Extension of Bush tax cuts in the 2010 Tax Relief Act

The heart of the recently enacted "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010" is a two-year extension of the Bush tax cuts. But what, exactly, are the Bush tax cuts? Here's a primer:

Bush tax-cut legislation

The Bush tax cuts refer primarily to tax changes in two major pieces of legislation back in 2001 and 2003: the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA).

The 2001 legislation (EGTRRA) was a 10-year $1.35 billion tax cut package which was the largest tax cut since 1981. Key elements of EGTRRA included:

- A lowering of individual income tax rates from 15%, 28%, 31%, 36%, and 39.6% to 10%, 15%, 25%, 28%, 33%, and 35%.
- A doubling of the child tax credit from $500 to $1,000.
- A gradual reduction in estate taxes, culminating in a one-year repeal in 2010 (but reinstatement in 2011).

But the crucial element of the 2001 tax cuts, at least for current purposes, is that they were temporary, set to expire at the end of 2010 unless Congress acted to extend them.

The 2003 legislation (JGTRRA) accelerated certain tax changes passed in EGTRRA, but the centerpiece of the law was a cut in the top capital gains rate from 20% to 15% and a cut in the top individual rate on dividends from 35% to 15%. Under the 2003 legislation, the capital gains and dividends cuts were set to expire after 2008, but they were later extended for two additional years (until 2010).

So when people talk about the "Bush tax cuts," they are referring, for the most part, to the provisions in the 2001 and 2003 Acts which lowered individual income tax rates and cut the top rates on capital gains and dividends.

New law extends lower rates for all taxpayers for two years

Over the past several years, a lot of political energy has been expended on the issue of whether the favorable individual income tax rates, which were set to expire at the end of 2010, should be extended for everyone, or for everyone except the "rich."

The new law settles the issue by extending the lower rates for all taxpayers. Under the new law, the rates which have been in effect in recent years - 10%, 15%, 25%, 28%, 33% and 35% - will remain in place. However, the extension is only for two years - through 2012.

New law extends lower capital gains rates for two years

Capital gains, generally speaking, refers to the profits realized on sales of non-inventory assets. For individuals, capital gains are generally taxed at a preferential rate in comparison to ordinary income.

The amount of tax depends on both the investor's tax bracket and how long the investment was held before being sold. Short-term capital gains on investments held for a year or less are taxed at the investor's ordinary income tax rate. Long-term capital gains, which apply to assets held for more than one year, are taxed at a lower rate than short-term gains.

Since 2008, the tax rate on long-term capital gains has been 0% for individuals in the 10% and 15% income tax brackets, and 15% for everyone else. However, those rates were scheduled to expire at the end of 2010, as explained above, with the result that in 2011 the long-term capital gains tax rate would have risen to 20% (10% for taxpayers in the 15% tax bracket) if Congress had not acted.

The new legislation forestalls these increases by extending the 0% and 15% long-term capital gains tax rates for two years (through 2012).

New law extends lower rates for qualified dividends for two years

Since 2003, “qualified dividends” have been taxed at the same low tax rates which apply to long-term capital gains. For dividend income falling in the higher tax brackets, the rate is 15%. In the first two brackets (where ordinary income is taxed at 10% and 15% rates), the dividend rate is 0%.

To count as “qualified,” dividend-paying common stocks must be held for at least 61 continuous days before the ex-dividend date - the last purchase day for collecting the dividend. For preferred stock, the required holding period is 91 days before the ex-dividend date.

The low rates for qualified dividends, like the other Bush tax cuts, were scheduled to expire at the end of 2010. If Congress had not acted, beginning in 2011 taxes on dividends would have returned to the rates that were in effect before 2001, and all dividend income received in 2011 would have been taxed as ordinary income. Since the top income tax rate was scheduled to return to 39.6%, individuals could have paid as much as a 39.6% tax on dividends.

The new legislation prevents that from happening by continuing the tax regime in effect for qualified dividends (i.e., treatment as long-term capital gains, subject to a 0% tax rate for individuals in the 10% and 15% tax brackets and a 15% tax rate for other taxpayers) for two years - through 2012.

Return of the estate tax

EGTRRA gradually lowered the maximum estate tax rate and substantially raised the applicable exclusion amount over the years 2002 through 2009. The maximum tax rate fell from 60% under prior law in 2001 (a 55% marginal rate on taxable estate values over $3 million plus a 5% surtax from $10 million to $17 million) to 45% in 2007 - 2009. EGTRRA repealed the estate tax completely for decedents dying in 2010. That led to several well-publicized instances in which famous people died in 2010 leaving multibillion-dollar estates which will pass to their heirs without paying so much as a penny in Federal estate tax. However, all of those provisions were scheduled to sunset on December 31, 2010, meaning that if Congress had not acted, starting January 1, 2011, the estate tax would have sprung back at a level which no one seemed to want. Where the exclusion was $3.5 million ($7 million for couples) in 2009 – a level at which it affected relatively few households – it would have been $1 million ($2 million for couples) in 2011. The tax rate would also have risen, from a top rate of 45% in 2009, to a top rate of 55% in 2011.

The new law brings back the estate tax, for 2011 and 2012 anyway. During 2011 and 2012, the top rate will be 35%. For 2011, the exemption amount will be $5 million per individual (indexed for inflation after 2011). At those levels, the vast majority of estates (all but an estimated 3,500 nationwide in 2011) will not be subject to any Federal estate tax, and the tax will raise about $11.4 billion for the government. By way of comparison, the 55% tax with a $1 million exemption would have resulted in about 43,540 taxable estates in 2011, and raised about $34.4 billion. Tax historians would also note that except for the temporary repeal of the estate tax in 2010, the estate tax rate has not been less than 45% since 1931.

The new law also gives heirs of decedents dying in 2010 a choice of which estate-tax rules to apply – 2010's or 2011's. That's important because although there is no estate tax in 2010, some inherited assets are subject to higher capital gains tax under the 2010 rules, a situation which actually raises the tax burden for some heirs. Inherited assets under the 2010 rules have a tax basis equal to the price when they were purchased (referred to in tax parlance as "carryover basis") rather than the price at death. That could lead to a significant tax burden for heirs who sell assets such as stocks that had been held for many years and have greatly appreciated in value. Under the 2011 rules, by contrast, heirs will be allowed to inherit assets with a "stepped-up basis." While most heirs would choose the 2011 regime ($5 million exemption from both estate and generation-skipping tax and an unlimited step-up in the basis of assets to their current market value), the heirs of superrich decedents could find it more advantageous to elect the 2010 law (limited step-up in the basis of assets and no estate tax). If the executor makes the election to have the 2010 rules apply, the estate tax return's due date will not be earlier than the date that's nine months after the new law's enactment date.

For gifts made after December 31, 2010, the gift tax will be reunified with the estate tax. Under the new law, the estate and gift tax exemptions will be reunified starting in 2011, which means that the $5 million estate tax exemption will also be available for gifts. The law in effect prior to 2010 provided a $3.5 million lifetime exemption for estates, but only $1 million for gifts. The gift tax rate, starting in 2011, will be 35%. The exemption from the generation-skipping tax (GST) – the additional tax on gifts and bequests to grandchildren when their parents are still alive – will also rise to $5 million from the $1 million it would have been without the new law. The GST tax rate for transfers made in 2011 and 2012 will be 35%.

From a planning standpoint, a nice feature of the new law is that it makes it easier to transfer the $5 million exemption to a surviving spouse, so married couples can shield $10 million of their assets from taxes. In the language of tax professionals, the estate tax exemption will be "portable."

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In addition to extending the Bush tax cuts, providing relief from the AMT and cutting the payroll tax by two percentage points, the recently enacted "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010" (Tax Relief Act) extends a host of other important tax breaks for businesses and individuals.

Individual tax relief

The following tax breaks for individuals that expired at the end of 2009 have been retroactively reinstated by the Tax Relief Act and extended through 2011:

- The election to take an itemized deduction for State and local general sales taxes instead of the itemized deduction permitted for State and local income taxes.

- The above-the-line deduction for qualified higher education expenses.

- The $250 above-the-line tax deduction for teachers and other school professionals for expenses paid or incurred for books, certain supplies, equipment, and supplementary materials used by the educator in the classroom.

- The increased contribution limits and carryforward period for contributions of appreciated real property (including partial interests in real property) for conservation purposes.

- The provision that permits tax-free distributions to charity from an Individual Retirement Account (IRA) of up to $100,000 per taxpayer, per tax year. Individuals also will be allowed to make charitable transfers during January of 2011 and treat them as if made during 2010.

- The look-thru rule for certain regulated investment company (RIC) stock in determining the gross estate of nonresidents.

- The increase in the monthly exclusion for employer-provided transit and vanpool benefits to equal that of the exclusion for employer-provided parking benefits.

In addition, the new law extends for an additional year (i.e., through 2011) the rule allowing premiums for mortgage insurance to be deductible as qualified residence interest.

Business tax relief.

On the business side, the following business tax breaks that expired at the end of 2009 have been retroactively reinstated and extended through 2011 by the Tax Relief Act:

- The research and development credit.

- 15-year writeoffs for qualified leasehold improvements, and restaurant buildings (and certain improvements to such restaurant buildings).

- 7-year writeoffs for certain motorsports racetrack property.

- The employer wage credit for activated military reservists.

- The active financing exception from the Code's Subpart F rules for a controlled foreign corporation predominantly engaged in the conduct of a banking, financing or similar business.

- Look-through treatment of payments between related controlled foreign corporations.

- The Indian employment credit.
- The new markets tax credit.
- Accelerated depreciation for business property on an Indian reservation.
- The railroad track maintenance credit.
- The special expensing rules for certain film and television productions.
- The mine rescue team training credit.
- The election to expense advanced mine safety equipment.
- Expensing of environmental remediation costs.
- The deduction allowable for domestic production activities in Puerto Rico.
- The American Samoa economic development credit.
- The rules exempting from gross basis tax and from withholding tax the interest-related dividends and short-term capital gain dividends received from a RIC by certain foreign persons (extended to apply to tax years of a RIC beginning before 2012).
- The inclusion of a RIC within the definition of a "qualified investment entity" under the provisions of the Foreign Investment in Real Property Tax Act as codified in Code Sec. 897.
- The enhanced deduction for contributions of food and book inventories and computer equipment for educational purposes.
- A liberal rule for S corporations making charitable donations.
- The special rules for interest, rents, royalties and annuities received by a tax-exempt entity from a controlled entity.
- Empowerment zone tax incentives.
- Renewal community tax incentives.
- Tax incentives for investments in the District of Columbia.
- The work opportunity credit (extended for four months (through the end of 2011).
- Qualified zone academy bonds.

In addition, the new law extends for an additional year (i.e., through 2011) the temporary exclusion of 100% of gain on the sale of certain small business stock.

Energy provisions.

The following energy provisions were extended by the Act (through 2011):

- The credit for energy-efficient improvements to existing homes.
- The energy efficient appliance credit.
- The credit for manufacturers of energy-efficient new homes.
- Incentives for biodiesel and renewable diesel.
- The credit for refined coal facilities.
- Excise tax credits and outlay payments for alternative fuel and alternative fuel mixtures.
- The special rule to implement FERCs and State electric restructuring policy.
- Suspension of the limitation on percentage depletion for oil and gas from marginal wells.
- Grants for specified energy property in lieu of tax credits.
- Provisions related to alcohol used as fuel.
- The energy efficient appliance credit.
- The credit for energy-efficient improvements to existing homes.
- The 30% investment tax credit for alternative vehicle refueling property.

Disaster relief provisions.

The following disaster relief provisions are extended through 2011:

- New York Liberty Zone tax-exempt bond financing.
- Increased rehabilitation credit for structures in the Gulf Opportunity Zone.
- Low-income housing credit rules for buildings in Gulf Opportunity Zones.
- Tax-exempt bond financing for the Gulf Opportunity Zones.
- Bonus depreciation deduction applicable to specified Gulf Opportunity Zone extension property.