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THE 2010 TAX RELIEF ACT - EXTENSIVE BUT TEMPORARY REFORM

On December 17, 2010, President Obama signed into law the "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010" (the "Tax Relief Act"). The Tax Relief Act is an extensive tax package that includes, among other items, an extension of the Bush-era tax cuts for an additional two years, estate tax relief, a 2% cut in employee-paid payroll taxes and self-employment taxes for 2011, new incentives for businesses to invest in machinery and equipment, and a myriad of retroactively resuscitated and extended tax breaks for businesses and individuals. The overall theme of the Tax Relief Act; however, is its temporary nature. The vast majority of the provisions in the Tax Relief Act are only effective for the next two years, pushing the ultimate fate of the Bush-era tax cuts into 2012, the next presidential election year. Some of the key elements of the Tax Relief Act are discussed in detail below.

INDIVIDUAL INCOME TAX INCENTIVES

For the vast majority of individual taxpayers, the most significant aspects of the Tax Relief Act are (i) the extension of the reduced individual income tax rates; (ii) the extension of the reduced capital gains and qualified dividend tax rates; and (iii) the 2% payroll tax cut. The extension of the reduced tax rates, combined with the payroll tax cut, is expected to put real dollars in the hands of many Americans in 2011, beyond what would have resulted without the passage of the Tax Relief Act. That being said, the overall revenue cost of the individual tax cuts in the Tax Relief Act is approximately $186 billion.

1. Reduced Individual Income Tax Rates. Under the Tax Relief Act, the tax rate schedules for individuals will remain at 10%, 15%, 25%, 28%, 33%, and 35% through 2012. Prior to the passage of the Tax Relief Act, these rates were scheduled to rise for tax years beginning in 2011 to 15%, 28%, 31%, 36%, and 39.6%. Nonetheless, President Obama has already announced that he will make the rate reduction for the two highest individual income tax brackets an issue in the 2012 presidential campaign.

2. Reduced Capital Gains and Qualified Dividend Rates. The Tax Relief Act extends the reduced tax rates applicable to capital gains and qualified dividends, which were the hallmark of the Bush-era tax cuts, for an additional two years. Under Section 102 of the Tax Relief Act, adjusted net capital gain and qualified dividends will continue to be taxed at a rate of 15% through 2012. Without the Tax Relief Act, the capital gains rate would have increased to 20% for tax years beginning in 2011 and qualified dividends would have been subject to tax at ordinary income tax rates.

3. Payroll Tax Cut. One of the most significant provisions in the Tax Relief Act is the two percentage point reduction in certain payroll and self-employment taxes for the 2011 tax year. This payroll tax cut alone is expected to inject over $110 billion dollars in to the U.S. economy during 2011, with a maximum per taxpayer savings of $2,136.

Under current law, FICA imposes two taxes on employers, employees, and the self-employed – the so-called "Social Security" tax for Old Age, Survivors and Disability Insurance ("OASDI") and the "Medicare" tax for Hospital Insurance ("HI"). Prior to the Tax Relief Act, the FICA tax rate for employees and employers was 7.65% each (6.2% for OASDI and 1.45% for HI) and the FICA tax rate for self-employed individuals was 15.3% (12.4% for OASDI and 2.9% for HI). Currently, the maximum amount of compensation subject to OASDI is $106,800 (there is no maximum for HI).

Pursuant to the Tax Relief Act, for the 2011 taxable year only, the OASDI tax rate for employees and the self-employed is reduced by two percentage points. As a result, the Tax Relief Act reduces the OASDI rate for employees to 4.2% and reduces the OASDI rate for self employed individuals to 10.4%. The maximum amount of compensation subject to OASDI will remain at $106,800. As noted above, taxpayers with compensation income in excess of $106,800 will save a maximum of $2,136 in 2011 as a result of the payroll tax cut.

Other important provisions in the Tax Relief Act impacting individual taxpayers include (i) the elimination of the itemized deduction limitations and personal exemption phase-out through 2012; and (ii) the extension of the $1,000 child tax credit through 2012, among others.

AMT PATCH

The Tax Relief Act also contains an "AMT" patch designed to prevent the AMT from applying to additional middle income taxpayers. Under the Tax Relief Act, the AMT exemption amounts are increased for 2010 to $47,450 for single individual taxpayers, $72,450 for married taxpayers filing joint returns and surviving spouses, and $36,225 for married taxpayers filing separate returns. The AMT exemption amounts for 2011 are also "patched" under the Tax Relief Act. In the absence of the Tax Relief Act, the AMT exemption amounts would have dropped, such that an additional 21 million Americans likely would have been subject to the AMT.

BUSINESS TAX INCENTIVES

In order to promote economic stimulus, the Tax Relief Act also introduces some significant new tax breaks for businesses. Key among these incentives are the expansion of the bonus first year depreciation deduction and the boosted expensing amounts under Internal Revenue Code ("IRC") § 179. The total revenue cost of these two new incentives is estimated at $21 million.

1. 100% Bonus First Year Depreciation Deduction. The Tax Relief Act significantly expands the allowance for bonus first-year depreciation deductions from 50% to 100% of the cost of certain qualified property placed in service after September 8, 2010 and before January 1, 2012. The Tax Relief Act also extends the treatment of qualified leasehold improvement property as 15-year property through 2011, making such property eligible for the 100% first-year bonus depreciation deduction if placed in service after September 8, 2010 and before January 1, 2012.

The Tax Relief Act's allowance of 100% bonus first-year depreciation is one of the most significant provisions in the Tax Relief Act for businesses because the allowance is not limited to use by smaller businesses or capped at a certain dollar amount. Thus, for example, a calendar-year business that purchases $1 million of new property eligible for bonus depreciation in December of 2010 will be able to claim a $1 million depreciation deduction (i.e., write off the entire cost of the new property) on its 2010 income tax return.

2. Increased Expensing Under IRC § 179. In order to encourage business spending, the dollar and investment limits under IRC § 179 have been regularly increased by Congress. The 2010 Small Business Jobs Act previously increased the IRC § 179 expensing dollar and investment limits to a $500,000 dollar limitation and a $2,000,000 investment limitation for the 2010 and 2011 tax years. The Tax Relief Act now increases the IRC § 179 expensing dollar and investment limits for the 2012 tax year to a $125,000 dollar limitation and a $500,000 investment limitation. Without the Tax Relief Act, the $500,000/$2,000,000 limitations under the 2010 Small Business Jobs Act were scheduled to revert back to $25,000/$200,000 for tax years beginning in 2012.

Other key tax incentives for businesses in the Tax Relief Act include the renewal of the IRC § 41 research tax credit through December 31, 2011 and the extension of the 100% exclusion on gain from the sale of qualified small business stock to stock acquired prior to January 1, 2012.

ESTATE AND GIFT TAX RELIEF

Prior to the enactment of the Tax Relief Act, there was no estate tax for individuals dying during the 2010 calendar year and, following 2010, estate and other transfer taxes were scheduled to rise substantially. The Tax Relief Act now provides temporary relief by reducing estate, gift, and generation-skipping transfer ("GST") taxes for the 2010 through 2012 tax years and by renewing certain other estate and gift tax relief provisions that were set to expire after 2010. Significantly, the Tax Relief Act also preserves the 2010 estate tax repeal, albeit in a roundabout manner, by allowing estates to elect the no estate tax and modified carryover basis rules applicable under prior law for the 2010 taxable year. However, non-electing estates will be subject to estate tax, as modified by the Tax Relief Act. The total revenue cost associated with the estate and gift tax relief provisions in the Tax Relief Act is $68 billion.

Under the Tax Relief Act, the estate tax is revived (again for non-electing estates) for 2010, with a $5 million exemption, a top tax rate of 35%, and a step-up in basis. In addition, for estates of decedent's dying after December 31, 2010, any portion of the deceased spouse's $5 million exemption that is unused may be transferred to the surviving spouse. That being said, these generous relief provisions are temporary, with much harsher estate tax rules scheduled to return in 2012.

With respect to gift taxes, for gifts made during 2010, the Tax Relief Act provides that the gift tax is computed using a rate schedule with a top rate of 35% and an applicable lifetime exclusion amount of $1 million. After 2010, the gift tax is reunified with the estate tax, with a top gift tax rate of 35% and a $5 million lifetime exclusion. Finally, with respect to the GST, the Tax Relief Act provides a $5 million exemption for 2010 along with a 0% tax rate in 2010. After 2010, the GST tax rate will be 35% and the exemption amount will remain at $5 million.

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