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Tax Relief Passes

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Despite opposition from some of his own party members, President Obama announced on December 6 that he had reached a compromise agreement with Republican leaders to delay the tax hikes that were otherwise scheduled to go into effect on January 1, 2011. Within ten days, actual legislation was passed by both the House and the Senate, now titled the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the “Act”).

The Act extends for two years the lower marginal rates and capital gain/dividend rates enacted in 2001 and 2003, generally referred to as the Bush tax cuts. Instead of expiring as of December 31, 2010, those rates continue for all taxpayers through 2012, when they are again scheduled to “sunset” – notably after the next Presidential election. Thus, our existing tax brackets for ordinary income continue at 10%, 15%, 25%, 28%, 33% and 35%, while the maximum rate on capital gains and qualified dividends will be 15% for two more years. For taxpayers whose taxable income does not exceed the 15% bracket (\$34,500 in 2011 for singles; \$69,000 for joint filers), a zero tax rate continues for capital gains and dividends.

Many other deductions and credits are also extended for two years, some of which had already expired at the end of 2009 and others now available through 2012. Both the itemized deduction phase-out and the personal exemption phase-out will not apply until 2013, regardless of income. Couples will also continue to enjoy relief from the marriage penalty provisions, at least temporarily. Some of the other popular deductions and credits now extended are listed at the end of this article.

Alternative Minimum Tax Relief

The alternative minimum tax (AMT) has continually required inflationary adjustments to its exemption amount since originally enacted, but had not received its “patch” for 2010 until this legislation passed. Although it remains a temporary fix, the exemption amount for joint filers is now increased to \$72,450 for 2010 and \$74,450 for 2011. It will require additional action by Congress to keep the exemption from returning to \$45,000 in 2012. Singles receive an exemption of \$47,450 in 2010 and \$48,450 in 2011, before the scheduled drop to \$33,750 in 2012.

One-Year Payroll Tax Cut

Along with a 13-month extension of unemployment benefits is a one-year reduction of the employee share of social security taxes from a 6.2% rate to 4.2% - computed on wages or self-employment income of up to \$106,800 during 2011. The employer will continue to pay the full 6.2%, while a self-employed worker reduces his 12.4% rate to 10.4%. There is no change to the 1.45% Medicare tax paid by both employers and wage earners. The IRS has already advised employers to implement the reduction no later than January 31, 2011, and correct any initial over withholding by March 31.

Reinstatement of Estate Tax

The federal estate tax was otherwise scheduled to spring back in 2011 with an exemption of \$1 million per person and a maximum tax rate of 55%. The Act provides a temporary reduction of the top rate to 35% and an exemption of \$5 million per person – both effective through 2012. The exemption is also indexed for inflation after 2011, suggesting the lawmakers' intent is to not allow the return of a \$1 million exemption in 2013. The gift tax exclusion, which is presently \$1 million in 2010, will also become \$5 million in 2011 and 2012.

For the first time and in the interest of simplicity, the Act allows a surviving spouse to add the unused exemption amount from a decedent spouse to his or her own exemption, provided a proper election is made by the estate of the predeceased spouse. At this time, the provision effectively applies only if both spouses die after 2010 and before 2013; unless another extension or permanent change becomes law.

An option is provided to executors for estates of 2010 decedents to elect the new 2011/2012 provisions instead of 2010 law which imposes no estate tax, but different carryover basis rules. Many estates will want to evaluate using the new law and \$5 million exemption because a full step-up in basis is then available to the heirs for income-tax purposes. Otherwise, 2010 law imposes a modified carryover basis and limits any step-up to \$1.3 million of estate property, plus an additional \$3 million for qualifying property received by a surviving spouse.

Business Benefits

Following through on his October proposal for immediate expensing of business assets, the President succeeded in delivering the largest investment incentive ever provided to businesses making capital asset purchases. Qualifying new property acquired after September 8, 2010, and through 2011 is now eligible for 100% bonus depreciation with no dollar limit. Fifty percent bonus depreciation then returns for one year in 2012. Although real estate does not qualify, certain leasehold improvements qualify along with equipment and other personal property, where its original use begins with the taxpayer.

Previous law also allowed immediate expensing of up to \$500,000 of "section 179" property through 2011. The Act prevents a substantial drop in the limits for 2012 by allowing up to \$125,000 to be expensed, with a dollar for dollar reduction where additions for the year exceed \$500,000. Qualifying "section 179" property includes used property and through 2011, includes up to \$250,000 of certain qualified real property.

Certain Other Extenders

As stated, the Act temporarily extends many other incentives for individuals and businesses. Among the most popular are the following:

1. Charitable contribution of IRA proceeds up to \$100,000 by taxpayers age 70 ½ (through 2011).
2. Child tax credit (through 2012).
3. Earned income tax credit (through 2012).
4. Dependent care credit (through 2012).
5. American Opportunity Tax Credit for all four years of postsecondary education (through 2012).
6. Student loan interest deduction (through 2012).
7. Higher education tuition deduction (through 2011).

8. State and local sales tax deduction (through 2011).
9. Research tax credit (through 2011).
10. Exclusion of gain from qualified small business stock held for five years (acquired through 2011).

As lawmakers have wrestled with many of the provisions in the Act over the past year, a renewed interest in fundamental tax reform has also surfaced. Time will tell whether the next Congress will choose to adopt permanent changes in our tax system or continue to make temporary changes and extensions of today's laws.

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