RECENT DEVELOPMENTS

December 22, 2010

Overview of the tax provisions in the 2010 Tax Relief Act

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:

- Current income tax rates will be retained for two years (2011 and 2012), with a top rate of 35% on ordinary income and 15% on qualified dividends and long-term capital gains.

- Employees and self-employed workers will receive a reduction of two percentage points in Social Security payroll tax in 2011, bringing the rate down from 6.2% to 4.2% for employees, and from 12.4% to 10.4% for the self-employed.

- A two-year AMT "patch" for 2010 and 2011 will keep the AMT exemption near current levels and allow personal credits to offset AMT. Without the patch, an estimated 21 million additional taxpayers would have owed AMT for 2010.

- Key tax credits for working families that were enacted or expanded in the American Recovery and Reinvestment Act of 2009 will be retained. Specifically, the new law extends the $1,000 child tax credit and maintains its expanded refundability for two years, extends rules expanding the earned income credit for larger families and married couples, and extends the higher education tax credit (the American Opportunity tax credit) and its partial refundability for two years.

- Businesses can write off 100% of their equipment and machinery purchases, effective for property placed in service after September 8, 2010 and through December 31, 2011. For property placed in service in 2012, the new law provides for 50% additional first-year depreciation.

- Many of the "traditional" tax extenders are extended for two years, retroactively to 2010 and through the end of 2011. Among many others, the extended provisions include the election to take an itemized deduction for state and local general sales taxes in lieu of the itemized deduction for state and local income taxes; the $250 above-the-line deduction for certain expenses of elementary and secondary school teachers; and the research credit.

- After a one-year hiatus, the estate tax will be reinstated for 2011 and 2012, with a top rate of 35%. The exemption amount will be $5 million per individual in 2011 and will be indexed to inflation in following years. Estates of people who died in 2010 can choose to follow either 2010's or 2011's rules.

- Omitted from the new law: Repeal of a controversial expansion of Form 1099 reporting requirements.

- Also not included: Extension of the Build America Bonds program, which permits state and localities to issue federally-subsidized municipal bonds.

AMT relief in the 2010 Tax Relief Act

Brief overview of the AMT. The AMT is a parallel tax system which does not permit several of the deductions permissible under the regular tax system, such as property tax. Taxpayers who may be subject to the AMT must calculate their tax liability under the regular federal tax system and under the AMT system taking into account certain "preferences" and "adjustments." If their liability is found to be greater under the AMT system, that's what they owe the federal government. Originally enacted to make sure that wealthy Americans did not escape paying taxes, the AMT has started to apply to more middle-income taxpayers, due in part to the fact that the AMT parameters are not indexed for inflation.

In recent years, Congress has provided a measure of relief from the AMT by raising the AMT "exemption amounts"— allowances that reduce the amount of alternative minimum taxable income (AMTI), reducing or eliminating AMT liability. (However, these exemption amounts are phased out for taxpayers whose AMTI exceeds specified amounts.) For 2009, the AMT exemption amounts were $70,950 for married couples filing jointly and surviving spouses; $46,700 for single taxpayers; and $35,475 for married filing separately. However, for 2010, those amounts were scheduled to fall back to the amounts that applied in 2000: $45,000, $33,750, and $22,500, respectively. This would have brought millions of additional middle-income Americans under the AMT system, resulting in higher federal tax bills for many of them, along with higher compliance costs associated with filling out and filing the complicated AMT tax form.

New law provides two-year stopgap fix. To prevent the unintended result of having millions of middle-income taxpayers fall prey to the AMT, Congress has once again relied on a temporary "patch" to the problem, this time a two-year extension of the 2009 exemption amounts, increased slightly. Under the new law, for tax years beginning in 2010, the AMT exemption amounts are increased to: (1) $72,450 in the case of married individuals filing a joint return and surviving spouses; (2) $47,450 in the case of unmarried individuals other than surviving spouses; and (3) $36,225 in the case of married individuals filing a separate return. For tax years beginning in 2011, the AMT exemption amounts are increased to: (1) $74,450 in the case of married individuals filing a joint return and surviving spouses; (2) $48,450 in the case of unmarried individuals other than surviving spouses; and (3) $37,225 in the case of married individuals filing a separate return.

Personal credits may be used to offset AMT through 2011. Another provision in the new law provides AMT relief for taxpayers claiming personal tax credits. The tax liability limitation rules generally provide that certain nonrefundable personal credits (including the dependent care credit and the elderly and disabled credit) are allowed only to the extent that a taxpayer has regular income tax liability in excess of the tentative minimum tax, which has the effect of disallowing these credits against the AMT. Temporary provisions had been enacted which permitted these credits to offset the entire regular and AMT liability through the end of 2009. The new law extends this temporary provision to 2010 and 2011.