ALERTS AND UPDATES

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010

December 27, 2010

Last-Minute Year-End Tax Planning Possible with the Passage of the Long-Anticipated Legislation

On December 17, 2010, President Obama signed into law the greatly contested and debated Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the "Act"). The Act contains a multitude of new and extended tax breaks, including a two-year extension of the 2001 Bush-era tax cuts, a new 2% payroll tax reduction for 2011, a two-year patch of the alternative minimum tax (AMT), an extension of federal unemployment benefits, and estate tax relief. Below is a summary of the Act's key provisions, followed by quick-strike tax planning strategies.

New Provisions

Social Security Break for Employees

For 2011, the Social Security payroll tax on individual wages will be lowered by two percentage points, resulting in a tax savings of up to $2,136. For employees, the rate will move from 6.2% to 4.2%, and for self-employed individuals, the rate will be reduced from 12.4% to 10.4%. There is no reduction in the employer's share of Social Security tax, which will remain at 6.2%. The payroll tax reduction will not affect a worker's future Social Security benefits since such benefits are based on lifetime earnings, not the amount of taxes paid in.

Alternative Minimum Tax

The Alternative Minimum Tax (AMT) exemption limits have been on the verge of expiration so frequently that 2010 is not a unique event. Congress has once again relied on a temporary patch for 2010 and 2011. Under the new law, for tax years beginning in 2010, the AMT exemption amounts are increased to $72,450, $47,450 and $36,225 for married taxpayers filing jointly, single filers, and married taxpayers filing separately, respectively. For 2011, the amounts are increased to $74,450, $48,500, and $37,225, respectively. Without this patch, the government reports that more than 20 million taxpayers may have been hit with an AMT.

Unemployment Benefits

The Act secures an extension of unemployment insurance for an additional 13 months. According to the White House, without this extension, two million unemployed individuals would have lost their benefits in December and another seven million in 2011.

Estate and Gift Tax

The 2001 Act gradually reduced the estate tax each year until it was completely abolished for decedents dying in 2010. After a one-year hiatus, the estate tax will be reinstated in 2011 and 2012. The top rate is 35%, with an exemption amount of $5 million per individual for 2011, and indexed for inflation in 2012. Without the new legislation, the estate tax was scheduled to return in 2011, with a top rate of 55% and a $1 million exclusion.

The Act also gives donors a $5 million gift tax exemption, adjusted for inflation, for 2011 and 2012. The gift tax exemption remains at $1 million in 2010. The maximum gift tax rate will also be 35%.

See the *Alert*, "*Tax Relief Act of 2010: Year-End Planning and Beyond*," for a deeper discussion of the estate, gift and

GST tax provisions included in the Act.

Extended Provisions—Individual

Extended Tax Rates

Current tax brackets established under the 2001 tax cuts will remain in effect until January 1, 2013. Without an extension, beginning in 2011, the 10% bracket would cease to exist and taxpayers currently subject to it would have moved to the 15% bracket. Additionally, the top four tax brackets would have increased from 25%, 28%, 33% and 35% to 28%, 31%, 36% and 39.6%, respectively. Below is a chart summarizing Act rates in addition to the rates that could have been in existence but for the extension, along with corresponding levels of taxable income.

Individual Tax Brackets for 2011–2012

Single	*Married Filing Jointly*	*With Act*	*Without Act*
$0–$8,500	$0–$17,000	10%	15%
$8,501–$34,500	$17,001–$69,000	15%	15%
$34,501–$83,600	$69,001–$139,350	25%	28%
$83,601–$174,400	$139,351–$212,300	28%	31%
$174,401–$379,150	$212,301–$379,150	33%	36%
Over $379,150	Over $379,150	35%	39.6%

Capital Gains and Qualified Dividends

The maximum tax rate on long-term capital gains and qualified dividends will remain at 15% for most taxpayers and 0% for taxpayers in the 15% tax bracket or below. If this provision was allowed to expire, long-term capital gains would be taxed at a maximum 20%, with minor exceptions, and qualified dividends would have returned to being taxed at the taxpayer's marginal tax rate, up to 39.6%.

Capital Gains and Qualified Dividends Tax Rates for 2011–2012

.	*With Act*	*Without Act*
Long-Term Capital Gains—Top Rate	15%	20%
Long-Term Capital Gains—10% & 15% Brackets	0%	20%
Qualified Dividend Income—Top Rate	15%	39.6%

Itemized Deduction and Personal Exemption Phase-Outs Limits

The phase-out limits for itemized deductions and personal exemptions have been gradually reduced since 2001 and were completely eliminated in 2010. The new law will continue the elimination of the adjusted gross income (AGI) limits for itemized deductions and personal exemptions for two years.

Child Tax Credit

The 2001 Act doubled the child tax credit from $500 to $1,000, per qualifying child. It also made the credit allowable against the AMT tax. This credit will remain in effect for two more years under the new law and continues to be phased out for most taxpayers with AGI in excess of $110,000.

Child and Dependent Care Credit

This credit permits taxpayers who pay expenses for children under age 13 or for incapacitated dependents or spouses to claim a nonrefundable credit for a percentage of their dependent-care expenses that enable them to work. The 2001 Act increased the maximum percentage of the credit from 30% to 35%, and the maximum amount of the credit from $2,400 to $3,000, or $4,800 to $6,000 for families with two or more children. These maximum limits have been extended for an additional two years.

Marriage Penalty

Prior to 2001, a married couple filing jointly would pay more taxes than two single filers with the same income. This was known as the marriage penalty and was eliminated in 2001. The 2010 Act extends the elimination of the marriage penalty for two years.

Earned Income Credit

The American Recovery and Reinvestment Act of 2009 provided a temporary increase in the starting point for the phase-out range of the earned income tax credit for all married couples filing a joint return, regardless of the number of children. It also temporarily increased the credit for taxpayers with three or more qualifying children. These enhancements are now extended to cover 2011 and 2012.

Adoption Credit and Adoption Assistance Exclusion

Prior to 2001, there was a maximum adoption credit of $5,000 for a non-special needs child and $6,000 for a special needs child. The 2001 tax cuts increased the credit to $10,000 for both categories and indexed them for inflation. The Patient Protection and Affordable Care Act of 2010 increased the credit by another $1,000 for 2010 and 2011; and this new Act extends the enhancements further, through December 31, 2012.

American Opportunity Tax Credit

The 2009 Recovery Act expanded and renamed the Hope credit as the American Opportunity Tax Credit for 2009 and 2010. The 2010 Act extends the credit for another two years through 2012. It also extends the income phase-out ranges of modified AGI of $80,000 to 90,000 for individuals and $160,000 to 180,000 for married filing jointly.

Education Savings Accounts

The education savings account is a trust established to pay qualified education expenses of a designated beneficiary. The 2001 Act increased the annual contribution limit from $500 to $2,000, raised the AGI phase-out from $160,000 to $220,000 for married filers, and made contributions allowable from corporations, tax-exempt organizations and other entities.

It also expanded the definition of qualified expenses to include elementary and secondary costs and extended the deadline for contributions from December 31 of the contribution year to April 15 of the following year. All of these changes are extended through 2012 under the new Act.

Student Loan Interest Deduction

The 2001 Act made it possible for many more taxpayers to deduct student loan interest. It increased the maximum deduction from $2,000 to $2,500, raised the AGI phase-out ranges, and indexed them for inflation. From 2001 to 2010, the phase-out ranges increased from $55,000 to $75,000 for single filers and from $75,000 to $150,000 for joint filers. The 2010 Act extends the maximum deduction of $2,500 and continues to index the AGI limits for inflation through 2012.

Other Selective Individual Tax Breaks Retroactively Reinstated for 2010 and Extended Through 2011

- The election to claim 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 2011 and treat them as if made during 2010;
- The look-through rule for certain regulated investment company (RIC) stock in determining the gross estate of nonresidents; and
- The increase in the monthly exclusion for employer-provided transit and vanpool benefits to equal that of the exclusion for employer-provided parking benefits.

Extended Provisions—Business

Bonus Depreciation

The new law extends the bonus depreciation allowance provision from the Small Business Jobs Act of 2010 through tax year 2011 and increases the depreciation amount from 50% to a full 100%. It also extends the provision through 2012, with the bonus depreciation amount returning to 50%.

Section 179 Expensing

The new law extends the 2010 maximum expensing amounts set under the Small Business Jobs Act through 2011. For property placed in service in 2010 and 2011, the maximum expense limit of $500,000 is decreased by the amount of total property that exceeds $2,000,000. Accordingly, no expense can be taken for property exceeding $2,500,000. For 2012, the maximum expense limit is reduced to $125,000 and decreased by the amount of total property that exceeds $500,000. No deduction would be available for property of over $625,000 in 2012.

Other Selective Business Tax Breaks Retroactively Reinstated for 2010 and Extended Through 2011

- 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 special expensing rules for certain film and television productions;
- Expensing of environmental remediation costs;
- 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;
- Empowerment zone tax incentives;
- Renewal community tax incentives; and
- The work opportunity credit (extended for four months (through the end of 2011)).

In addition, the new law extends through 2011 the temporary exclusion of 100% of gain on the sale of certain small business stock.

Quick-Strike Tax Planning Strategies

With tax rates and laws finally established for 2011 and 2012, year-end tax planning can at last be performed with certainty. As the Act includes no changes to the income tax rates through 2012, the traditional tax planning strategies of accelerating deductions and deferring income, in general, will continue to be an effective method of minimizing your tax obligation. However , you can sometimes achieve overall tax efficiency by reversing this technique. For example, you should consider accelerating income and deferring deductions if you expect to be in a higher tax bracket next year, your filing status will change, you expect to be subject to alternative minimum tax (AMT) in 2010, or you have a net operating loss or capital loss carryovers to absorb next year.
Here's a quick-strike look at some key tax planning strategies in light of the new Act.

Select Individual Strategies

- **Coordinate timing of capital gains and losses.** If you have realized capital gains or losses or have stock and/or other capital assets that are ripe for sale, coordinate the timing of your gains and losses to minimize tax on your gains and maximize the tax benefit from your losses.
- **Maximize the benefit of lower tax rates on capital gains.** To qualify for the lower 15% (or 5%) capital gain rate, a capital asset must be held for more than one year. It is vital when disposing of your appreciated stocks, bonds, investment real estate and other capital assets, to pay close attention to the holding period. If it is less than one year, consider deferring the sale so that you can meet the longer-than-one year period and take advantage of the long-term rate available through 2012. While it is generally not wise to let tax implications be your only consideration in making investment decisions, you should not ignore them either. Keep in mind that realized capital gains may increase AGI, which in turn may reduce your AMT exemption and therefore increase your AMT exposure.
- **Consider converting a traditional IRA to a Roth IRA.** Beginning in 2010, taxpayers with modified adjusted gross income in excess of $100,000 are permitted to convert a traditional IRA to a Roth IRA. Previously, only individuals with modified adjusted gross incomes of $100,000 or less could initiate the conversion. Upon conversion, the IRA is taxable as if the account was distributed in its entirety to the account holder. To ease the tax bite, taxpayers have the option to defer or spread the payment of income taxes upon the Roth IRA conversion over two years, specifically 2011 and 2012, or recognize 100 percent of the conversion income in 2010. The tax deferral option is only available for 2010 conversions.
- **Maximize contributions to a nonworking spouse's IRA.** As a general rule, deductible IRA contributions cannot be made, unless taxpayers have wages or other earned income. However, an exception applies to

couples with only one working spouse. For 2010, a deductible IRA contribution of up to $5,000 ($6,000 for taxpayers 50 and over) is allowed for the non-working spouse, even if the working spouse is covered by an employer-provided retirement plan, provided the couple's modified AGI does not exceed $177,000. To be deductible for the 2010 tax year, the IRA contribution must be made by April 18, 2011, regardless of whether an extension is filed.

- **Consider establishing a self-employed retirement plan.** The plan, in general, must be established by December 31, 2010, but it does not have to be funded until the due date of your tax return, including extensions. However, simplified employee pensions, known as SEPs, can be established as late as the due date of your return, including extensions, or as late as October 15, 2011.
- **"Bunch" itemized deductions.** You may be able to save taxes this year and next by bunching itemized deductions, such as medical expenses, state and local taxes, charitable gifts and other miscellaneous itemized deductions into one year, as opposed to spreading them over two years.
- **Charitable gifting through an IRA.** If you own IRAs, or Roth IRAs, and are thinking of making a charitable gift, arrange for the gift to be made directly by the IRA trustee. Such a transfer can achieve important tax savings, but under current law is only available through 2011. Gifts can also be made in January 2011 and treated as if made in 2010. The tax-free distribution limit is $100,000 per taxpayer, per tax year.
- **Assess gifting options.** Individuals contemplating year-end gifts should determine whether it would be preferable to complete any gifts in 2010 or postpone such gifts until 2011 to take advantage of the increased gift tax exemption.

Select Business Strategies

- **Purchase new equipment.** Purchase and write-off equipment up to $2 million for 2011.
- **Maximize net operating loss (NOL) carrybacks.** A new law enacted last November makes it easier for most businesses to dig up immediate tax savings from NOLs by allowing them to be carried back to earlier years. This allows businesses that have incurred tax losses during the recent economic downturn to recover taxes paid in profitable prior years. In deciding whether to elect to carry back an NOL three, four or five tax years, taxpayers should assess whether the election will result in the largest tax refund.
- **Maximize your business tax credits.** Consider taking advantage of the following business tax credits that expired at the end of 2009, but have been retroactively reinstated and extended through 2011, including:
    - the research and development credit;
    - the employer wage credit for activated military reservists;
    - empowerment zone tax incentives;
    - renewal communities tax incentives;
    - the work opportunity credit; and more.
- **Increase your basis in partnerships or S corporations to take advantage of any losses generated by the pass-through entities.** Keep in mind that loans made by a third-party lender to an S corporation, and guaranteed by an S corporation shareholder, do not increase the shareholder's basis. The loan must be directly from the S corporation shareholder to the S corporation.

These are but a few of the quickly deployable last-minute strategies you may wish to consider as you approach year-end. In addition, there are items you may wish to consider as you plan for 2011. This alert intentionally focuses on certain strategies related to the recent legislation, but many other techniques may also apply to your particular situation.

For Further Information

If you have any questions regarding this *Alert*, or would like more information, please contact Michael A. Gillen, Director of the Tax Accounting Group, Steven M. Packer, Manager in the Tax Accounting Group, or the practitioner with whom you are regularly in contact.