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CERTIFIED PUBLIC ACCOUNTANTS
YOUR PUBLIC ACCOUNTING & CONSULTING FIRM

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Dear Clients and Friends:

On December 17, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the 2010 Tax Relief Act) was signed into law. It includes many taxpayer-friendly provisions for both individuals and businesses. This letter summarizes the changes we think will affect the most taxpayers.

Changes Affecting Individuals

Lower Tax Rates Extended through 2012. The Act extends the 10%, 15%, 25%, 28%, 33%, and 35% federal income tax rates on ordinary income through 2012. Without the new law, these rates would have been replaced in 2011 and beyond by the pre-Bush rates of 15%, 28%, 31%, 36%, and 39.6%.

The Act also extends the 0% and 15% federal income tax rates on most long-term capital gains and dividends through 2012. Without the new law, most long-term capital gains would have been taxed at 10% or 20% and dividends would have been taxed at ordinary rates of up to 39.6%.

Marriage Penalty Relief Extended through 2012. As you know, getting married can cause a couple's combined federal income tax bill to be higher than the sum of their tax bills when they were single. The 2001 Bush tax cut legislation eased this marriage penalty by tweaking the lowest two tax brackets for married couples and by giving them bigger standard deductions. Without the new law, these fixes would have disappeared after 2010. The Act extends them through 2012.

Social Security Tax Reduction for 2011 Only. The Act cuts the 6.2% Social Security tax withholding rate on employee salaries from 6.2% to 4.2%. This temporary change only affects the first $106,800 of 2011 wages (i.e., wages up to the 2011 Social Security tax ceiling). The maximum savings is $2,136 for unmarried individuals and $4,272 for couples. The Social Security tax component of the self-employment tax is cut from 12.4% to 10.4% for 2011, so self-employed individuals will benefit too. The employer's matching half was NOT reduced.

Good News: Because of this change, employees should notice bigger paychecks by the end of January, if not sooner. Self-employed individuals can account for the change by reducing their 2011 estimated payments, if appropriate.

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Personal Exemption and Itemized Deduction Phase-outs Repealed through 2012. For 2010, unfavorable phase-out rules that could reduce some of your most-cherished write-offs were temporarily repealed. The phase-out rules were scheduled to come back in 2011. The Act keeps the repeal in place through 2012.

Alternative Minimum Tax (AMT) Patch for 2010 and 2011. As you know, it has become an annual ritual for Congress to "patch" the AMT rules to prevent millions more households from being impacted by this add-on tax. The patch primarily consists of allowing bigger AMT exemptions and allowing personal tax credits to offset the AMT. The Act makes the patch for 2010, and for 2011 as well – so we will not have to worry about this issue for 2011 year-end planning.

100% Gain Exclusion for Qualified Small Business Corporation Stock Extended to Cover Shares Issued in 2011. The Small Business Jobs Act of 2010 (enacted last September) created a temporary 100% gain exclusion (within limits) for sales of qualified small business corporation (QSBC) stock issued between 9/28/10 and 12/31/10. The Act extends the window for taking advantage of this change by one year to cover QSBC shares issued between 9/28/10 and 12/31/11.

Note: QSBC shares must be held for more than five years to be eligible for the gain exclusion break. Thus, we are only talking about sales that will occur well down the road.

IRA Qualified Charitable Contributions Extended through 2011. For 2006-2009, IRA owners who had reached age 70 1/2 were allowed to make annual tax-free distributions of up to $100,000 paid directly out of their IRAs to charitable organization. These donations are called qualified charitable distributions (QCDs). They generally do not directly affect your federal income tax bill because the distribution is not reportable as income, and therefore no itemized deduction must be claimed. However, QCDs do count as IRA required minimum distributions (RMDs). Therefore, charitably inclined seniors can get a break by arranging for tax-free QCDs to take the place of taxable RMDs. Further, those who do not itemize can effectively get the benefit of the deduction by arranging for tax-free QCDs. The QCD break expired at the end of 2009. The Act retroactively restores it for 2010 and extends it through 2011.

Important Note: If you are interested, you still have time to take advantage of the QCD opportunity for the 2010 tax year. That is because you can make an election to treat QCDs taken during January of 2011 as 2010 QCDs that count as part of the 2010 $100,000 QCD limit and 2010 RMDs (to the extent you have not already taken your RMDs for 2010). Any other QCDs taken in 2011 will be treated as 2011 QCDs that count as part of the 2011 $100,000 QCD limit and 2011 RMDs (up to your RMD amount for 2011). Please contact us if you are considering QCDs.

Bigger Child Credit Extended through 2012. For 2011 and beyond, the maximum credit was scheduled to drop from $1,000 to only $500. The Act extends the $1,000 credit through 2012.

American Opportunity Education Credit Extended through 2012. The American Opportunity credit can be worth up to $2,500, can be claimed for up to four years of undergraduate education, and is 40% refundable.

It was scheduled to expire at the end of 2010 and be replaced by the Hope Scholarship credit which is smaller, can only be claimed for the first two years of college, is subject to phase-out at lower income levels, and is nonrefundable. The Act extends the more generous American Opportunity credit through 2012.

College Tuition Deduction Extended through 2011. This write-off, which can be as much as $4,000, or $2,000 at higher income levels, expired at the end of 2009. The Act retroactively restores the deduction for 2010 and extends it through 2011.

More Generous Student Loan Interest Deduction Rules Extended through 2012. This write-off, which can be as much as $2,500 (whether you itemize or not), was scheduled to fall under less favorable rules in 2011 and beyond. The Act extends through 2012 the more favorable rules established by the 2001 Bush tax cut legislation.

More Generous Coverdell Education Savings Account Rules Extended through 2012. For 2011, the maximum contribution to federal-income-tax-free Coverdell college savings accounts was scheduled to drop from $2,000 to only $500, and a stricter phase-out rule would have limited contributions by many married joint-filing couples. The Act extends through 2012 the more generous contribution rules established by the 2001 Bush tax cut legislation.

Employer Educational Assistance Plans Extended through 2012. Through 2010, an employer can provide up to $5,250 in annual federal-income-tax-free educational assistance to each eligible employee. Both undergraduate and graduate school costs can be covered by the plan, and the education need not be job-related. This taxpayer-friendly deal was scheduled to expire at the end of 2010. The Act extends it through 2012.

Option to Deduct State and Local Sales Taxes Extended through 2011. For the last few years, individuals who paid little or no state income taxes had the option of claiming an alternative itemized deduction for state and local general sales taxes. The sales tax deduction option expired at the end of 2009. The Act retroactively restores it for 2010 and extends it through 2011.

More Generous Earned Income Tax Credit Rules Extended through 2012. The 2009 Stimulus Act increased the refundable earned income credit (EIC) percentage for families with three or more qualifying children from 40% to 45%.

This change was effective for 2009 and 2010, and it resulted in larger EICs for affected families. The Stimulus Act also increased the income threshold for the phase-out rule that can reduce or eliminate EICs for married joint-filing couples. Both changes were scheduled to expire at the end of 2010. The Act extends them through 2012.

More Generous Dependent Care Tax Credit Rules Extended through 2012. For the last few years, parents (if both have earned income, e.g. W-2 wages or self-employed income) could claim a credit of up to $600 for costs to care for one under-age-13 child or up to $1,200 for costs to care for two or more under-age-13 kids.

Lower-income parents can claim larger credits of up to $1,050 and $2,100, respectively. For 2011 and beyond, the maximum credits were scheduled to drop. The Act extends the more generous maximum credit amounts through 2012. Note that in some cases, the credit can also be claimed for dependents other than under-age-13 children.

Smaller Tax Credit for 2011 Energy-efficient Home Improvements. The 2009 Stimulus Act provided that 30% of 2009 and 2010 expenditures for energy-efficient insulation, windows, doors, roofs, and heating and cooling equipment in U.S. residences could qualify for a credit, up to a maximum credit amount of $1,500 over the two years combined. The new law extends the credit through 2011, but the credit percentage is scaled back to only 10% and the lifetime credit limit is only $500. The $500 credit cap is reduced by any credits claimed in 2006-2010.

$250 Deduction for K-12 Educators Extended through 2011. For the last few years, teachers and other eligible personnel at K&-12 schools could deduct up to $250 of school-related expenses paid out of their own pockets—whether they itemized or not. This break expired at the end of 2009. The Act retroactively restores it for 2010 and extends it through 2011.

Bigger Tax-free Limit for Employer-provided Transportation Fringes Extended through 2011. The 2009 Stimulus Act increased the maximum monthly amount that an employee can receive as a tax-free fringe benefit for employer-provided transit passes and/or employer-provided transportation in a commuter highway vehicle (van pooling) to equal the maximum monthly tax-free amount for employer-provided parking benefits. As a result of the increase, the maximum monthly tax-free amount that could be received in 2010 for transit passes and/or van pooling (together or separately) was $230. However, the increased limit expired at the end of 2010. The new law extends the increased limit for transit passes and/or van pooling through 2011. The IRS just announced that the 2011 tax-free monthly limit for transit passes and/or van pooling is $230 (same as for 2010).

New Estate and Gift Tax Rules for 2010–2012

The new law includes favorable estate tax provisions for individuals who died in 2010, as well as those who die in 2011 and 2012.

$5 Million Estate Tax Exemption and 35% Rate. For estates of individuals who die in 2010-2012, the Act establishes a $5 million federal estate tax exemption with the 2012 amount indexed for inflation. Estates above the $5 million threshold are taxed at a flat 35%. (We have more on the special rules for estates of individuals who died in 2010 later in this letter.)

Unused Estate Tax Exemption Can Be Left to Surviving Spouse. For the first time, married individuals who do not consume their entire estate tax exemption will be able to pass along unused amounts to their surviving spouse. In other words, unused exemptions of individuals who die in 2011 or 2012 (but not 2010) will be "portable." The ability to pass along unused estate tax exemptions to surviving spouses is a very favorable development.

It allows both spouses' exemptions to be utilized without having to set up a credit shelter trust or engage in other tax planning maneuvers—as long as they both die in 2011 or 2012.

Unfortunately, this new portability rule sunsets after 2012, so it will not help decedents who die after 2012. Also, the portability rules do not apply to the generation-skipping transfer tax exemption. Thus, trusts may still be needed in many situations.

Unlimited Basis Step-ups for Inherited Assets. For heirs of decedents who die in 2011 and beyond, the familiar rule that allows the federal income tax basis of inherited capital-gain assets (such as real estate and stock) to be stepped up to reflect fair market value on the date of death is reinstated. This favorable rule is also reinstated for decedents who died in 2010 unless the estate elects to instead use the modified carryover basis rule. (More on that in a moment.) With the restoration of the unlimited basis step-up rule, heirs will not owe any federal capital gains taxes on appreciation that occurs through the date of death—as long as that date is after 2010 or, for decedents who died in 2010, their estate does not elect to use the modified carryover basis rules.

Estate and Gift Tax Exemptions and Rates Are Equalized. The Act sets the lifetime federal gift tax exemption for 2011 and 2012 at $5 million—with the 2012 amount indexed for inflation (same for the generation-skipping transfer tax exemption). Thus, the gift tax and estate tax exemptions are equalized for 2011 and 2012. This is a huge improvement over the previous $1 million gift tax exemption (which continues to apply for 2010). An unmarried person can now give away up to $5 million while alive without paying any gift tax, and a married couple can give away up to $10 million. (To the extent you dip into your gift tax exemption, your estate tax exemption is reduced dollar-for-dollar.) The tax rate on 2011 and 2012 gifts in excess of the $5 million exemption is 35%, same as the estate tax rate. Again, thanks to sunset provisions, the gift tax exclusion reverts to $1 million after 2012.

Clarity for Estates of 2010 Decedents and 2010 Generation-skipping Transfers. The Act clarifies the estate tax treatment of estates of individuals who died in 2010 and the generation-skipping transfer (GST) tax treatment of generation-skipping gifts made in 2010, but it does so in a weird way. The new law reinstates both taxes for 2010 with $5 million exemptions for each. However, executors have the option of electing out of the estate tax for 2010 in accordance with the 2010 repeal.

If executors elect out of estate tax, the aforementioned modified carryover basis rules apply to heirs for income tax basis purposes. So, heirs of large estates can wind up owing capital gains taxes on appreciation that occurs through the decedent's date of death, but there will not be any federal estate tax.

If the election out is *not* made for an estate, the $5 million exemption applies for 2010, and the income tax basis of inherited assets equals FMV on the date of death.

For 2010, the GST exemption is $5 million. However, the 2010 GST rate is deemed to be 0%, so there is no actual GST liability for 2010. Therefore, large generation-skipping gifts can be made in 2010, and only the gift tax will be owed (2010 gifts in excess of the $1 million gift tax exemption for that year are taxed at a flat 35% rate). The GST tax exemption is not subject to any portability, unlike the estate tax exclusion amount.

Thus, up to $5 million of GST tax exemption may be allocated to transfers in trust in 2010 (depending on how much GST tax exemption was used by the transferor prior to 2010).

Note: The $5 million GST tax exemption is available to an estate whether the executor of an estate for a decedent who died in 2010 chooses to be subject to estate tax or elects out of the estate tax and instead applies the modified carryover basis rules.

Business Depreciation and Depletion Changes

First-year Bonus Depreciation Allowed for Assets Placed in Service through 2012. The Act generally allows 100% first-year bonus depreciation for qualifying new (not used) assets that are acquired and placed in service between 9/9/10 and 12/31/11. It also allows 50% first-year bonus depreciation for qualifying new (not used) assets that are placed in service in calendar year 2012. For a new passenger auto or light truck that's used for business and is subject to the luxury auto depreciation limitation, the 100% and 50% bonus depreciation breaks increase the maximum first-year depreciation deduction by $8,000 for vehicles acquired and placed in service by 12/31/12.

15-year Depreciation for Leasehold Improvements, Restaurant Property, and Retail Space Improvements Extended through 2011. The 15-year straight-line depreciation privilege for qualified leasehold improvements, qualified restaurant buildings and improvements, and qualified retail space improvements is retroactively restored for property placed in service in 2010 and extended to cover property placed in service in 2011. (Without the favorable 15-year depreciation rule, leasehold improvements, restaurant building improvements, restaurant buildings, and retail space improvements generally would have to depreciated straight-line over 39 years.)

Suspension of Percentage Depletion Net Income Limitation for Marginal Properties Extended through 2011. The suspension of the 100%-of-net-income limitation on percentage depletion deductions for marginal oil and gas properties is retroactively reinstated for tax years beginning in 2010 and extended through tax years beginning in 2011.

Business Tax Credit Changes

Research Credit Extended through 2011. The Act retroactively restores the research credit for 2010 and extends it through 2011 to cover qualifying expenses paid or incurred in those years.

Work Opportunity Credit Hiring Deadline Extended by Four Months. The Act extends the general deadline for employing eligible individuals for purposes of claiming the Work Opportunity Tax Credit by four months, from 8/31/11 to 12/31/11.

Differential Pay Credit for Small Employers Extended through 2011. Legislation enacted in 2008 created a tax credit for eligible small employers that provide differential pay to employees while they serve in the military. The credit equals 20% of differential pay of up to $20,000 paid to each qualifying employee during the tax year. The credit expired at the end of 2009. The Act retroactively restores it to cover payments made in 2010 and extends it to cover payments made in 2011.

Contractor Credit for Building Energy-efficient Homes Extended through 2011. The Act retroactively reinstates the $2,000 per-home contractor tax credit for building new energy-efficient homes in the U.S. (including manufactured homes) for 2010 and extends it through 2011. The credit can also be claimed for substantially reconstructing and rehabilitating an existing home and making it more energy-efficient. Homes that do not fully meet the energy-efficiency standards may qualify for a reduced $1,000 credit. To qualify for this credit, a home must be sold by 12/31/11 for use as a residence.

Business Charitable Contribution Changes

Enhanced Deduction for Food Donations Extended through 2011. The new law retroactively restores for 2010 and extends through 2011 the enhanced charitable contribution deduction for non-C corporation businesses that donate food (it must be apparently wholesome when donated). This provision is intended for non-C corporation businesses that have food inventories, such as restaurants.

Enhanced C Corporation Deduction for Book Donations Extended through 2011. The Act retroactively restores for 2010 and extends through 2011 the enhanced deduction for C corporations that donate books to schools. This provision is intended for C corporations that have book inventories, such as publishers and retailers.

Enhanced C Corporation Deduction for Computer Donations Extended through 2011. The new law retroactively restores for tax years beginning in 2010 and extends through tax years beginning in 2011 the enhanced deduction for C corporations that donate computer equipment and technology to qualifying educational organizations and libraries.

Favorable Rule for S Corporation Donations of Appreciated Assets Extended through 2011. The new law retroactively restores for tax years beginning in 2010 and extends through tax years beginning in 2011 the favorable shareholder basis rule for stock in S corporations that make charitable donations of appreciated assets.

Conclusion

As you can see, the new law includes lots of changes, and we did not cover them all here due to space constraints. If you have questions or would like more detailed information about the new law, please contact us.

Very truly yours,

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