CCH Tax Briefing

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Sunsetting Benefits of the Economic Growth and Tax Relief Reconciliation Act of 2001

September 13, 2010

Special Report

HIGHLIGHTS

- Sunset Of EGTRRA Individual Rate Cuts
- Expiration Of Marriage Penalty Relief
- Reinstated Itemized Deduction/Personal Exemption Phaseouts
- Reduced Child Tax Credit
- End Of Lower Capital Gains/ Dividends Rates
- Reduced Code Sec. 179 Expensing
- Sunset Of Enhanced Education Tax Incentives
- Revived Federal Estate Tax
- Expiration of GST Tax Reforms
- And More

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EGTRRA SUNSET BRINGS NEW CHALLENGES TO PLANNING FOR 2011

Time is almost up for the historic tax cuts enacted by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). Without any Congressional action, many popular tax cuts automatically disappear ("sunset") after December 31, 2010. They will be replaced by rates, deductions, credits and other provisions based on the far less generous law in place before EGTRRA. Additionally, enhanced capital gains and dividends tax rates in the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) and subsequent legislation will also sunset after December 31, 2010. *This CCH Tax Briefing alerts tax practitioners and their clients to what the Tax Code is scheduled to look like after EGTRRA's and JGTRRA's tax benefits sunset after December 31, 2010.*

IMPACT. *While individual, capital gains/ dividends and estate tax rate cuts remain the focus of the expiring tax cuts and are the most likely provisions to get Congress' attention this Fall, EGTRRA made over 50 other major changes to the Tax Code that will also sunset. Congress may ignore them entirely, or re-evaluate each on a case-by-case basis. Other EGTRRA changes, notably its sizeable package of pension reform measures, were spared the sunset ax by the Pension Protection Act of 2006 and subsequent legislation.*

COMMENT. *It appears the House is looking to the Senate to take the lead on extending EGTRRA. The Senate, however, is hampered by its supermajority rules, which require 60 votes to defeat any filibuster and pass a bill. The Senate may seek a compromise and extend the EGTRRA tax cuts for one or two years, rather than permanently. The timeline for Senate action is also uncertain. On September 8, Senate Majority Leader Harry Reid, D-Nevada, said he is committed to holding a lame-duck session after the November elections but did not say what legislation he intends to address.*

SUNSETS FACING INDIVIDUALS

EGTRRA targeted tax relief to individuals through marginal tax rate reduction, marriage penalty relief, an increased child tax credit, and more. *See also Capital Gains and Investment Sunsets and Estate Tax Sunsets in this Briefing for additional provisions affecting individuals.*

Income Tax Rates for Individuals

Regular income tax liability is determined by applying the regular income tax rate schedules to the individual's taxable income. The rate schedules are divided into ranges of income, known as income brackets, and vary for single filers, married taxpayers filing separately, joint filers, heads of households, and estates and trusts. The marginal tax rate increases as the taxpayer's income increases.

Before EGTRRA, the individual marginal income tax rates were 15, 28, 31, 36, and 39.6 percent. EGTRRA gradually reduced the individual marginal income tax rates (accelerated by JGTRRA). For 2010, the indi-

vidual marginal income tax rates are 10, 15, 25, 28, 33, and 35 percent.

Under the sunset provision of EGTRRA, amendments made by the Act will not apply to tax years beginning after December 31, 2010. Consequently, the individual marginal tax rates will revert to 15, 28, 31, 36, and 39.6 percent effective for tax years beginning after December 31, 2010.

10 Percent Rate. EGTRRA created a new bracket, the 10 percent tax rate, for a portion of individual income previously taxed at 15 percent. After December 31, 2010, the 10 percent rate will disappear and the first portion of taxable income for all taxpayers therefore will again be taxed at 15 percent.

IMPACT. *EGTRRA made across the board rate reductions but its greatest benefit was to taxpayers in the top two income brackets. After 2010, higher-income taxpayers not only are scheduled to be subject to higher marginal income tax rates, they also, effective for tax years after December 31, 2012, will be subject to an additional 0.9 percent Medicare tax on earned income above $200,000 ($250,000 for married couples filing a joint return) and a 3.8 percent Medicare tax on the lesser of the individual's net investment income for the tax year or modified AGI in excess of $200,000 ($250,000 for married couples filing a joint return).*

IMPACT. *Individuals expecting to be subject to a higher income tax rate after 2010 should explore the timing of income or deductible expenses. Deferring deductions into 2011 may help to offset income that would be subject to a higher rate of taxation. Accelerating income into 2010 likewise might lower overall tax liability. Acceleration techniques include billing earlier, selling appreciated property, avoiding installment sales that defer gain, and accelerating bonuses. Converting to a Roth IRA in 2010 also gives the taxpayer the option of recognizing the conversion income in 2010 or pro-rata over 2011 and 2012 under existing rules.*

IMPACT. *Taxpayers doing business as an S corp may be motivated to convert to a C corp in response to the rate increases, since the highest corporate tax rate remains at 35 percent. However, taxpayers should keep in mind the expected increase in dividend tax rates after 2010. Additionally, after an S corp converts to a C corp, it generally cannot switch back to being an S corp for the next five years.*

"EGTRRA made across the board rate reductions but its greatest benefit was to taxpayers in the top two income brackets."

COMMENT. *President Obama has proposed to make permanent the 10, 15, 25, and 28 percent rates for tax years beginning after December 31, 2010 but allow the 33 and 35 percent rates to sunset as scheduled. The president has also proposed to widen the tax bracket for the 28 percent rate so that individuals with less than $195,550 of taxable income in 2011 ($200,000 of AGI, assuming one personal exemption and the basic standard deduction, indexed for inflation from 2009), would not be subject to the 36 percent rate. For married couples filing a joint return, the dollar threshold for the 36 percent rate would be set at approximately $237,300.*

COMMENT. *Although the tax rates are scheduled to revert to the levels in place in 2001 prior to EGTRRA, the bracket amounts to which each rate is applied will continue to reflect annual inflation adjustments. Unlike some other EGTRRA sunset dollar amounts, those inflation adjustments are required under the pre-EGTRRA, EGTRRA and post-EGTRRA versions of the Tax Code.*

IMPACT. *By far the costliest provision to extend is the reduced individual taxes. According to the Congressional Budget Office (CBO), they account for over 50 percent of the total revenue loss.*

Itemized Deduction Phaseout for Higher-Income Taxpayers

The limitation on itemized deductions (called the "Pease" limitation after the name of the member of Congress who sponsored the legislation enacting the limitation) reduces the total amount of a higher-income taxpayer's otherwise allowable itemized deductions. However, certain items, such as medical expenses, investment interest, and casualty, theft or wagering losses, are excluded.

Under EGTRRA, the limitation on itemized deductions was gradually repealed starting in 2006. For 2010, the limitation on itemized deductions is entirely repealed.

The limitation threshold amount, $100,000 for most taxpayers and $50,000 for married taxpayers filing separate returns, was set in 1991, adjusted annually for inflation.

Under the sunset provision of EGTRRA, the limitation on itemized deductions will be reinstated in full for tax years beginning after December 31, 2010.

IMPACT. *Higher-income taxpayers who anticipate being subject to the limitation on itemized deductions after 2010 may want to explore the value of shifting some of their itemized deductions to 2010 by accelerating payment of deductible expenses before year-end. In accelerating deductions to avoid the itemized deduction limitation, however, those anticipating being in a higher rate bracket in 2011 should weigh carefully the benefits of getting a reduced deduction that offsets income taxed at a higher rate in 2011 against a full deduction that offsets income taxed at a lower rate in 2010.*

COMMENT. *President Obama has proposed to modify the limitation on item-*

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ized deductions for tax years beginning after December 31, 2010, to only start beyond the $200,000 level ($250,000 for joint filers). Future years would be adjusted for inflation.

Personal Exemption Phaseout for Higher-Income Taxpayers

The personal exemption phaseout (PEP) reduces or eliminates the deduction for personal exemptions for taxpayers with incomes over certain thresholds. The total amount of exemptions that may be claimed by a taxpayer is reduced by two percent for each $2,500 or portion thereof (two percent for each $1,250 for married couples filing separate returns) by which the taxpayer's AGI exceeds the applicable threshold.

Under EGTRRA, the personal exemption phaseout was gradually repealed starting in 2006. For 2010, the personal exemption phaseout is entirely repealed.

Under the sunset provision of EGTRRA, the personal exemption phaseout will be reinstated in full for tax years beginning after December 31, 2010.

COMMENT. *As in the case of the itemized deduction limitation, President Obama has proposed to modify the limitation on personal exemptions for tax years beginning after December 31, 2010, to only start beyond the $200,000 level ($250,000 for joint filers), adjusted for inflation.*

Standard Deduction for Married Couples Filing a Joint Return

Non-itemizers may take the basic standard deduction (and additional standard deductions if applicable), which is subtracted from AGI to calculate taxable income. Prior to EGTRRA, the basic standard deduction for 2001 for a single individual was 60 percent of the basic standard deduction for married couples filing a joint return.

Under EGTRRA, the basic standard deduction for a married couple filing a joint return gradually increased to twice the basic standard deduction for an unmarried individual filing a single return. For 2010, the standard deduction for joint returns as a percentage of the standard deduction for single returns is 200 percent.

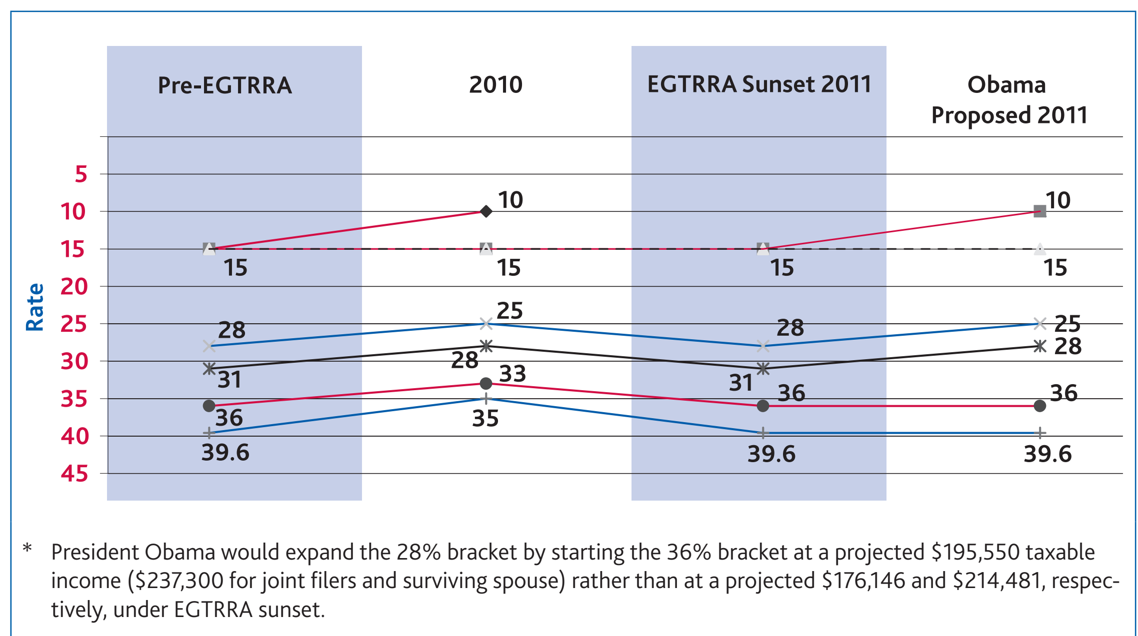
Under the sunset provision of EGTRRA, amendments made by the Act will not apply to tax years beginning after December 31, 2010. Consequently, the increased basic standard deduction at 200 percent of the amount allowed for an unmarried individual filing a single return will not be available to a married couple filing a joint return after 2010.

COMMENT. *Married individuals filing joint return are entitled to a standard deduction of $11,400 in 2010, however if the EGTRRA sunset takes effect, the basic standard deduction for 2011 can be expected to drop to somewhere between $9,500 and $10,000 for joint returns.*

IMPACT. *The gradual increase in the basic standard deduction was intended to ameliorate the so-called marriage penalty and its sunset after 2010 will revive the marriage penalty. A marriage penalty exists when the combined tax liability of a married couple filing a joint return is greater than the sum of the tax liabilities of each individual computed as if they were unmarried. Married couples may want to explore increasing their withholding or making larger estimated tax payments in 2011 to avoid any adverse impact from the sunset of the increased standard deduction for married couples.*

COMMENT. *President Obama has proposed to permanently increase the basic standard deduction for a married couple filing a joint return to twice the basic standard deduction for an unmarried individual filing a single return, irrespective of income level.*

COMPARISON OF INDIVIDUAL INCOME TAX RATES



* President Obama would expand the 28% bracket by starting the 36% bracket at a projected $195,550 taxable income ($237,300 for joint filers and surviving spouse) rather than at a projected $176,146 and $214,481, respectively, under EGTRRA sunset.

15 Percent Income Tax Bracket for Married Couples Filing a Joint Return

To remove the marriage penalty, the size of the 15 percent regular income tax rate bracket for a married couple filing a joint return gradually increased under EGTRRA and subsequent legislation to twice the size of the corresponding rate bracket for an unmarried individual filing a single return. For 2010, as fully phased-in, the end point of the 15 percent rate bracket for a married couple filing a joint return as a percentage of the end point of the 15 percent rate bracket for an unmarried individual filing a single return is 200 percent.

Under the sunset provision of EGTRRA, effective for tax years beginning after December 31, 2010, the 15 percent regular income tax rate bracket for a married couple filing a joint return will return to being less than the combined 15 percent regular income tax rate brackets of two unmarried individuals filing single returns.

COMMENT. *President Obama has proposed permanently increasing the size of the 15 percent regular income tax rate bracket for a married couple filing a joint return to twice the 15 percent regular income tax bracket for an unmarried individual filing a single return.*

Earned Income Credit

Qualified individuals with earned income may claim a refundable earned income credit (EIC). The amount of the EIC reflects the taxpayer's income and the number, if any, of qualifying children.

Under EGTRRA, the beginning and end points of the earned income credit phaseout were gradually increased for married couples filing a joint return over and above annual inflation adjustments. EGTRRA also simplified the definition of earned income, eliminated the rule that reduced a taxpayer's EIC by the amount of alternative minimum tax (AMT) liability, reformed the relationship test, modified the tie-breaking rule, and gave the IRS additional math error authority. The Working Families Tax Relief Act of 2004 (WFTRA) and the American Recovery and Reinvestment Act of 2009 (2009 Recovery Act) further enhanced the credit but both retained EGTRRA's sunset schedule.

Under the sunset provision of EGTRRA, the enhancements to the EIC will disappear after 2010.

COMMENT. *In August 2010, President Obama signed legislation (P.L. 111-226) abolishing the advance payment option for the EIC. EGTRRA's sunset does not revive the advance EIC.*

IMPACT. *Some taxpayers also may experience a marriage penalty in the EIC after 2010. Generally, this may occur because the EIC is based on earned income and numbers of qualifying children and not on marital status.*

COMMENT. *President Obama has proposed to permanently extend EGTRRA's enhancements to the EIC for tax years beginning after December 31, 2010. The president has not indicated if he endorses extending the enhancements to the EIC under the 2009 Recovery Act.*

Child Tax Credit

A taxpayer may claim a tax credit for each qualifying child. The qualifying child must be under age 17 at the close of the year and satisfy relationship, residency, support, citizenship and dependent tests.

Under EGTRRA, the child tax credit gradually increased in amount ($1,000 for the 2010 tax year). EGTRRA also modified the refundable component, provided that the refundable portion of the child tax credit does not constitute income, provided that the child tax credit is allowable against regular income tax and, for tax years beginning before January 1, 2011, allowable against AMT, repealed the AMT offset against the additional child tax credit for families with three or more children, and eliminated the supplemental child tax credit.

Under the sunset provision of EGTRRA, the child tax credit will revert to $500 per qualifying child. In addition, the other EGTRRA enhancements to the child tax credit will expire after 2010.

IMPACT. *The flat $500 amount, which was in place before EGTRRA, is not adjusted annually for inflation. Also unadjusted for inflation are the income levels beyond which the credit is reduced or eliminated. The child tax credit is reduced and phased out when a taxpayer's modified AGI reaches certain thresholds. Those thresholds remain at $110,000 for joint filers and $75,000 for others.*

COMMENT. *President Obama has proposed permanently extending the $1,000 child tax credit for tax years beginning after December 31, 2010. Additionally, the president has proposed permanently extending the modified refundable component, the allowance of the child tax credit against regular income tax and AMT, the rule that the refundable portion of the child tax credit does not constitute income, the repeal of the AMT offset against the additional child tax credit for families with three or more children, and elimination of the supplemental child tax credit for tax years beginning after 2010.*

Dependent Care Credit

The dependent care credit applies to expenses paid for the care of a qualifying individual to enable the taxpayer to be gainfully employed. The dependent care credit is a percentage of employment-related expenses and is limited by the taxpayer's AGI.

Under EGTRRA, the maximum amount of eligible employment-related expenses increased from $2,400 to $3,000 (in the case of one qualifying individual) and from $4,800 to $6,000 (in the case of two or more qualifying individuals) for tax years beginning before January 1, 2011. EGTRRA also raised the maximum credit

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from 30 to 35 percent and provided for a reduction in the credit, but not below 20 percent, by one percentage point for each $2,000, or fraction thereof, of AGI above a threshold amount ($28,000).

Under the sunset provisions of EGTRRA, the maximum amount of employment-related expenses will decrease from $3,000 to $2,400 (in the case of one qualifying individual) and from $6,000 to $4,800 (in the case of two or more qualifying individuals). There will be no adjustment for inflation since 2001. The maximum credit will also decline, from 35 to 30 percent.

Adoption Credit

Taxpayers who incur qualified adoption expenses may be eligible for the adoption credit or an exclusion from income for employer provided adoption assistance.

Under EGTRRA, the maximum adoption credit and the exclusion from income of employer-provided adoption assistance increased from $5,000 to $10,000 (indexed for inflation) for each eligible child, including a child with special needs. In the case of a special needs child, EGTRRA allowed $10,000 (rather than $6,000) (indexed for inflation) as an adoption credit and as an exclusion from income, regardless of whether the taxpayer has qualified adoption expenses.

The Patient Protection and Affordable Care Act (PPACA) increased the dollar limitation for the adoption credit and income exclusion for employer-paid or employer-reimbursed adoption expenses through a qualified adoption assistance program by $1,000 to $13,170 per eligible child (including a special needs child) for 2010 and 2011. Additionally, the adoption credit has been made refundable under the PPACA for 2010 and 2011.

COMMENT. *President Obama has proposed permanently extending the adoption credit and the exclusion from income of employer-provided adoption assistance at 2010 levels, rather than revert to the pre-EGTRRA $5,000 general level (adjusted for inflation). Additionally, the president has proposed to make permanent the refundability of the adoption credit.*

AMT Exemption Amounts

The Internal Revenue Code imposes an alternative minimum tax (AMT) on taxpayers to the extent that tentative tax exceeds regular tax. A certain amount of a taxpayer's alternative minimum taxable income (AMTI) is exempt from the AMT tax rates.

Under EGTRRA, the exemption amounts increased for unmarried individuals filing a single return, married couples filing a joint return, married couples filing a separate return, and surviving spouses. The increased exemption amounts were available for tax years beginning after December 31, 2000 and before January 1, 2005. In subsequent years, including 2009, Congress enacted temporary AMT "patches" with increased exemption amounts for unmarried individuals filing a single return, married couples filing a joint return, married couples filing a separate return, and surviving spouses.

COMMENT. *The AMT patches also allowed the nonrefundable personal credits to the full amount of the individual's regular tax and AMT.*

IMPACT. *Unless Congress enacts an AMT patch for 2010, the exemption amounts for 2010 and again for 2011 are $33,750 for unmarried individuals filing a single return, $45,000 for married couples filing a joint return and surviving spouses, and $22,500 for married individuals filing a separate return. The exemption amounts for 2009 were $46,700 for unmarried individuals fil-*

IMPACT OF SUNSETS—ILLUSTRATIONS

#1: Assume a couple, two children eligable for the child tax credit, filing a joint return and taking the standard deduction, with $130K wage income, $10,000 net capital gains, and $2,000 dividend income. Their tax liability for 2011 (all figures are estimates and, for illustration, assume no inflation adjustments for 2011 from 2010 bracket amounts):

***No sunset:* $19,513 tax due for 2011**
***Sunset:* $26,343 tax due for 2011**
***Obama modified sunset:* $19,513 tax due for 2011**

#2: Assume a couple, no children, filing a joint return and taking the standard deduction, with $300K wage income, $50,000 net capital gains, and $5,000 dividend income. Their tax liability for 2011 (assuming for illustration, no inflation adjustments for 2011 from 2010 bracket amounts):

***No sunset:* $78,860 tax due for 2011**
***Sunset:* $91,789 tax due for 2011**
***Obama modified sunset:* $84,011 tax due for 2011**

#3: Assume a single filer, no children, taking the standard deduction, with $70K wage income, $5,000 net capital gains, and $1,000 dividend income. The individual's tax liability for 2011 (assuming for illustration, no inflation adjustments for 2011 from 2010 bracket amounts):

***No sunset:* $12,244 tax due for 2011**
***Sunset:* $13,842 tax due for 2011**
***Obama modified sunset:* $12,244 tax due for 2011**

ing a single return, $70,950 for married couples filing a joint return and surviving spouses, and $35,475 for married couples filing a separate return.

CAPITAL GAINS AND INVESTMENT SUNSETS

Capital Gains Rates for Individuals

Any gain or loss on the sale of a capital asset is generally included in income. The Tax Code provides different tax rates for various types of capital gains.

Under JGTRRA, starting in 2003, and enhanced and extended by the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA), the maximum rate of tax on the adjusted net capital gain of an individual has been set at a reduced rate of 15 percent for tax years beginning before January 1, 2011 for both regular tax and AMT. JGTRRA also provided for a five percent rate (subsequently reduced to zero) for taxpayers in the 10 and 15 percent tax brackets.

Under the sunset provisions of JGTRRA and TIPRA, the maximum rate of tax on the adjusted capital gain of an individual will revert to 20 percent (except 18 percent for gains on assets held over five years) and the zero percent rate will disappear, replaced with a 10 percent rate (except eight percent for gains on assets held over five years).

IMPACT. *The JGTRRA/TIPRA extension through December 31, 2010 aligned the capital gains (and dividends) tax rate cuts with EGTRRA's income tax rate cuts so that they share the same sunset date and require coordinated effort to plan income recognition accordingly. Post-2012, planning will be further complicated by the 3.8 percent unearned income Medicare contribution tax, to be imposed on net investment income above certain amounts.*

IMPACT. *Individuals should consider the benefits of accelerating capital gains into 2010 while the rates may be lower. Accelerating the sale of capital assets is the general strategy available to accelerate gain. As long as the sale is bona fide and the proceeds are received in 2010, capital gains can be accelerated. Unlike the "wash sale" rules that require a sale for loss purposes not to be followed within a certain number of days by reacquisition of the same shares of stock, reacquiring the shares in the same corporation at any time is allowed if gain is realized, thereby legitimately preserving the investor's position in the market under this strategy.*

CAUTION. *Installment payments received after 2010 are subject to the tax rates for the year of the payment, not the year of the sale. Thus, the capital gains portion of payments made in 2011 and after would be taxed at the 20 percent rate for taxpayers in the higher income levels.*

COMMENT. *President Obama has proposed permanently extending the 15 and zero percent capital gains tax rates for everyone except taxpayers in the two highest income tax rate brackets. For those taxpayers, he recommends that the 15 percent capital gains rate sunset in favor of a 20 percent rate.*

IMPACT. *A permanent extension of the zero percent rate on adjusted capital gain of an individual is unlikely to stimulate significant investment. Individuals in the affected tax rate brackets (currently the 10 and 15 percent rate brackets) are generally not significant investors in capital assets.*

COMMENT. *The current 28 and 25 percent rates for collectibles and recaptured 1250 gain, respectively, would continue unchanged.*

Five-Year Holding Period for Capital Assets. The time a taxpayer owns an asset before disposing of it is the holding period. Under JGTRRA and as extended by TIPRA, the special holding period rule for capital assets held for more than five years was eliminated. TIPRA also repealed the 18 percent tax rate applicable for qualified five-year property (eight percent for taxpayers in the 10 or 15 percent tax rate brackets).

Under the sunset provision of JGTRRA and subsequent legislation, amendments made by the Act will not apply to tax years beginning after December 31, 2010. Consequently, the special holding period rule for capital assets held for more than five years will return along with the 18 percent tax rate applicable for that property (eight percent for taxpayers in the 10 or 15 percent tax rate brackets).

COMMENT. *President Obama has proposed permanently repealing the special holding period rule for capital assets held for more than five years along with extending the repeal of the applicable 18 percent (eight percent) tax rate.*

Dividend Income of Individuals

A dividend is the distribution of property made by a corporation to its shareholders out of its after-tax earnings and profits.

Under JGTRRA and as extended by TIPRA, the maximum tax rate for qualified dividends received by an individual was reduced to 15 percent for tax years beginning before January 1, 2011. A zero percent rate applies to qualified dividends received by an individual in the 10 or 15 percent income tax rate brackets.

Under the sunset provisions of JGTRRA and TIPRA, qualified dividends received by an individual for tax years beginning after December 31, 2010 will be taxed at ordinary income tax rates.

IMPACT. *Unlike capital gains (taxed at a maximum tax rate of 20 percent pre-JGTRRA), if Congress does not act, the tax rates on dividends would increase substantially, to ordinary income rates that could be as high as 39.6 percent.*

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IMPACT. *Qualified corporations may want to explore accelerating dividends to shareholders before January 1, 2011.*

COMMENT. *President Obama has proposed permanently extending the 15 and zero percent tax rates on qualified dividends. In addition, the president has proposed a 20 percent tax rate on qualified dividends for unmarried individuals filing a single return with AGI over $200,000 and for married couples filing a joint return with AGI above $250,000 for tax years beginning after December 31, 2010.*

COMMENT. *Only qualified dividends have been eligible for the reduced tax rates. Generally, these are dividends received from a domestic corporation or a qualified foreign corporation, on which the underlying stock is held for at least 61 days within a specified 121-day period.*

Small Business Stock

Non-corporate investors may exclude a percentage of the gain they realize on the sale or exchange of qualified small business stock. Generally, the stock must have been issued after a certain date by a qualified C corporation and held by the taxpayer for more than five years.

Under JGTRRA, seven percent (rather than 42 percent) of the excluded gain is treated as a tax preference item subject to the AMT for tax years beginning before January 1, 2011.

Under the sunset provision of JGTRRA and subsequent legislation, amendments made by the Act will not apply to tax years beginning after December 31, 2010. Consequently, the percentage of excluded gain treated as a tax preference item subject to the AMT will increase from seven to 42 percent.

COMMENT. *To qualify as small business stock, the stock must be issued by a C corporation that invests 80 percent of its assets in the active conduct of a trade or business and that has assets of $50 million or less when the stock is issued.*

COMMENT. *The 2009 Recovery Act allows investors to exclude 75 percent of the gain from small business stock acquired after February 17, 2009 and before January 1, 2011. President Obama has proposed raising the exclusion to 100 percent of the gain and to eliminate the AMT preference item.*

Other Dividend-Related Changes

The following changes are also scheduled to be made because of EGTRRA and JGTRRA sunsets:

- ***Mutual funds and REITs.*** Under JGTRRA, dividends received from a regulated investment company (RIC), real estate investment trust (REIT) and other qualified pass-through entities are qualified dividends for purposes of the reduced tax rates (15 and zero percent) for tax years beginning before January 1, 2011. Under JGTRRA's sunset provision, qualified dividend income received from a RIC, REIT or other qualified pass-through entity by an individual after December 31, 2010 will be taxed at ordinary income tax rates.
- ***Collapsible corporations.*** Under JGTRRA, the collapsible corporation rules were repealed for tax years beginning before January 1, 2011. JGTRRA's sunset effectively reinstates the pre-JGTRRA collapsible corporation rules.
- ***Accumulated earnings tax.*** The accumulated earnings tax imposed on corporations was reduced from the highest tax rate imposed on dividends distributed to individuals to 15 percent for tax years beginning before January 1, 2011. Under the sunset provisions, the 15 percent tax rate on accumulated earnings will disappear and accumulated earnings will be subject to the highest tax rate imposed on dividends distributed to individuals.
- ***Personal holding companies.*** The tax on undistributed personal holding company (PHC) income was reduced from the highest individual tax rate to 15 percent. Under sunset provisions applicable to tax years beginning after December 31, 2010, the 15 percent tax rate on undistributed personal holding company income will disappear and undistributed personal holding company income once again will be subject to the highest tax rate imposed on individuals.

Alaska Native Settlement Trusts

Alaska Native Corporations (ANCs) can establish settlement trusts to separate portfolio assets of an ANC from its business assets. EGTRRA enhanced the tax treatment of qualified settlement trusts.

Under the sunset provision of EGTRRA, amendments made by the Act will not apply to tax years beginning after December

SCHEDULE OF POTENTIAL TAX RATE INCREASES

	2010	Sunset 2011	Obama 2011 Budget
Regular Income Tax	10%, 15%, 25%, 28%, 33%, 35%	15%, 28%, 31%, 36%, 39.6%	10%, 15%, 25%, 28%, 36%, 39.6%
Capital Gains	0%, 15%	10%, 20%	0%, 15%, 20%
Dividends	0%, 15%	Regular Income tax rate, up to 39.6%	0%, 15%, 20%
Estate Tax	0%	55% / $1 million applicable exclusion amount	45% / $3.5 million applicable exclusion amount

31, 2010. The pre-EGTRRA treatment of qualified settlement trusts will return.

Tax Credit for Employer-Provided Child Care Facilities

Employers that provide child care facilities may be eligible for a tax credit.

Under EGTRRA, employers may be eligible for a tax credit equal to 25 percent of qualified expenses for employee child care and a tax credit equal to 10 percent of qualified expenses for child care resource and referral services. EGTRRA's tax treatment is subject to a $150,000 cap for the applicable tax year.

Under the sunset provision of EGTRRA for tax years beginning after December 31, 2010, the tax credit for employer-provided child care facilities will disappear.

IMPACT. *Employers that terminate child-care services would have to recapture a portion of the credit. While employers would be reluctant to eliminate child-care services, they could seek to save money by spending less or by charging employees more for child-care services that they may be able to fund, at least partially, through a pre-tax dependent care spending account.*

COMMENT. *President Obama has proposed permanently extending the tax credit for employer-provided child care facilities for tax years beginning after December 31, 2010.*

Expensing for Small Business

Taxpayers that purchase tangible depreciable property can elect to deduct the cost of the property in the year it is placed in service, rather than take depreciation on the property. The expensing amount is phased-out (but not below zero) by the amount by which the cost of qualifying property placed in service during the tax year exceeds a threshold amount.

Under JGTRRA and subsequent legislation, the $25,000 expensing amount and $200,000 threshold amount were repealed. In their place, JGTRRA and subsequent legislation provided for higher amounts and included off-the-shelf computer software as qualifying property. The Hiring Incentives to Restore Employment (HIRE) Act of 2010 increased the expensing amount to $250,000 and the threshold for reducing the deduction to $800,000 for tax years beginning on or after January 1, 2010 and on or before December 31, 2010.

Under the sunset provision of JGTRRA and subsequent legislation, amendments made by the Act will not apply to tax years beginning after December 31, 2010. Consequently, the expensing amount will revert to $25,000 and the threshold amount to $200,000, both not indexed for inflation.

IMPACT. *As the expensing and threshold amounts increased each year in recent years, the benefits of expensing became available to larger businesses, not just small businesses. Correspondingly, the significant decrease in these amounts after 2010 will preclude many businesses from taking advantage of Code Sec. 179 expensing, even at the lower $25,000 level.*

COMMENT. *President Obama has proposed a permanent expensing amount of $125,000 and a permanent phase-out threshold amount of $500,000 for tax years beginning after December 31, 2010. Both amounts would be indexed for inflation.*

EDUCATION SUNSETS

A number of education tax incentives are affected by the sunset of EGTRRA.

Educational Assistance Programs

Employer-paid educational expenses are generally deductible by the employer and excludable from the gross income and wages of employees.

Under EGTRRA, employers have been able to deduct up to $5,250 annually for qualifying education expenses paid for on behalf of an employee through December 31, 2010. The benefit is not taxable to the employee. EGTRRA expanded the scope of coverage to both undergraduate and graduate education.

Under the sunset provision of EGTRRA, the entire exclusion for employer-provided educational assistance—and not just the expansion to cover graduate courses—disappears after December 31, 2010.

IMPACT. *After the sunset, employer-paid educational assistance will be excludable from gross income only if it qualifies under the more stringent working condition fringe rules. Under the fringe benefit rules, the employee must be able to meet the business expense requirements that call for a direct relationship between the course and the employee's current job.*

Coverdell Education Savings Accounts

A Coverdell Education Savings Account (ESA) is an account created to pay certain qualified education expenses.

Under EGTRRA, the maximum annual contribution that can be made to a Coverdell ESA increased from $500 to $2,000, for tax years through December 31, 2010. The annual contribution limit phase-out increased for joint filers to eliminate any marriage penalty. EGTRRA also expanded the scope of "qualified education expenses" to include elementary and secondary education expenses, in addition to higher education expenses.

Under the sunset provision of EGTRRA, the annual contribution limit to a Coverdell ESA reverts to $500 for tax years beginning after December 31, 2010, and distributions from a Coverdell ESA will no longer be allowed to pay elementary and secondary education expenses, apparently irrespective of when the funds were contributed. The modified AGI phaseout range also returns to pre-EGTRRA levels, without inflation adjustment.

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IMPACT. *Taxpayers with unused funds in Coverdell ESAs may want to explore rolling over these amounts into a 529 college savings plan. EGTRRA's taxpayer-friendly revisions to 529 plans, which were scheduled to sunset after December 31, 2010, were made permanent by the Pension Protection Act of 2006.*

Student Loan Interest Deduction

Eligible taxpayers may deduct up to $2,500 in student loan interest, above-the-line, on a qualified student loan used to pay qualified educational expenses at an eligible institution. The $2,500 amount, however, is reduced as the taxpayer's modified adjusted gross income (AGI) rises and based on filing status.

Under EGTRRA, the modified AGI phaseout range for the student loan interest deduction increased for tax years through December 31, 2010. EGTRRA also eliminated the 60-month limitation that applied to limit the number of months during which interest paid on a student loan is deductible.

Under the sunset provision of EGTRRA, the increased modified AGI phaseout ranges will no longer apply. Additionally, the 60-month limitation will be reinstated for tax years beginning after December 31, 2010.

IMPACT. *The reinstatement of the 60-month limitation means that taxpayers will not be able to obtain a longer period of deductions by consolidating loans or changing payment schedules. With the reinstatement of the 60-month limitation, taxpayers who may take many years to pay off their education loans are prevented from deducting the interest payments for the full term of their loan.*

Deduction for Higher Education Expenses

The above-the-line deduction for higher education expenses under EGTRRA originally expired for tax years beginning after December 31, 2005. The deduction was extended by subsequent legislation through December 31, 2009. A maximum deduction of either $4,000 or $2,000 was allowed based upon modified AGI limits that ranged from $65,000 to $160,000, depending on filing status.

COMMENT. *Pending legislation (the American Jobs and Closing Tax Loopholes Act (H.R. 4213) and the Tax Extenders Act of 2009 (H.R. 4213)) would extend the deduction through December 31, 2010.*

Scholarships

A "qualified scholarship" generally may be excluded from the recipient's gross income. EGTRRA treats the National Health Service Corps Scholarship Program (NHSCSP) and the Armed Forces Scholarship Program (AFSP) as qualified scholarships. Under the sunset provisions of EGTRRA, the NHSCSP and the AFSP will not be qualified scholarships for tax years after December 31, 2010.

Bonds

Some enhancements to tax-exempt bonds will terminate upon EGTRRA's sunset:

- ***School construction bonds.*** Under the sunset provision of EGTRRA, the amount of governmental bonds for public schools that small governmental units can issue in a calendar year starting in 2011 without being subject to the arbitrage rebate requirement decreases from $15 million to $10 million.
- ***Exempt facility bonds.*** Under the sunset provisions of EGTRRA, exempt facility bonds cannot be used to finance the development and construction of "qualified public educational facilities" after December 31, 2010.

FEDERAL ESTATE, GIFT AND GST SUNSETS

Some of EGTRRA's most extensive reforms were to the federal estate, gift and generation-skipping transfer (GST) tax rules. EGTRRA repeals the federal estate tax but only for decedents dying during calendar year 2010. After 2010, the pre-EGTRRA estate tax provisions, with significantly higher tax rates, are scheduled to return unless Congress acts.

IMPACT. *While the estate tax ended under EGTRRA in 2010, that is not a sunset provision, but rather is part of the gradual phaseout of the estate tax under EGTRRA. What "sunsets" after December 31, 2010, is that phase out, with the estate tax regime returning to the way it had been pre-EGTRRA. This sunset includes not only a return to the pre-EGTRRA levels of rates and exemptions, but also impacts over a dozen other estate tax changes inaugurated by EGTRRA, for the 10-year period that is now ending.*

COMMENT. *In December 2009, the House passed the Permanent Estate Tax Relief for Families, Farmers, and Small Businesses Bill (H.R. 4154), which would repeal the carryover basis at death rules under EGTRRA for decedents dying on or after January 1, 2010. The House bill would permanently extend the federal estate tax at its 2009 parameters (a top federal estate tax rate of 45 percent and a $3.5 million exclusion ($7 million for married couples who fully utilize their exclusions)).*

Estate and Gift Tax Rates

The Tax Code traditionally applies a rate schedule for the taxation of estates and gifts.

Under EGTRRA, the maximum federal estate tax gradually declined from 55 percent to 45 percent, with the 45-percent rate applicable to decedents dying in 2007, 2008, and 2009. The estate tax is repealed entirely for decedents dying in 2010. EGTRRA also gradually reduced the federal gift tax down to a top marginal rate of 35 percent for gifts made after December 31, 2009.

Under the sunset provision of EGTRRA, the maximum federal estate tax rate reverts

to 55 percent for decedents dying after December 31, 2010. The maximum gift tax rate also reverts to 55 percent.

COMMENT. *The House bill (H.R. 4154) would provide for maximum federal estate and gift tax rates of 45 percent after December 31, 2009.*

COMMENT. *EGTRRA also repealed a five-percent surtax on certain large estates, which will be restored after EGTRRA's sunset.*

Estate and Gift Tax Exemption Amounts

The Tax Code provides every decedent a credit equal to the "applicable credit amount" in determining the amount of estate tax due. The applicable credit amount operates to exempt a specified amount of the value of a decedent's estate from the estate tax. This exempted amount is referred to as the "applicable exclusion amount." Under EGTRRA, the applicable exclusion amount for federal estate tax purposes is $3.5 million for decedents dying during 2009. EGTRRA provides for a $1 million gift tax exclusion beginning with gifts made in 2002.

Under the sunset provision of EGTRRA, the applicable exclusion amount for decedents dying after December 31, 2010 returns to the pre-EGTRRA figure of $1 million. The applicable gift tax exclusion amount will remain at $1 million.

IMPACT. *The $1 million applicable exclusion amount for decedents dying after December 31, 2010, would not include an adjustment for inflation. As a result, the value of the applicable credit amount is significantly reduced from its value under EGTRRA.*

Qualified Family Owned Business Deduction

Pre-EGTRRA, the Tax Code provided a deduction from the gross estates of individuals holding certain qualified family-owned business interests (QFOBIs). The intent was to provide additional federal estate tax relief for closely-held businesses.

EGTRRA repealed the deduction for qualified family-owned businesses interests for decedents dying after December 31, 2003. Under the sunset provision of EGTRRA, the deduction for QFOBIs revives after 2010.

> "After 2010, the pre-EGTRRA estate tax provisions, with significantly higher tax rates, are scheduled to return unless Congress acts."

COMMENT. *An additional tax is imposed if certain recapture events occur within 10 years of the decedent's death and before the qualified heir's death, including if the qualified heir ceases to meet material participation requirements. The additional tax continued to apply during the time that the QFOBI deduction was repealed.*

State Death Tax Credit

The Tax Code provides rules for the treatment of state death taxes paid—generally, any estate, inheritance, legacy, or succession taxes paid to any state or the District of Columbia.

EGTRRA changed the tax credit for state death taxes paid to a deduction for estates of decedents dying after December 31, 2004. Under the sunset provision of EGTRRA, the state death tax deduction terminates and the state death tax credit returns for the estates of decedents dying after December 31, 2010.

COMMENT. *EGTRRA also repealed a credit for state GST taxes imposed on a GST (other than a direct skip) occurring as a result of death. The credit will be restored for GST taxes paid to a state following a GST (other than a direct skip) that occurs as a result of the death of an individual after December 31, 2010.*

Reporting and Penalty Provisions

Under the EGTRRA carryover basis rules effective for decedents dying in 2010, the executor is permitted to increase the basis of assets owned by the decedent. Each decedent's estate may increase the basis of assets transferred by up to a total of $1.3 million. An estate may increase the basis of assets passing to a surviving spouse by an additional $3 million (for a total of $4.3 million).

The executor makes the basis increase allocations on an information return (yet to be released by the IRS). If the executor fails to file the information return by the prescribed due date, a $10,000 penalty is imposed. The executor is also required to provide a written statement to each recipient of the decedent's property included on the information return. There is a $50 penalty for each failure to furnish such written statement.

Under the sunset provision of EGTRRA, the reporting provisions for carryover basis are eliminated after December 31, 2010.

Income Tax Exclusion for Sale of Principal Residence

A single individual generally may exclude from income up to $250,000 of gain ($500,000 if married filing jointly) from the sale or exchange of a qualified principal residence if ownership and occupancy requirements are satisfied.

Under EGTRRA, the income tax exclusion of gain from the sale of a principal residence is applicable to a decedent's principal residence sold by the decedent's estate, applicable to estates of decedents dying in 2010. Under the sunset provision of EGTRRA, the income tax exclusion for the sale of a principal residence will no longer be applicable to a decedent's principal residence sold by the decedent's estate.

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Treatment of Appreciated Carryover Basis Property to Satisfy Pecuniary Bequest

The Tax Code provides rules for recognition of gain on appreciated carryover basis property transferred to satisfy pecuniary bequests. A pecuniary bequest is a bequest of a specific dollar amount.

Under EGTRRA, a decedent's estate must recognize gain on the distribution, but the gain is measured by the excess of the fair market value of the property at the time of distribution over the date of death value, rather than the carryover basis of the property (applicable to estates of decedents dying in 2010). Under the sunset provision of EGTRRA, the limitation on the recognition of gain on appreciated carryover basis property in satisfaction of a pecuniary bequest no longer applies to estates of decedents dying after December 31, 2010.

Treatment of Miscellaneous Provisions under Carryover Basis

Various provisions of the Tax Code are amended to reflect the carryover basis regime in effect for 2010. These include the provisions for certain transfers of property by a U.S. person to a nonresident alien, the capital gains treatment of the sale of certain inherited creative works of art, the imposition of private foundation rules on split-interest trusts, and the definition of the term executor.

Under the sunset provision of EGTRRA, the amended provisions revert to their pre-EGTRRA language.

Distance Requirements for Qualified Conservation Easements

Under EGTRRA, the estate tax exclusion for a conservation easement contribution was available for qualified property located in the United States or in a U.S. possession. EGTRRA repealed the prior rule that the qualified real property be located within 25 miles of a metropolitan area, national park or wilderness area or within 10 miles of an Urban National Forest. Under the sunset provision of EGTRRA, this geographical requirement returns.

Generation-Skipping Transfer (GST) Tax Sunsets

The generation-skipping transfer (GST) tax acts in tandem with the estate tax to ensure that the transfer of wealth will be taxed on a generation-by-generation basis. Some significant GST reforms will sunset after December 31, 2010:

- ***Deemed and retroactive allocations of GST exemptions.*** EGTRRA's deemed allocation rule applicable to "indirect skips," as well as the EGTRRA provision for retroactive allocations, will disappear.
- ***Severing of trusts.*** The ability to make a "qualified severance" of a trust for GST purposes will be eliminated.
- ***Modification of valuation rules.*** EGTRRA's clarification of the date on which allocation of the GST exemption becomes final is technically eliminated.
- ***Substantial compliance and late GST elections.*** Under EGTRRA, relief is available for a transferor who substantially complies with the rules for allocating the GST exemption. EGTRRA also allows transferors who inadvertently fail to allocate GST exemption on a timely filed gift tax return to obtain an extension of time to allocate GST exemption to a transfer of property. This relief will not be available after December 31, 2010.

Installment Payments

The federal estate tax liability generally must be paid within nine months of the decedent's date of death. In the case of an estate that includes an interest in a closely-held business, the time in which to pay the estate tax liability attributable to the interest may be extended up to 14 years payable in installments. This installment payment availability is subject to certain limitations, including a requirement that there be an active trade or business.

Under EGTRRA, the number of allowable partners or shareholders of a closely-held business for purposes of the installment payment provisions is increased from 15 to 45. EGTRRA also treats stock in qualifying lending and finance businesses as stock in an active trade or business for purposes of the election to pay estate taxes in installments. Additionally, EGTRRA clarified the installment payment rules to provide that only the stock of holding companies, not that of operating subsidiaries, must be non-readily tradable.

Under the sunset provision of EGTRRA, the number of allowable partners or shareholders for purposes of the installment payment provisions reverts to 15, lending and finance businesses are treated as passive activities, and the amended non-readily tradable stock rule reverts to its pre-EGTRRA language.

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