The Tax Relief Act of 2010 – Finally!

By Christopher J. Loughran

Overview

After much anticipation, the Tax Relief Act of 2010 (the Act) was signed into law by President Obama on December 17, 2010. The most widely reported items included in the Act were the two year extension of existing income tax rates through December 31, 2012, and the implementation of an estate and gift tax regime for 2011 and 2012 that is more favorable than what would have kicked in effective January 1, 2011. Some of the other important features of the legislation are: enhanced bonus depreciation and expensing elections; extension of the research credit; a two year alternative minimum tax (AMT) patch; and the temporary extension of many other tax benefits. We have provided some detail for the key provisions below.

Tax Rate Extensions

The current tax rates, which would have automatically increased effective January 1, are now extended through the end of 2012. The essence of this change is a retention of a top tax rate on ordinary income of 35 percent (rather than a change to 39.6 percent); retention of the maximum rate on qualified dividends of 15 percent (rather than being taxed at the ordinary income rate); and retention of the maximum rate on long-term capital gains of 15 percent (rather than escalation to 20 percent). The can is essentially kicked down the road for two years, as the rates increase in 2013 unless additional extension legislation is enacted.

The personal exemption and itemized deduction phase-out rules (which acted as hidden rate increases) for higher income taxpayers were already fully eliminated with respect to the 2010 tax year, but would have been reinstated without extension legislation. The Act retains the beneficial elimination of these phase-out rules, but only for 2011 and 2012.

Estate and Gift Tax Changes

Although few observers would have expected it, Congress failed to act earlier, allowing the estate tax to lapse entirely for 2010. If not for the Act, it would have been automatically reinstated in 2011 with a top rate of 55 percent and an exemption amount of only $1 million ($2 million per couple). Under the Act, the estate tax rate for 2011 and 2012 is 35 percent, and the exemption is $5 million ($10 million per married couple) for 2011 and is indexed for inflation in 2012. As with the income tax changes, these changes are not permanent and will require further legislation before 2013 to prevent reversion to higher rates and lower exemption amounts.

The new law allows heirs of decedents (via estate executor election) who died in 2010 to choose whether to use the existing law for 2010 (no estate tax, combined with modified carryover basis on inherited assets), or to apply the 2011 law to 2010 (heirs obtain assets with tax basis stepped up to current fair market value, but the estate is taxable under 2011 rates and exemptions). The optimal decision can be complex depending on the specific facts of each estate.

The Act provides for the first time "portability" of the estate exemption. This means that the surviving spouse can increase their exemption amount by the unused portion of the $5 million exemption from the deceased spouse. The portability provision is effective for estates of decedents dying after 2010.

Gifts made during 2010 are subject to a lifetime exemption of $1 million. For gifts made after 2010, the gift and estate tax regimes are reunified, so that the 2011 $5 million estate tax exemption will also apply for gift and generation skipping transfer (GST) tax purposes. The 35 percent rate for estates will also apply in 2011 and 2012 for gift and GST tax purposes.

For Oregon decedents, note that the Oregon estate tax exemption remains at $1 million for 2010 and later years. Therefore, smaller estates may require estate tax planning or return filing only for Oregon purposes.

Bonus Depreciation and Expensing Provisions

The Act allows 100 percent bonus depreciation for all new (first use commencing with taxpayer) business equipment placed in service from September 9, 2010 to December 31, 2011. Bonus depreciation of 50 percent applies to qualifying assets placed in service earlier in 2010 (September 8, 2010 and prior), and for 2012. Qualifying property generally includes: depreciable property with a recovery period of 20 years or less; water utility property; computer software; and qualified leasehold improvements.

As amended by the Act, the section 179 expensing rules apply as follows for new or used personal property and off-the-shelf computer software acquired for a trade or business: for 2010 and 2011 the maximum amount of depreciable personal property that can be expensed is limited to $500,000, with a $2 million phase-out level (qualifying assets acquired in excess of the phase-out level reduce the maximum expense allowance dollar for dollar); for 2012 the maximum write off is $125,000, with a phase-out level of $500,000 (both amounts indexed for inflation). The Act also extends through 2012 the ability to amend or revoke a section 179 election without consent from the IRS. The Act did not extend to 2012 the special provision that continues to apply for 2010 and 2011 whereby up to $250,000 of "qualified real property" can be included in the section 179 maximum cost expensed.

Oregon taxpayer – keep in mind that Oregon disconnected from both bonus depreciation and increased section 179 limits for 2009 and future years. Bonus depreciation is no longer allowed for Oregon tax purposes, and the minimum section 179 limit is $133,000 for 2010 and 2011.

Other Business and Individual Extenders

These benefits were retroactively enacted for 2010 (if expired at the end of 2009) and through the end of 2011 by the Act:

- The research credit;
- The 15 year recovery period for qualified leasehold improvements and restaurant buildings and certain improvements thereto;
- Expensing of environmental remediation costs;
- The ability to exclude 100 percent of the gain on certain small business stock;
- The ability of individuals to elect to deduct sales taxes in lieu of itemized deductions for state and local income taxes;
- The above the line deduction of $250 for elementary and secondary school teacher expenses;
- The ability to make tax-free distributions to charity of up to $100,000 from individual retirement accounts (note the special rule for taxpayers 70 ½ or older, who can elect to have a tax-free distribution from an IRA to public charities in January 2011 count against their 2010 $100,000 limit and count toward their 2010 minimum distribution requirement);
- The ability to deduct mortgage insurance premiums as qualified residence interest;
- The credits for energy efficient appliances and energy efficiency existing home improvements.

Payroll Tax Cut

The Act includes a two percentage point reduction in payroll taxes for 2011. The Social Security tax withholding on wages in 2011 is reduced to 4.2 percent from the normal 6.2 percent. The self-employment tax rate is also reduced in 2011 to 10.4 percent (from 12.4 percent). There is no phase-out, but since Social Security taxes only apply to the first $106,800 of earnings in 2011, the maximum savings for a wage earner in 2011 is $2,136 ($4,272 for a two-earner household). The reduction only applies to the employee's share of FICA/Social Security withholding; the employer share must still be calculated using 6.2

percent. This provision by itself has no impact on an individual employee's projected Social Security benefits since they are based on lifetime earnings, not FICA tax withheld.

Individual Alternative Minimum Tax "Patch"

The Act implements a two year AMT "patch" for 2010 and 2011, which includes increasing the AMT exemption levels from 2009 slightly and allowing personal credits (such as the dependent care credit) to offset AMT. For tax years beginning in 2010, the AMT exemption amounts are increased to $72,450 for jointly filing couples and surviving spouses; $47,450 for unmarried individuals (other than surviving spouses); and $36,225 for married individuals filing separately. For tax years beginning in 2011, these amounts are increased to $74,450, $48,450, and $37,225, respectively.

Research Credit

The research credit would have expired effective December 31, 2009. The Act retroactively extends the research credit for any amounts paid or incurred after December 31, 2009 and through December 31, 2011.

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