposes of depleting a marginal oil or gas well
- Credit for U.S.-based manufacture of energy-efficient clothes washers, dishwashers and refrigerators, although the standards have been modified
- 30 percent investment tax credit for alternative vehicle refueling property

Extension of disaster relief provisions

The list of disaster relief provisions extended through 2011 includes:

- Time for issuing New York Liberty Zone bonds, effective for bonds issued after Dec. 31, 2009
- Increased rehabilitation credit for qualified expenditures in the Gulf Opportunity Zone
- Additional depreciation deduction claimed by businesses equal to 50 percent of the cost of new property investments made in the Gulf Opportunity Zone, with expenditures in 2011 eligible if the property is placed in service by Dec. 31, 2011

ESTATE TAX

Over the past several years, the estate tax and the generation-skipping tax (GST) have been gradually reduced until they were repealed for 2010. In 2010, the maximum gift tax rate was 35 percent, with a $1 million lifetime exemption.

In addition, for 2010, the basis rules for inherited property were similar to the gift tax rules (carryover basis), with many exceptions.

Under the new act, the estate tax and GST that come into effect on Jan. 1, 2011, will have a $5 million exemption that is indexed for inflation after 2011 and a top tax rate of 35 percent. Inherited assets will receive stepped-up basis.

With proper planning, married couples will be able to entirely avoid the estate tax for combined estates aggregating $10 million. The estate tax exemption has been made portable. For deaths after Dec. 31, 2010, the executor will be able to transfer the unused portion of the exemption to the surviving spouse.

For gifts made after Dec. 31, 2010, the gift tax calculation and the estate tax calculation are re-unified. So, the top gift tax rate will be 35 percent, with a $5 million exclusion. The annual gift tax exclusion is expected to remain at $13,000 for 2011.

Most people will need to review their estate plans and gifting strategies in light of this new legislation.

Special rules for 2010

To deal with the highly publicized estates of wealthy individuals who died during 2010, the act offers a choice:

1. No estate tax, with modified carryover basis for inherited assets
2. The estate tax in effect for 2011, with step-up in basis for inherited assets

Technically, the act makes the new estate tax rules effective Jan. 1, 2010, but allows the estates of decedents who died in 2010 to opt out.

Similarly, the GST changes are effective Jan. 1, 2010, but with a 0 percent GST rate. So, up to a $5 million GST exemption may be allocated to a trust created or funded during 2010. The GST tax rate for transfers made in 2010, 2011 and 2012 will be 0 percent, 35 percent, and 35 percent, respectively.

Estate tax returns for decedents dying during 2010 are not due before Sept. 17, 2011.

INDIVIDUAL AND BUSINESS TAX INCENTIVES

Temporary employee/self-employed payroll tax cut for 2011

For 2011 only, the new act reduces the Social Security tax on employees, which will result in a higher take-home pay. The act similarly reduces the Social Security tax paid by self-employed individuals. But since the self-employed pay their Social Security tax either through quarterly estimates or with their income tax, the effect of this tax cut is not as immediate as it is for employees.

Under current law, employees would have paid a 6.2 percent Social Security tax on all wages earned up to $106,800 in 2011, and self-employed individuals would have paid 12.4 percent of all their self-employment income up to the same threshold. The act provides a 2-percentage-point payroll/self-employment tax holiday for everyone subject to the Social Security tax.

As a result, employees will pay 4.2 percent Social Security tax on wages, and self-employed individuals will pay 10.4 percent on self-employment income, up to $106,800.

For those earning more than $106,800, the maximum savings for 2011 will be $2,136. Some public employees and others who do not pay into Social Security will not benefit from the payroll tax cut.

Note that this tax holiday applies only to the employee’s portion of the Social Security tax. Employers will have to “match” the full amount of the employee’s tax.

The payroll tax forgiveness provided to employers under the Hiring Incentives to Restore Employment (HIRE) Act expires Dec. 31, 2010. This provision was not extended by the act.

To estimate the tax savings per pay period, check the amount of Social Security – but not Medicare tax – withheld from the last paycheck, and multiply the amount by 32 percent. For those who earn more than $106,800, the Social Security withholding has already stopped for 2010 but it will begin again in 2011.

Incentives for businesses to invest in machinery and equipment

The new act adds new incentives for businesses to invest in machinery and equipment:

- The bonus first-year depreciation percentage is increased from 50 percent to 100 percent for qualifying property, including machinery and equipment acquired and placed in service after Sept. 8, 2010, and before Jan. 1, 2012.
- The 50 percent bonus first-year depreciation allowance is extended an additional year for eligible property placed in service after Dec. 31, 2011, and before Jan. 1, 2013. To qualify, the property must be new and must either:
  - Have an applicable MACRS recovery period of 20 years or less
  - Be water utility property
  - Be computer software not covered by the Section 197 amortization rules
  - Be qualified leasehold improvement property
- The election to accelerate the AMT credit instead of claiming additional first-year depreciation is extended through Dec. 31, 2012.
- For tax years beginning after Dec. 31, 2011, the maximum expensing amount under Section 179 will be $125,000 and the investment-based phaseout amount will be $500,000. For 2010 and 2011, the figures are $500,000/$2 million. They had been scheduled to drop to $25,000/$200,000 after 2011.
- Off-the-shelf computer software will qualify for the Section 179 expensing election if placed in service in a tax year beginning before Jan. 1, 2013.

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