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AN ALERT FROM THE BDO FEDERAL TAX PRACTICE

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► SUBJECT

TAX RELIEF ACT EXTENDS CURRENT TAX RATES, RENEWS EXPIRING PROVISIONS AND PROVIDES NEW INCENTIVES FOR INVESTMENT

► SUMMARY

On December 17, 2010, President Obama signed the Tax Relief, Unemployment Insurance Reauthorization, and Jobs Creation Act of 2010 (the "Act"). The Act extends current tax rates on individuals through 2012, reinstates the estate tax with a 35% tax rate for 2011 and 2012, and extends various other expiring tax provisions that had expired at the end of 2009 or were scheduled to expire at the end of 2010. The Act provides individual alternative minimum tax ("AMT") relief for 2010 and 2011. The Act also provides for a reduction in employment taxes during 2011. This Tax Alert provides a brief summary of the principal provisions of the Act.

TWO-YEAR EXTENSION OF INDIVIDUAL TAX RELIEF

Significant provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (the "EGTRRA") and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (the "JGTRRA") were scheduled to expire at the end of 2010. The Act extends these provisions through the end of 2012. The Act also extends certain provisions of the American Recovery and Reinvestment Act of 2009 (the "ARRA").

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Individual Income Tax Brackets

The Act extends the current 25%, 28%, 33%, and 35% tax brackets through 2012. Upon expiration, the brackets will revert to the previous 28%, 31%, 36%, and 39.6% rates. Prior to the enactment of the EGTRRA, individual taxpayers were subject to a single 15% tax rate at all taxable income levels below the level at which the 28% rate applied. The EGTRRA created a 10% tax rate for the lowest portion of the previous 15% tax bracket. The Act also extended through 2012 this lowest 10% bracket, which will be rejoined with the larger 15% bracket upon expiration.

Personal Exemption and Itemized Deduction Phase-Outs

The EGTRRA repealed the phase-out for personal exemptions and the overall limitation on itemized deductions for 2010 only. The Act extends the repeal of both provisions through 2012.

Capital Gain and Dividend Rates

Under changes made by the JGTRRA, the current long-term capital gain tax rate is zero for taxpayers whose capital gains would otherwise be subject to rates below 25% and 15% for taxpayers whose capital gains would otherwise be subject to rates at or above 25%. The Act extends these rates through 2012. Upon expiration the rates will increase to 10% and 20%, respectively. The JGTRRA also reduced the tax rate on qualified dividends from the otherwise applicable ordinary rates to the long-term capital gain rates. The Act extends this provision through 2012.

Marriage Penalty Relief

The EGTRRA provided marriage penalty tax relief in two forms. First, it increased the standard deduction for married taxpayers filing joint returns from 167% to 200% of the deduction for single filers. Second, it increased the range of the first three tax brackets for married taxpayers filing joint returns to 200% of that of single filers. The Act extends both of these provisions through 2012.

Child Tax Credit

Under prior law, taxpayers could claim a \$500 credit for each qualifying child under the age of 17. The credit is phased out beyond a certain level of income. The EGTRRA doubled the child tax credit from \$500 to \$1,000. The ARRA expanded the amount of the credit that can be refunded to 15% of earned income over \$3,000. The Act extends these provisions through the end of 2012.

Extension of Other EGTRRA, JGTRRA, and ARRA Provisions

Various other provisions of the EGTRRA, JGTRRA, and ARRA that would have expired at the end of 2010 have been extended through 2012 as well, including:

- The expanded dependent care credit
- The increased adoption tax credit
- The tax credit for employer expenses for child care assistance
- Expanded exclusion of employer-provided education assistance
- Exclusion from income of certain scholarship program proceeds
- Expanded contribution amounts to Coverdell education savings accounts
- Expanded student loan interest deduction
- Expanded earned income tax credit for families with three or more children
- The American Opportunity Tax Credit for tuition and related expenses

INDIVIDUAL AMT RELIEF

The Act increases the AMT exemption amount for taxable years beginning in 2010 to \$47,450 for single taxpayers and \$72,450 for married taxpayers filing joint returns. These amounts are increased to \$48,450 and \$74,450, respectively, for 2011. The Act also allows nonrefundable personal tax credits to be used to offset AMT for 2010 and 2011.

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ESTATE TAX PROVISIONS

Prior Law

The EGTRRA phased out the estate and generation-skipping transfer taxes over a period of several years, with both taxes fully repealed in 2010. The EGTRRA also provided for carryover basis rules for assets passing through certain estates in 2010. In addition the EGTRRA decoupled the gift tax from the estate tax. Under the EGTRRA provisions the gift tax rate is 35% in 2010, with a lifetime credit equivalent to an exclusion of the first \$1,000,000 of otherwise taxable gifts. All these provisions expire at the end of 2010, at which point the estate, generation-skipping transfer, and gift taxes would have been reinstated at pre-2001 levels. A rate of 55% would have applied to transfers subject to both the estate and gift tax, with the lifetime credit equivalent to an exclusion of \$1,000,000.

Reinstatement of Estate Tax/Generation Skipping Tax

The Act reinstates the estate tax for 2010 through 2012 with a top tax rate of 35%, but with special transitional provisions in effect for 2010 only. The individual lifetime credit amount is increased to an equivalent exemption of \$5 million (\$10 million per couple). The carryover basis rules are eliminated beginning in 2011. For estates of decedents dying in 2010, the estate can elect to either apply the new estate tax provisions of the Act or apply the carryover basis rules of the EGTRRA and pay no estate tax. The generation-skipping transfer tax is also reinstated effective for 2010-2012 with a \$5 million exemption amount for each of these years. The flat tax rate for GST transfers will be 0% for 2010 and 35% for 2011 and 2012. The zero percent tax rate for 2010 eliminates any tax on GST taxable transfers occurring in 2010. Irrevocable transfers to trusts in 2010 that have a potential for future generation skipping transfers post 2010 would be subject to the GST tax at that time depending on the inclusion ratio of the trust.

Modifications to Gift Tax

The Act reunifies the gift and estate taxes by allowing taxpayers to use their same \$5 million lifetime equivalent exclusion amount against taxable gifts, as well as amounts passing through their estates, for gifts made during 2011 and 2012. The top tax rate for gifts is also set at 35% for 2011 and 2012. The top rate for gifts for 2010 remains 35% and the lifetime equivalent exclusion also remains at \$1 million.

Transfer of Exclusion Amount to Spouse

The Act allows the executor of a deceased spouse to transfer any exclusion amount that is not used by the deceased spouse to the surviving spouse.

Sunset Provisions

The changes made by the Act to the estate, generation-skipping transfer, and gift taxes only apply through 2012. In 2013, the provisions prior to the EGTRRA, including the 55% maximum rate and \$1 million exemption equivalent, will be reinstated.

INVESTMENT INCENTIVES

Bonus Depreciation

A bonus depreciation allowance had previously applied to certain property placed in service between January 1, 2008, and December 31, 2010. In order to qualify for bonus depreciation, the property must be (a) property to which the modified accelerated cost recovery system applies with a recovery period of 20 years or less, (b) water utility property, (c) most computer software, or (d) qualified leasehold improvement property. Original use of the property must commence with the taxpayer; used property will generally not qualify. The first-year allowance is 50% of the basis of the qualifying property, with the remaining 50% being depreciated under generally applicable rules. Taxpayers may elect not to claim bonus depreciation on a class-by-class basis.

The Act extends and expands the bonus depreciation provisions by allowing taxpayers to claim a 100% bonus allowance on qualifying property placed in service after September 8, 2010, and through December 31, 2011. For qualifying property placed in service after December 31, 2011, and through December 31, 2012, the bonus depreciation allowance will be 50% of the basis of such property. In addition, the Act allows certain taxpayers to elect to convert old AMT credits to refundable credits (within certain limitations) in lieu of taking bonus depreciation for property placed in service in 2011 or 2012. As under prior law, taxpayers must agree to depreciate qualifying property on a straight-line basis in addition to forgoing bonus depreciation.

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Additional First-Year Expensing

Business taxpayers may elect to deduct the cost of certain fixed assets placed in service during the taxable year under the section 179 “expensing” provisions. For 2010 and 2011, the allowance is limited to \$500,000, but the limitation is phased out to the extent that the cost of qualifying property placed in service during the year exceeds \$2 million. Within this overall annual limitation of \$500,000, taxpayers could also deduct the cost of certain real property acquisitions up to \$250,000 per year. For 2012 and subsequent years, the allowance would have been reduced to \$25,000, with the limitation phased out if the cost of qualifying property exceeds \$200,000. Off-the-shelf computer software is qualifying property for taxable years beginning before 2012.

The Act increases the allowance to \$125,000 for assets placed in service during 2012, with the allowance phased out if the cost of qualifying property exceeds \$500,000. The \$25,000/\$200,000 parameters are now scheduled to return in 2013. Off-the-shelf computer software is qualifying property for taxable years beginning before 2013.

TEMPORARY PAYROLL TAX CUT

Under current law, all employees pay 6.2% of their wages up to a certain threshold (\$106,800 in 2011) as Social Security taxes (in addition to Medicare Hospital Insurance taxes). Employers pay an equal amount. Self-employed individuals pay 12.4% of their self-employment income up to the same threshold as social security taxes. The Act reduces the employee’s share of the tax to 4.2% for 2011 only. Employers must still pay 6.2%. The social security component of the self-employment tax is reduced to 10.4% for 2011 only.

EXTENSION OF EXPIRING PROVISIONS

Energy Incentives

The Act extends various energy incentives that have expired or would have expired as follows:

- Biodiesel and renewable diesel production credits are extended through 2011.
- The credit for refined coal facilities is extended for property placed in service prior to January 1, 2012.
- The credit for the construction or manufacture of energy-efficient residential homes is extended through 2011.
- The alternative fuel credit is extended through 2011.
- The deferral of gain on sales of electric transmission property from vertically integrated electric utilities to approved independent transmission companies is extended through 2011.
- The taxable income limit is suspended for purposes of depleting a marginal oil or gas well through 2011.
- The start-of-construction deadline for the cash grant in lieu of tax credit program under section 1603 of the ARRA is extended for one year.
- The per-gallon tax credits and outlay payments for ethanol are extended through 2011, as are the tariffs on imported ethanol.
- The section 45M credit for United States based manufacture of energy-efficient washers, dishwashers, and refrigerators is modified and extended through 2011.
- The section 25C credit for energy-efficient improvements to existing homes is reinstated to the rates and structure as they existed before the ARRA and is extended through 2011.
- The investment tax credit for alternative vehicle refueling property is extended through 2011.

Individual Tax Relief

The Act extends various individual tax provisions that had expired or would have expired, as follows:

- The above-the-line deduction for certain expenses of elementary and secondary school teachers is extended two years through 2011.
- The ability to deduct state and local sales tax in lieu of state income taxes is extended two years through 2011.
- The increased contribution limits and carryforward period for the contribution of real property, including the transfer of partial interests, for conservation purposes is extended two years through 2011.

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- The above-the-line deduction for qualified tuition and related expenses is extended two years through 2011.
- Tax-free distributions of up to \$100,000 from an individual retirement account to a charity are allowed for both 2010 and 2011. A taxpayer can elect to treat distributions made under this provision in January 2011 as having occurred in 2010.
- The look-through of certain regulated investment company ("RIC") stock held by nonresidents for estate tax purposes is extended through 2011.
- The increase in the monthly exclusion for employer-provided transit benefits is extended through 2011.
- Refundable tax credits will be excluded from income for the purposes of means-tested benefit programs through 2011.

Business Tax Relief

The Act extends numerous business tax provisions that had expired or would have expired, as follows:

- The research and development tax credit is extended for two years through 2011.
- The Indian employment credit is extended for two years through 2011.
- The new markets tax credit program is extended for two years through 2011 with a maximum annual amount of qualified equity investment of \$3.5 billion.
- The railroad track maintenance credit is extended for two years through 2011.
- The mine rescue team training credit is extended for two years through 2011.
- The employer wage credit for activated military reservists is extended for two years through 2011.
- The 15-year recovery period for certain leasehold improvements, restaurant buildings and improvements, and retail improvements is extended for two years, for property placed in service prior to January 1, 2012.
- The seven-year recovery period for property used for land improvements and support facilities at motorsports entertainment complexes is extended for two years, for property placed in service prior to January 1, 2012.
- The special recovery period for qualified Indian reservation property is extended for two years, for property placed in service prior to January 1, 2012.
- The enhanced deduction for contributions of food inventory is extended for two years, for contributions made prior to January 1, 2012.
- The enhanced deduction for contributions of book inventories to public schools is extended for two years, for contributions made prior to January 1, 2012.
- The enhanced deduction for contributions of computer inventory for educational purposes is extended for two years, for contributions made prior to January 1, 2012.
- The election to expense mine safety equipment is extended to equipment placed in service prior to January 1, 2012.
- The provision to allow film and television producers to expense the first \$15 million of production costs incurred in the United States is extended for two years, for productions commencing prior to January 1, 2012.
- The provision to allow expensing of environmental remediation costs at qualified sites is extended for two years, for costs incurred prior to January 1, 2012.
- The section 199 domestic production activities deduction for activities conducted in Puerto Rico is extended to taxable years beginning before January 1, 2012.
- The special rules for interest, rents, royalties, and annuities received by a tax-exempt entity from a controlled entity are extended for payments made before January 1, 2012.
- The treatment of certain dividends of RICs as interest-related dividends is extended for taxable years of the RIC beginning before January 1, 2012.
- The inclusion of a RIC as a qualified investment entity for purposes of the Foreign Investment in Real Property Tax Act is extended through December 31, 2011.
- The active financing exception to subpart F income is extended to taxable years of a foreign corporation beginning before January 1, 2012 (and taxable years of United States shareholders with or within such taxable year ends).

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- The look-through treatment of payments between related controlled foreign corporations is extended to taxable years of a foreign corporation beginning before January 1, 2012 (and taxable years of United States shareholders with or within such taxable year ends).
- The ability of S corporation shareholders to reduce their stock basis by their share of the corporation's basis in appreciated property contributed to a charitable organization (rather than by the amount of the deduction) is extended for two years through 2011.
- The designation of certain economically depressed census tracts as empowerment zones is extended for two years through 2011.
- The designation of certain areas within the District of Columbia as the District of Columbia Enterprise Zone is extended for two years through 2011, including the \$5,000 first-time homebuyer credit for residences in the District of Columbia.
- The temporary decrease on excise taxes applied against certain distilled spirits produced or imported into the United States is extended for two years through 2011.
- The American Samoa economic development credit is extended for two years through 2011.
- The work opportunity tax credit is extended four months through December 31, 2011.
- The qualified zone academy bond program is extended for one year through 2011.
- The provision that allows taxpayers with an adjusted gross income of less than \$110,000 to deduct premiums for mortgage insurance as home mortgage interest is extended through 2011.
- The 100% gain exclusion on qualifying small business tax enacted by the Small Business Jobs Act of 2010 is extended to qualifying small business stock issued prior to January 1, 2012.

Disaster Relief Provisions

The Act extends certain disaster relief tax provisions that had expired or would have expired, as follows:

- The time for issuing New York Liberty Zone bonds is extended for two years through 2011.
- The increased rehabilitation credit for historic structures in the Gulf Opportunity Zone is extended for two years through 2011.
- The placed-in-service date for property qualifying for additional low-income housing credits in the Gulf Opportunity Zone is extended for one year to December 31, 2011.
- Tax-exempt bond provisions for the Gulf Opportunity Zone are extended for one year through December 31, 2011.
- The temporary depreciation allowance for new property investments in the Gulf Opportunity Zone is extended for one year, for property placed in service prior to January 1, 2012.

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