December 20, 2010

The newly enacted “Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010” signed into law on December 17, 2010 is a sweeping tax package that includes, among many other items, an extension of the Bush-era tax cuts for two years, estate tax relief, a two-year “patch” of the alternative minimum tax (AMT), a two-percentage-point cut in employee-paid payroll taxes and in self-employment tax for 2011, new incentives to invest in machinery and equipment, and a host of retroactively resuscitated and extended tax breaks for individuals and businesses. Here’s a look at the key elements of the package:

Extension of Bush Tax Cuts in the 2010 Tax Relief Act

The heart of the recently enacted “Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010” is a two-year extension of the Bush tax cuts. But what, exactly, are the Bush tax cuts? Here’s a primer:

Bush tax-cut legislation. The Bush tax cuts refer primarily to tax changes in two major pieces of legislation back in 2001 and 2003: the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA).

The 2001 legislation (EGTRRA) was a 10-year $1.35 billion tax cut package that was the largest tax cut since 1981. Key elements of EGTRRA included:

- A lowering of individual income tax rates from 15%, 28%, 31%, 36%, and 39.6% to 10%, 15%, 25%, 28%, 33%, and 35%.

- A doubling of the child tax credit from $500 to $1,000.

- A gradual reduction in estate taxes, culminating in a one-year repeal in 2010 (but reinstatement in 2011).

New law extends lower rates for all taxpayers for two years. Over the past several years, a lot of political energy has been expended on the issue of whether the favorable individual income tax rates, which were set to expire at the end of 2010, should be extended for everyone, or for everyone except the “rich.”

The new law settles the issue by extending the lower rates for all taxpayers. Under the new law, the rates that have been in effect in recent years—10%, 15%, 25%, 28%, 33%, and 35%—will remain in place. However, the extension is only for two years—through 2012.

New law extends lower capital gains rates for two years. Capital gains, generally speaking, refers to the profits realized on sales of non-inventory assets. For individuals, capital gains are generally taxed at a preferential rate in comparison to ordinary income.

The amount of tax depends on both the investor’s tax bracket and how long the investment was held before being sold. Short-term capital gains on investments held for a year or less are taxed at the investor's ordinary income tax rate. Long-term capital gains, which apply to assets held for more than one year, are taxed at a lower rate than short-term gains.

Since 2008, the tax rate on long-term capital gains has been 0% for individuals in the 10% and 15% income tax brackets, and 15% for everyone else. However, those rates were scheduled to expire at the end of 2010, as explained above, with the result that in 2011 the long-term capital gains tax rate would have risen to 20% (10% for taxpayers in the 15% tax bracket) if Congress had not acted.

The new legislation forestalls these increases by extending the 0% and 15% long-term capital gains tax rates for two years (through 2012).

New law extends lower rates for qualified dividends for two years. Since 2003, "qualified dividends" have been taxed at the same low tax rates that apply to long-term capital gains. For dividend income falling in the higher tax brackets, the rate is 15%. In the first two brackets (where ordinary income is taxed at 10% and 15% rates), the dividend rate is 0%

To count as "qualified," dividend-paying common stocks must be held for at least 61 continuous days before the ex-dividend date—the last purchase day for collecting the dividend. For preferred stock, the required holding period is 91 days before the ex-dividend date.

The low rates for qualified dividends, like the other Bush tax cuts, were scheduled to expire at the end of 2010. If Congress had not acted, beginning in 2011 taxes on dividends would have returned to the rates that were in effect before 2001, and all dividend income received in 2011 would have been taxed as ordinary income. Since the top income tax rate was scheduled to return to 39.6%, individuals could have paid as much as a 39.6% tax on dividends.

The new legislation prevents that from happening by continuing the tax regime in effect for qualified dividends (i.e., treatment as long-term capital gains, subject to a 0% tax rate for individuals in the 10% and 15% tax brackets and a 15% tax rate for other taxpayers) for two years—through 2012.

Payroll Tax Cut in the 2010 Tax Relief Act

The biggest new tax break for individuals in the recently enacted "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010" is the one-year payroll tax reduction. Under this new provision, which is intended to supplement income and boost economic growth, the payroll tax—which funds Social Security—will be cut by two percentage points during 2011.

Here are the details:

- The Social Security payroll tax on individual wages will be lowered to 4.2% in 2011, from the usual 6.2% rate. For an individual with wages of $60,000, that amounts to a $1,200 savings for individuals with an income of $60,000. If the individual gets paid twice a month, it will mean an extra $50 in his or her paycheck starting in January.

- Self-employed workers will also get the tax break. Their self-employment taxes will be cut from 12.4% to 10.4%.

- There is no phaseout (i.e., gradual reduction) of the payroll tax reduction for higher income workers. It goes to everyone who works, regardless of income. However, since Social Security taxes apply only to the first $106,800 in earnings in 2011, the benefit for high earners tops out at $2,136.

- The employer's share of Social Security tax is not affected; it stays at 6.2%. Thus, the cost of hiring new workers isn't directly affected by the payroll tax reduction.

- The tax break only applies for one year, 2011—for now anyway. There will almost certainly be efforts to extend it beyond 2011, and I will keep you apprised of any developments in that regard.

- The payroll tax reduction will not affect the worker's future Social Security benefit, because benefits are based on lifetime earnings, not the amount of tax paid by the worker into the Social Security system.

Individual and business extenders in the 2010 Tax Relief Act

In addition to extending the Bush tax cuts and cutting the payroll tax by two percentage points, the recently enacted Tax Relief Act extends a host of other important tax breaks for businesses and individuals.

Individual tax relief. The following tax breaks for individuals that expired at the end of 2009 have been retroactively reinstated by the Tax Relief Act and extended through 2011:

- The election to take 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 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 of 2011 and treat them as if made during 2010.

In addition, the new law extends for an additional year (i.e., through 2011) the rule allowing premiums for mortgage insurance to be deductible as qualified residence interest.

Business tax relief. On the business side, the following business tax breaks that expired at the end of 2009 have been retroactively reinstated and extended through 2011 by the Tax Relief Act:

- The research and development credit.

- 15-year write-offs for qualified leasehold improvements, and restaurant buildings (and certain improvements to such restaurant buildings).

- Empowerment zone tax incentives.

In addition, the new law provides incentives for businesses to invest in machinery and equipment by allowing for faster cost recovery of business property. Here are the details.

Expansion and extension of additional first-year depreciation. Businesses are allowed to deduct the cost of capital expenditures over time according to depreciation schedules. In previous legislation, Congress allowed businesses to more rapidly deduct capital expenditures of most new tangible personal property, and certain other new property, placed in service in 2008, 2009, or 2010 (2011 for certain property), by permitting the first-year write-off of 50% of the cost. The new law extends and temporarily increases this additional first-year depreciation provision for investment in new business equipment. For investments placed in service after September 8, 2010 and through December 31, 2011 (through December 31, 2012 for certain longer-lived and transportation property), the new law provides for 100% additional first-year depreciation. In other words, the entire cost of qualifying property placed in service during that time frame can be written off, without limit. Note that even though the legislation did not take shape in Congress until mid-December of 2010, the effective date of this provision was made retroactive, to include qualifying property placed in service after September 8, 2010.

Fifty percent additional first-year depreciation will apply again in 2012.

The new law leaves in place the existing rules as to what kinds of property qualify for additional first-year depreciation. Generally, the property must be (1) depreciable property with a recovery period of 20 years or less; (2) water utility property; (3) computer software; or (4) qualified leasehold improvements. Also the original use of the property must commence with the taxpayer – used machinery doesn't qualify.

Return of the Estate Tax in the 2010 Tax Relief Act

The estates of wealthy individuals who died in 2010 didn't pay any federal estate tax, but that situation is about to change. As mentioned above, the federal estate tax, which disappeared for 2010, springs back to life in 2011 and is imposed at the top rate of 35% of the estate's value after the first $5 million.

The new law also gives heirs of decedents dying in 2010 a choice of which estate-tax rules to apply – 2010's or 2011's. That's important because although there is no estate tax in 2010, some inherited assets are subject to higher capital gains tax under the 2010 rules, a situation that actually raises the tax burden for some heirs. Inherited assets under the 2010 rules have a tax basis equal to the price when they were purchased (referred to in tax parlance as "carryover basis") rather than the price at death. That could lead to a significant tax burden for heirs who sell assets such as stocks that had been held for many years and have greatly appreciated in value. Under the 2011 rules, by contrast, heirs will be allowed to inherit assets with a "stepped-up basis." While most heirs would choose the 2011 regime ($5 million exemption from both estate and generation-skipping tax and an unlimited step-up in the basis of assets to their current market value), the heirs of superrich decedents could find it more advantageous to elect the 2010 law (limited step-up in the basis of assets and no estate tax). If the executor makes the election to have the 2010 rules apply, the estate tax return's due date will not be earlier than the date that's nine months after the new law's enactment date.

For gifts made after December 31, 2010, the gift tax will be reunified with the estate tax. Under the new law, the estate and gift tax exemptions will be reunified starting in 2011, which means that the $5 million estate tax exemption will also be available for gifts. The law in effect prior to 2010 provided a $3.5 million lifetime exemption for estates, but only $1 million for gifts. The gift tax rate, starting in 2011, will be 35%. The exemption from the generation-skipping tax (GST) – the additional tax on gifts and bequests to grandchildren when their parents are still alive – will also rise to $5 million from the $1 million it would have been without the new law. The GST tax rate for transfers made in 2011 and 2012 will be 35%.

Please feel free to contact our office if you would like more details about these changes or any other aspect of the new law.

Sincerely,

Regier Carr & Monroe, L.L.P.

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