AMERI-CAN TAX TALK NEWSLETTER

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THE MORE THINGS CHANGE THE MORE THEY STAY THE SAME – THE TAX RELIEF ACT OF 2010

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The tax legislation negotiations went to the wire in December with drama worthy of a political television miniseries. There was speculation that the entire economy would collapse if Congress recessed without passing legislation to replace the expiring temporary legislation enacted by G. W. Bush, as several congress sessions and two presidential administrations had no success in seeking permanent legislation.

With hourly changes and twists and turns, a tax bill arrived that shocked many with the degree to which it helped the wealthier taxpayer, considering the political party currently occupying the West Wing. Below is a brief survey of the areas that the "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010" addresses.

Individual Income Taxation

Prior to 2002, the federal tax rates ranged from 15% to 39.6%. They were reduced at that time to 10%-35%. In 2003, the capital gains rates were cut from 20% to 15% and some dividends were also reduced from 35% to the capital gains rate of 15%. The tax reductions were set to expire in 2010 and the capital gains and dividends reductions in 2008 (they were later extended to 2010).

The new law continues these rates through 2012, with a maximum income tax bracket of 35%, a maximum rate of capital gains of 15%, and a rate of 0% on long term capital gains for income in the 10% bracket. For qualified dividends, which are dividends paid from stock that are held for at least 61 continuous days (or 91 days for preferred stock) before the last purchase day for collecting the dividend, the rate stands at 15%.

Other changes that have been extended include the ability to deduct state and local sales taxes instead of state and local income taxes, the ability of teachers to claim up to $250 in supplies they purchased for their classroom, and the ability to claim tuition expenses as a deduction in computing adjusted gross income.

Business Taxation

Payroll taxes (FICA) are being reduced from 6.2% to 4.2%. This is extremely significant as these taxes have no phase-out and apply for all workers, up to the first $106,800 in earnings. The benefit will be a maximum of $2,136 for the employee; meanwhile, the employer's portion has not been reduced and remains at 6.2%. Self-employed workers will also benefit, as the Self-Employment tax will be cut from 12.4% to 10.4%, mirroring the payroll tax reduction for employees. However, this change will last only one year; i.e. 2011.

There are new rules relating to the purchase of new business equipment between September 8, 2010 and December 31, 2011, permitting a potential additional 50% or 100% first year depreciation for qualifying property. The § 179 deduction limitations will be changed to a maximum deduction of $125,000, with a phase out beginning at $500,000 of total expenditures.

Alternative Minimum Tax

There are new alternative minimum tax limits for 2011. For tax years beginning in 2011, the AMT exemption amounts will be increased to $74,450 for married individuals filing joint returns, $37,225 for married individuals filing separate returns, and $48,450 for single individuals.

New changes in the AMT now permit certain personal credits that were formerly disallowed under the AMT, including those for the elderly and disabled, to offset both regular tax and AMT for tax years 2010 and 2011.

Estate Tax

The estates of wealthy individuals who died in 2010 were not subject to any federal estate tax, but that situation is about to change. Under the recently enacted “Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010,” the federal estate tax, which disappeared for 2010, springs back to life in 2011 and will be imposed at the top rate of 35% of the estate's value after the first $5 million.

In 2001, Congress passed legislation lowering the maximum estate tax rate from 60% to 45% with a total repeal in 2010. There are a few famous individuals with multi-billion dollar estates who passed in 2010, seemingly without paying any estate tax. Without any congressional action, the estate tax was set to re-appear automatically on January 1, 2011 at a top marginal rate of 55% and an exclusion of $1,000,000, in comparison to the 2009 top marginal rate of 45% and exclusion of $3,500,000.

Further, while there was no estate tax in 2010, there was a change in the income tax rules. Under the old income tax rules, a person receiving property from a decedent would generally receive that property at a basis equal to the fair market value. Thus, if a decedent bought property for $1,000 in 1920 that was valued at $1,000,000 when they passed in 2008, and the beneficiary sold it for $1,020,000 in 2011, the beneficiary would only be subject to tax on the $20,000 gain, at the long term capital gains rate. However, if the decedent had passed in 2010, there would be no estate tax, but the tax paid by the beneficiary would be based on a gain of the whole $1,020,000 value (less the $1,000 cost).

The new legislation gives the executor the option of choosing which rules to follow for 2010 decedents: either those created by the repeal in 2010 with no estate tax, coupled with the new income tax rules with respect to carry-over basis, or the estate tax rules for 2011. The executor will have until September to make this choice, a very important one!

For the new rules, the top rate will be 35% with an exemption amount of $5,000,000.

New in 2011 is the ability for US citizen spouses to share their credits. Under the old rules, if a decedent spouse were to transfer all of their property to their US citizen spouse, there was a deduction and no estate tax was due, but the exemption was wasted. There were some strategies called “Credit Shelter Trusts” or “A-B Trusts” which protected the exemption, but these are no longer necessary because unused exemptions can now be carried over to spouses. Of course, non-citizen spouses will still have to seek special planning to be able to use their spouses’ exemptions. It is important to note, however, that the ability to carryover the unused portion of the deceased spouse’s exemption is set to expire at the end of 2012, and uncertainty exists as to what will happen to taxpayers who have carried over a portion of their spouse’s exemption from their passing during 2010 through 2012. More information and clarification will need to be provided by Congress and the IRS on this.

Another major change is the re-unification of the gift tax with the estate tax. In the last few years, use of the exclusion for lifetime gifts was limited to $1,000,000; this has changed and now the exclusion can be used up to a full $5,000,000 or the current estate tax exemption amount. The generation skipping tax (GST) exemption will also rise to $5,000,000.

The new law is quite a favorable compromise, but is also very difficult to incorporate into long-term planning, as it is only for two years. There is no repeal at the end of its term; the law just ends. It will be interesting to see what happens in 2013!

Tax Preparer Notes

Beginning January 1, 2011, to prepare US tax returns a preparer (and almost everyone who works for a tax preparer and who makes almost any decision on a tax return) must have a PTIN even if they don’t sign the tax return.

A PTIN can be obtained by filing Form W-12. In order to be issued the PTIN, US people will need to have a SSN and be current on all of their personal US tax filings. Non-US people will need to provide a notarized copy of their foreign passport, and file Form 8946 along with the W-12.

Later this year, the IRS is anticipating having some preparers that sign tax returns who are not US attorneys or CPA’s write an exam to obtain their PTIN number, to ensure competency.

Because the law was signed so late in December the IRS is not able to have the new forms or computer systems ready to process returns with itemized deductions (Schedule A) until mid February. Taxpayers will not be able to send in their returns if they itemize their deductions until at least this time.

Finally, it should be noted that April 15, 2011 is a holiday in the District of Columbia. DC holidays are considered federal holidays for tax purposes, and as such the federal tax deadline for 2011 is April 18. However for state tax returns, each state may have its own rules on the due date so be sure to confirm for each return.

For more information, please contact:

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