



American CPE®

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Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (HR 4853)

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Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (HR 4853)

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Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (HR 4853)

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 ("TRUIRJCA") was passed by Congress on December 16, 2010, and signed by the President on December 17, 2010. The Act follows a December 6, 2010 agreement between President Obama and Congressional GOP leaders and provides taxpayers some certainty in tax planning until 2012, the next presidential election year.

The following topics are the major provisions of TRUIRJCA which I have selected based upon their general application to practitioners and clients.

Individual Tax Rates - §1

Prior or Existing Law

The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") created a 10-percent regular income tax bracket for a portion of taxable income that was previously taxed at 15 percent. EGTRRA also reduced the other regular income tax rates. The otherwise applicable regular income tax rates of 28 percent, 31 percent, 36 percent, and 39.6 percent were reduced to 25 percent, 28 percent, 33 percent, and 35 percent, respectively. EGTRRA scheduled these tax rates to cease to apply for taxable years beginning after December 31, 2010.

To determine regular tax liability, a taxpayer generally must apply the tax rate schedules (or the tax tables) to his or her regular taxable income. The rate schedules are broken into several ranges of income, known as income brackets, and the marginal tax rate increases as a taxpayer's income increases. Separate rate schedules apply based on an individual's filing status. For 2010, the regular individual income tax rate schedules are as follows:

<u>Filing Status</u>	<u>Taxable Income Rate</u>
Single	\$1 to \$8,375 10%
	\$8,375 to \$34,000 15%
	\$34,000 to \$82,400 25%
	\$82,400 to \$171,850 28%

	\$171,850 to \$373,650	33%
	Over \$373,650	35%
Head of Household	\$1 to \$11,950	10%
	\$11,950 to \$45,550	15%
	\$45,550 to \$117,650	25%
	\$117,650 to \$190,550	28%
	\$190,550 to \$373,650	33%
	Over \$373,650	35%
Married, Joint	\$1 to \$16,750	10%
	\$16,750 to \$68,000	15%
	\$68,000 to \$137,300	25%
	\$137,300 to \$209,250	28%
	\$209,250 to \$373,650	33%
	Over \$373,650	35%
Married, Separate	\$1 to \$8,375	10%
	\$8,375 to \$34,000	15%
	\$34,000 to \$68,650	25%
	\$68,650 to \$104,625	27%
	\$104,625 to \$186,825	33%
	Over \$186,825	35%

TRUIRJCA

The Act extends the 10-percent, 15-percent, 25-percent, 28-percent, 33-percent and 35-percent individual income tax rates for two years (through 2012). The rate structure is indexed for inflation.

A comparison of the 2011 table below, with the 2010 table, illustrates the tax rate changes. Note that the 2011 table below also incorporates the provision to retain the marriage penalty relief with respect to the size of the 15 percent rate bracket. For 2011, the regular individual income tax rate schedules are as follows:

<u>Filing Status</u>	<u>Taxable Income Rate</u>	
Single	\$1 to \$8,500	10%
	\$8,500 to \$34,500	15%
	\$34,500 to \$83,600	25%
	\$83,600 to \$174,400	28%
	\$174,400 to \$379,150	33%
	Over \$379,150	35%
Head of Household	\$1 to \$12,150	10%

	\$12,150 to \$46,250	15%
	\$46,250 to \$119,400	25%
	\$119,400 to \$193,350	28%
	\$193,350 to \$379,150	33%
	Over \$379,150	35%
Married, Joint	\$1 to \$17,000	10%
	\$17,000 to \$69,000	15%
	\$69,000 to \$139,350	25%
	\$139,350 to \$212,300	28%
	\$212,300 to \$379,150	33%
	Over \$379,150	35%
Married, Separate	\$1 to \$8,500	10%
	\$8,500 to \$34,500	15%
	\$34,500 to \$69,675	25%
	\$69,675 to \$106,150	27%
	\$106,150 to \$189,575	33%
	Over \$189,575	35%

Effective Date

The provision applies to taxable years beginning after December 31, 2010.

Marriage Penalty Relief & EITC - §1, §32, & §63

Prior or Existing Law

Marriage Penalty

A married couple generally is treated as one tax unit that must pay tax on the couple's total taxable income. Although married couples may elect to file separate returns, the rate schedules and other provisions are structured so that filing separate returns usually results in a higher tax than filing a joint return. Other rate schedules apply to single persons and to single heads of households.

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 not married. A "marriage bonus" exists when the combined tax liability of a married couple filing a joint return is less than the sum of the tax liabilities of each individual computed as if they were not married.

Basic Standard Deduction

EGTRRA increased 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. The basic standard deduction for a married taxpayer filing separately continued to equal one-half of the basic standard deduction for a married couple filing jointly; thus, the basic standard deduction for unmarried individuals filing a single return and for married couples filing separately are the same.

Fifteen Percent Rate Bracket

EGTRRA increased the size of the 15-percent regular income tax rate bracket for a married couple filing a joint return to twice the size of the corresponding rate bracket for an unmarried individual filing a single return.

Earned Income Tax Credit

The earned income tax credit ("EITC") is a refundable credit available to certain low-income taxpayers. Generally, the amount of an individual's allowable earned income credit is dependent on the individual's earned income, adjusted gross income, the number of qualifying children and (through 2010) filing status.

TRUIRJCA

Basic Standard Deduction

The provision increases 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 for two years (through 2012).

Fifteen Percent Rate Bracket

The provision increases 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 rate bracket for an unmarried individual filing a single return for two years (through 2012).

Earned Income Tax Credit

The provision extends certain EITC provisions adopted by EGTRRA for two years (through 2012). These include:

- (1) a simplified definition of earned income;
- (2) a simplified relationship test;
- (3) use of AGI instead of modified AGI;
- (4) a simplified tie-breaking rule;
- (5) additional math error authority for the Internal Revenue Service;

- (6) a repeal of the prior-law provision that reduced an individual's EITC by the amount of his alternative minimum tax liability; *and*
- (7) increases in the beginning and ending points of the credit phase-out for married taxpayers by \$5,000 indexed annually for inflation.

Effective Date

The provision applies to taxable years beginning after December 31, 2010.

Family & Child Incentives - §21, §36C, §45F & §137

Prior or Existing Law

Adoption Credit (old §23 §137)

Tax law for 2010 provides:

- (1) a maximum adoption credit of \$13,170 per eligible child (both special needs and non-special needs adoptions); *and*
- (2) a maximum exclusion of \$13,170 per eligible child (both special needs and non-special needs adoptions).

Comment: EGTRRA increased the maximum credit and exclusion to \$10,000 (indexed for inflation after 2002) for both non-special needs and special needs adoptions, increased the phase-out starting point to \$150,000 (indexed for inflation after 2002), and allowed the credit against the AMT. Section 10909 of the Patient Protection and Affordable Care Act (Pub. L. No. 111-148): (1) extended the EGTRRA expansion of the adoption credit and exclusion from income for employer-provided adoption assistance for one year (for 2011); (2) increased by \$1,000 (to \$13,170, indexed for inflation) the maximum adoption credit and exclusion from income for employer-provided adoption assistance for two years (2010 and 2011); and (3) made the credit refundable for two years (2010 and 2011).

These dollar amounts are adjusted annually for inflation. These benefits are phased-out over a \$40,000 range for taxpayers with modified adjusted gross income ("modified AGI") in excess of certain dollar levels. For 2010, the phase-out range is between \$182,520 and \$222,520. The phase-out threshold is adjusted for inflation annually, but the phase-out range remains a \$40,000 range.

For taxable years beginning after December 31, 2011, the adoption credit and employer-provided adoption assistance exclusion are available only to special needs adoptions and the maximum credit and exclusion are reduced to \$6,000, respectively. The phase-out range is reduced to lower income levels (i.e., between \$75,000 and \$115,000). The maximum credit, exclusion, and phase-out range are not indexed for inflation.

Employer-Provided Child Care Tax Credit (§45F)

Taxpayers receive a tax credit equal to 25 percent of qualified expenses for employee child care and 10 percent of qualified expenses for child care resource and referral services. The maximum total credit that may be claimed by a taxpayer cannot exceed \$150,000 per taxable year.

Qualified child care expenses include costs paid or incurred:

- (1) to acquire, construct, rehabilitate or expand property that is to be used as part of the taxpayer's qualified child care facility;
- (2) for the operation of the taxpayer's qualified child care facility, including the costs of training and certain compensation for employees of the child care facility, and scholarship programs; *or*
- (3) under a contract with a qualified child care facility to provide child care services to employees of the taxpayer.

To be a qualified child care facility, the principal use of the facility must be for child care (unless it is the principal residence of the taxpayer), and the facility must meet all applicable State and local laws and regulations, including any licensing laws. A facility is not treated as a qualified child care facility with respect to a taxpayer unless:

- (1) it has open enrollment to the employees of the taxpayer;
- (2) use of the facility (or eligibility to use such facility) does not discriminate in favor of highly compensated employees of the taxpayer (within the meaning of section 414(q) of the Code); *and*
- (3) at least 30 percent of the children enrolled in the center are dependents of the taxpayer's employees, if the facility is the principal trade or business of the taxpayer.

Qualified child care resource and referral expenses are amounts paid or incurred under a contract to provide child care resource and referral services to the employees of the taxpayer. Qualified child care services and qualified child care resource and referral expenditures must be provided (or be eligible for use) in a way that does not discriminate in favor of highly compensated employees of the taxpayer (within the meaning of section 414(q) of the Code).

Any amounts for which the taxpayer may otherwise claim a tax deduction are reduced by the amount of these credits. Similarly, if the credits are taken for expenses of acquiring, constructing, rehabilitating, or expanding a facility, the taxpayer's basis in the facility is reduced by the amount of the credits.

Credits taken for the expenses of acquiring, constructing, rehabilitating, or expanding a qualified facility are subject to recapture for the first ten years after the qualified child care facility is placed in service. The amount of recapture is reduced as a percentage of the applicable credit over the 10-year recapture period. Recapture takes effect if the taxpayer either ceases operation of the qualified child care facility or transfers its interest in the qualified child care facility without securing an agreement to assume recapture liability for the transferee. The recapture

tax is not treated as a tax for purposes of determining the amount of other credits or determining the amount of the alternative minimum tax. Other rules apply.

This tax credit expires for taxable years beginning after December 31, 2010.

Dependent Care Tax Credit (§21)

The maximum dependent care tax credit is \$1,050 (35 percent of up to \$3,000 of eligible expenses) if there is one qualifying individual, and \$2,100 (35 percent of up to \$6,000 of eligible expenses) if there are two or more qualifying individuals. The 35-percent credit rate is reduced, but not below 20 percent, by one percentage point for each \$2,000 (or fraction thereof) of adjusted gross income ("AGI") above \$15,000. Therefore, the credit percentage is reduced to 20 percent for taxpayers with AGI over \$43,000.

The level of this credit is reduced for taxable years beginning after December 31, 2010, under the EGTRRA sunset.

TRUIRJCA

Adoption Credit (new §36C & §137)

The Act extends the EGTRRA expansion of these two benefits for one year (2012). Therefore, for 2012, the maximum benefit is \$12,170 (indexed for inflation after 2010). The adoption credit and exclusion are phased out ratably for taxpayers with modified adjusted gross income between \$182,520 and \$222,520 (indexed for inflation after 2010).

Comment: The changes to the adoption credit and exclusion from employer-provided adoption assistance for 2010 and 2011 (relating to the \$1,000 increase in the maximum credit and exclusion and the refundability of the credit) enacted as part of the Patient Protection and Affordable Care Act (Pub. L. No. 111-148) are not extended by the provision.

Employer-Provided Child Care Tax Credit (§45F)

The Act extends this tax benefit for two years (through 2012).

Dependent Care Tax Credit (§21)

The Act extends the dependent care tax credit EGTRRA expansion for two years (through 2012).

Effective Dates

These provisions apply to taxable years beginning after December 31, 2010.

Child Tax Credit - §24

Prior or Existing Law

An individual may claim a tax credit for each qualifying child under the age of 17. The maximum amount of the credit per child is \$1,000 through 2010 and \$500 thereafter. A child who is not a citizen, national, or resident of the United States cannot be a qualifying child.

The aggregate amount of child credits that may be claimed is phased out for individuals with income over certain threshold amounts. Specifically, the otherwise allowable aggregate child tax credit amount is reduced by \$50 for each \$1,000 (or fraction thereof) of modified adjusted gross income ("modified AGI") over \$75,000 for single individuals or heads of households, \$110,000 for married individuals filing joint returns, and \$55,000 for married individuals filing separate returns. For purposes of this limitation, modified AGI includes certain otherwise excludable income earned by U.S. citizens or residents living abroad or in certain U.S. territories.

The credit is allowable against the regular tax and, for taxable years beginning before January 1, 2011, is allowed against the alternative minimum tax ("AMT"). To the extent the child tax credit exceeds the taxpayer's tax liability, the taxpayer is eligible for a refundable credit (the additional child tax credit) equal to 15 percent of earned income in excess of a threshold dollar amount (the "earned income" formula). EGTRRA provided, in general, that this threshold dollar amount is \$10,000 indexed for inflation from 2001. The American Recovery and Reinvestment Act of 2009 ("ARRA") set the threshold at \$3,000 for both 2009 and 2010. After 2010, the ability to determine the refundable child credit based on earned income in excess of the threshold dollar amount expires.

Families with three or more qualifying children may determine the additional child tax credit using the "alternative formula" if this results in a larger credit than determined under the earned income formula. Under the alternative formula, the additional child tax credit equals the amount by which the taxpayer's social security taxes exceed the taxpayer's earned income tax credit ("EITC"). After 2010, due to the expiration of the earned income formula, this is the only manner of obtaining a refundable child credit.

Earned income is defined as the sum of wages, salaries, tips, and other taxable employee compensation plus net self-employment earnings. Unlike the EITC, which also includes the preceding items in its definition of earned income, the additional child tax credit is based only on earned income to the extent it is included in computing taxable income. For example, some ministers' parsonage allowances are considered self-employment income, and thus are considered earned income for purposes of computing the EITC, but are excluded from gross income for individual income tax purposes. Therefore, these allowances are not considered earned income for purposes of the additional child tax credit.

TRUIRJCA

The Act extends the \$1,000 child tax credit and allows the child tax credit against the individual's regular income tax and AMT for two years (through 2012). The provision also extends the EGTRRA repeal of a prior-law provision that reduced the refundable child credit by the amount of the AMT for two years (through 2012). The provision extends the earned income formula for determining the refundable child credit, with the earned income threshold of \$3,000 (also, the provision stops indexation for inflation of the \$3,000 earnings threshold) for two years (through 2012).

Note: The Act also extends the EGTRRA modifications to the provision. Section 103 of the bill extends the modifications to the provision (including reduction in the earnings threshold for the refundable portion of the child tax credit to \$3,000).

Finally, the provision extends the rule that the refundable portion of the child tax credit does not constitute income and shall not be treated as resources for purposes of determining eligibility or the amount or nature of benefits or assistance under any Federal program or any State or local program financed with Federal funds for two years (through 2012).

Effective Date

The provision applies to taxable years beginning after December 31, 2010.

American Opportunity Tax Credit - §25A

Prior or Existing Law

Hope Credit

For taxable years beginning before 2009 and after 2010, individual taxpayers are allowed to claim a nonrefundable credit, the Hope credit, against Federal income taxes of up to \$1,800 (for 2008) per eligible student per year for qualified tuition and related expenses paid for the first two years of the student's post-secondary education in a degree or certificate program. The Hope credit rate is 100 percent on the first \$1,200 of qualified tuition and related expenses, and 50 percent on the next \$1,200 of qualified tuition and related expenses; these dollar amounts are indexed for inflation, with the amount rounded down to the next lowest multiple of \$100. Thus, for example, a taxpayer who incurs \$1,200 of qualified tuition and related expenses for an eligible student is eligible (subject to the adjusted gross income phaseout described below) for a \$1,200 Hope credit. If a taxpayer incurs \$2,400 of qualified tuition and related expenses for an eligible student, then he or she is eligible for a \$1,800 Hope credit.

The Hope credit that a taxpayer may otherwise claim is phased out ratably for taxpayers with modified AGI between \$48,000 and \$58,000 (\$96,000 and \$116,000 for married taxpayers filing a joint return) for 2008. The beginning

points of the AGI phaseout ranges are indexed for inflation, with the amount rounded down to the next lowest multiple of \$1,000. The size of the phaseout ranges are always \$10,000 and \$20,000 respectively.

The qualified tuition and related expenses must be incurred on behalf of the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer. The Hope credit is available with respect to an individual student for two taxable years, provided that the student has not completed the first two years of post-secondary education before the beginning of the second taxable year.

The Hope credit is available in the taxable year the expenses are paid, subject to the requirement that the education is furnished to the student during that year or during an academic period beginning during the first three months of the next taxable year. Qualified tuition and related expenses paid with the proceeds of a loan generally are eligible for the Hope credit. The repayment of a loan itself is not a qualified tuition or related expense.

A taxpayer may claim the Hope credit with respect to an eligible student who is not the taxpayer or the taxpayer's spouse (e.g., in cases in which the student is the taxpayer's child) only if the taxpayer claims the student as a dependent for the taxable year for which the credit is claimed. If a student is claimed as a dependent, the student is not entitled to claim a Hope credit for that taxable year on the student's own tax return. If a parent (or other taxpayer) claims a student as a dependent, any qualified tuition and related expenses paid by the student are treated as paid by the parent (or other taxpayer) for purposes of determining the amount of qualified tuition and related expenses paid by such parent (or other taxpayer) under the provision. In addition, for each taxable year, a taxpayer may elect either the Hope credit, the Lifetime Learning credit, or an above-the-line deduction for qualified tuition and related expenses with respect to an eligible student.

The Hope credit is available for "qualified tuition and related expenses," which include tuition and fees (excluding nonacademic fees) required to be paid to an eligible educational institution as a condition of enrollment or attendance of an eligible student at the institution. Charges and fees associated with meals, lodging, insurance, transportation, and similar personal, living, or family expenses are not eligible for the credit. The expenses of education involving sports, games, or hobbies are not qualified tuition and related expenses unless this education is part of the student's degree program.

Qualified tuition and related expenses generally include only out-of-pocket expenses. Qualified tuition and related expenses do not include expenses covered by employer-provided educational assistance and scholarships that are not required to be included in the gross income of either the student or the taxpayer claiming the credit. Thus, total qualified tuition and related expenses are reduced by any scholarship or fellowship grants excludable from gross income under section 117 and any other tax-free educational benefits received by the student (or the taxpayer claiming the credit) during the taxable year. The Hope credit is not allowed

with respect to any education expense for which a deduction is claimed under section 162 or any other section of the Code.

An eligible student for purposes of the Hope credit is an individual who is enrolled in a degree, certificate, or other program (including a program of study abroad approved for credit by the institution at which such student is enrolled) leading to a recognized educational credential at an eligible educational institution. The student must pursue a course of study on at least a halftime basis. A student is considered to pursue a course of study on at least a half-time basis if the student carries at least one half the normal full-time work load for the course of study the student is pursuing for at least one academic period that begins during the taxable year. To be eligible for the Hope credit, a student must not have been convicted of a Federal or State felony consisting of the possession or distribution of a controlled substance.

Eligible educational institutions generally are accredited post-secondary educational institutions offering credit toward a bachelor's degree, an associate's degree, or another recognized post-secondary credential. Certain proprietary institutions and post-secondary vocational institutions also are eligible educational institutions. To qualify as an eligible educational institution, an institution must be eligible to participate in Department of Education student aid programs.

Effective for taxable years beginning after December 31, 2010, the changes to the Hope credit made by EGTRRA no longer apply. The principal EGTRRA change scheduled to expire is the change that permits a taxpayer to claim a Hope credit in the same year that he or she claims an exclusion from a Coverdell education savings account. Thus, after 2010, a taxpayer cannot claim a Hope credit in the same year he or she claims an exclusion from a Coverdell education savings account.

American Opportunity Tax Credit

The American Opportunity Tax Credit refers to modifications to the Hope credit that apply for taxable years beginning in 2009 or 2010. The maximum allowable modified credit is \$2,500 per eligible student per year for qualified tuition and related expenses paid for each of the first four years of the student's post-secondary education in a degree or certificate program. The modified credit rate is 100 percent on the first \$2,000 of qualified tuition and related expenses, and 25 percent on the next \$2,000 of qualified tuition and related expenses. For purposes of the modified credit, the definition of qualified tuition and related expenses is expanded to include course materials.

Under the provision, the modified credit is available with respect to an individual student for four years, provided that the student has not completed the first four years of post-secondary education before the beginning of the fourth taxable year. Thus, the modified credit, in addition to other modifications, extends the application of the Hope credit to two more years of post-secondary education.

The modified credit that a taxpayer may otherwise claim is phased out ratably for taxpayers with modified AGI between \$80,000 and \$90,000 (\$160,000 and

\$180,000 for married taxpayers filing a joint return). The modified credit may be claimed against a taxpayer's AMT liability.

Forty percent of a taxpayer's otherwise allowable modified credit is refundable. However, no portion of the modified credit is refundable if the taxpayer claiming the credit is a child to whom section 1(g) applies for such taxable year (generally, any child who has at least one living parent, does not file a joint return, and is either under age 18 or under age 24 and a student providing less than one-half of his or her own support).

Bona fide residents of the U.S. possessions are not permitted to claim the refundable portion of the modified credit in the United States. Rather, a bona fide resident of a mirror code possession (Commonwealth of the Northern Mariana Islands, Guam, and the Virgin Islands) may claim the refundable portion of the credit in the possession in which the individual is a resident. Similarly, a bona fide resident of a non-mirror code possession (Commonwealth of Puerto Rico and American Samoa) may claim the refundable portion of the credit in the possession in which the individual is resident, but only if the possession establishes a plan for permitting the claim under its internal law. The U.S. Treasury will make payments to the possession in respect of credits allowable to their residents under their internal laws.

TRUIRJCA

The Act extends for two years (through 2012) the temporary modifications to the Hope credit for taxable years beginning in 2009 and 2010 that are known as the American Opportunity Tax Credit, including the rules governing the treatment of the U.S. possessions.

Effective Date

The provision is effective for taxable years beginning after December 31, 2010.

Earned Income Tax Credit - §32

Prior or Existing Law

Low and moderate income workers may be eligible for the refundable earned income tax credit ("EITC"). Eligibility for the EITC is based on earned income, adjusted gross income, investment income, filing status, number of children, and immigration and work status in the United States. The amount of the EITC is based on the presence and number of qualifying children in the worker's family, as well as on adjusted gross income and earned income.

The EITC generally equals a specified percentage of earned income up to a maximum dollar amount. The maximum amount applies over a certain income range and then diminishes to zero over a specified phaseout range. For taxpayers with earned income (or adjusted gross income ("AGI"), if greater) in excess of the beginning of the pha-

seout range, the maximum EITC amount is reduced by the phaseout rate multiplied by the amount of earned income (or AGI, if greater) in excess of the beginning of the phaseout range. For taxpayers with earned income (or AGI, if greater) in excess of the end of the phaseout range, no credit is allowed.

An individual is not eligible for the EITC if the aggregate amount of disqualified income of the taxpayer for the taxable year exceeds \$3,100 (for 2010). This threshold is indexed for inflation. Disqualified income is the sum of:

- (1) interest (both taxable and tax exempt);
- (2) dividends;
- (3) net rent and royalty income (if greater than zero);
- (4) capital gains net income; *and*
- (5) net passive income that is not self-employment income (if greater than zero).

The EITC is a refundable credit, meaning that if the amount of the credit exceeds the taxpayer's Federal income tax liability, the excess is payable to the taxpayer as a direct transfer payment.

An unmarried individual may claim the EITC if he or she files as a single filer or as a head of household. Married individuals generally may not claim the EITC unless they file jointly. An exception to the joint return filing requirement applies to certain spouses who are separated. Under this exception, a married taxpayer who is separated from his or her spouse for the last six months of the taxable year is not considered to be married (and, accordingly, may file a return as head of household and claim the EITC), provided that the taxpayer maintains a household that constitutes the principal place of abode for a dependent child (including a son, stepson, daughter, stepdaughter, adopted child, or a foster child) for over half the taxable year, and pays over half the cost of maintaining the household in which he or she resides with the child during the year.

Four separate credit schedules apply: one schedule for taxpayers with no qualifying children, one schedule for taxpayers with one qualifying child, one schedule for taxpayers with two qualifying children, and one schedule for taxpayers with three or more qualifying children.

Taxpayers with no qualifying children may claim a credit if they are over age 24 and below age 65. The credit is 7.65 percent of earnings up to \$5,980, resulting in a maximum credit of \$457 for 2010. The maximum is available for those with incomes between \$5,980 and \$7,480 (\$12,490 if married filing jointly). The credit begins to phase out at a rate of 7.65 percent of earnings above \$7,480 (\$12,480 if married filing jointly) resulting in a \$0 credit at \$13,460 of earnings (\$18,470 if married filing jointly).

Taxpayers with one qualifying child may claim a credit in 2010 of 34 percent of their earnings up to \$8,970, resulting in a maximum credit of \$3,050. The maximum credit is available for those with earnings between \$8,970 and \$16,450 (\$21,460 if married filing jointly). The credit begins to phase out at a rate of 15.98 percent of earnings

above \$16,450 (\$21,460 if married filing jointly). The credit is completely phased out at \$35,535 of earnings (\$40,545 if married filing jointly).

Taxpayers with two qualifying children may claim a credit in 2010 of 40 percent of earnings up to \$12,590, resulting in a maximum credit of \$5,036. The maximum credit is available for those with earnings between \$12,590 and \$16,450 (\$21,460 if married filing jointly). The credit begins to phase out at a rate of 21.06 percent of earnings above \$16,450 (\$21,460 if married filing jointly). The credit is completely phased out at \$40,363 of earnings (\$45,373 if married filing jointly).

A temporary provision enacted by ARRA allows taxpayers with three or more qualifying children to claim a credit of 45 percent for 2009 and 2010. For example, in 2010 taxpayers with three or more qualifying children may claim a credit of 45 percent of earnings up to \$12,590, resulting in a maximum credit of \$5,666. The maximum credit is available for those with earnings between \$12,590 and \$16,450 (\$21,460 if married filing jointly). The credit begins to phase out at a rate of 21.06 percent of earnings above \$16,450 (\$21,460 if married filing jointly). The credit is completely phased out at \$43,352 of earnings (\$48,362 if married filing jointly).

Under another provision of ARRA, the phase-out thresholds for married couples were raised to an amount \$5,000 above that for other filers for 2009 (and indexed for inflation). The increase is \$5,010 for 2010. Formerly, the phase-out thresholds for married couples were \$3,000 (indexed for inflation from 2008) greater than those for other filers as provided for in EGTRRA.

If more than one taxpayer lives with a qualifying child, only one of these taxpayers may claim the child for purposes of the EITC. If multiple eligible taxpayers actually claim the same qualifying child, then a tiebreaker rule determines which taxpayer is entitled to the EITC with respect to the qualifying child. Any eligible taxpayer with at least one qualifying child who does not claim the EITC with respect to qualifying children due to failure to meet certain identification requirements with respect to such children (i.e., providing the name, age and taxpayer identification number of each of such children) may not claim the EITC for taxpayers without qualifying children.

TRUIRJCA

The Act extends the EITC at a rate of 45 percent for three or more qualifying children for two years (through 2012). In addition, the Act extends the higher phase-out thresholds for married couples filing joint returns enacted as part of ARRA for two years (through 2012).

Effective Date

The provision applies to taxable years beginning after December 31, 2010.

Alternative Minimum Tax Relief - §26 & §55

Prior or Existing Law

Present law imposes an alternative minimum tax ("AMT") on individuals. The AMT is the amount by which the tentative minimum tax exceeds the regular income tax. An individual's tentative minimum tax is the sum of:

- (1) 26 percent of so much of the taxable excess as does not exceed \$175,000 (\$87,500 in the case of a married individual filing a separate return), *and*
- (2) 28 percent of the remaining taxable excess.

The taxable excess is so much of the alternative minimum taxable income ("AMTI") as exceeds the exemption amount. The maximum tax rates on net capital gain and dividends used in computing the regular tax are used in computing the tentative minimum tax. AMTI is the individual's taxable income adjusted to take account of specified preferences and adjustments.

The exemption amounts are:

- (1) \$70,950 for taxable years beginning in 2009 and \$45,000 in taxable years beginning after 2009 in the case of married individuals filing a joint return and surviving spouses;
- (2) \$46,700 for taxable years beginning in 2009 and \$33,750 in taxable years beginning after 2009 in the case of other unmarried individuals;
- (3) \$35,475 for taxable years beginning in 2009 and \$22,500 in taxable years beginning after 2009 in the case of married individuals filing separate returns; *and*
- (4) \$22,500 in the case of an estate or trust.

The exemption amount is phased out by an amount equal to 25 percent of the amount by which the individual's AMTI exceeds:

- (1) \$150,000 in the case of married individuals filing a joint return and surviving spouses,
- (2) \$112,500 in the case of other unmarried individuals, *and*
- (3) \$75,000 in the case of married individuals filing separate returns or an estate or a trust.

These amounts are not indexed for inflation.

Present law provides for certain nonrefundable personal tax credits (i.e., the dependent care credit, the credit for the elderly and disabled, the child credit, the credit for interest on certain home mortgages, the Hope Scholarship and Lifetime Learning credits, the credit for savers, the credit for certain nonbusiness energy property, the credit for residential energy efficient property, the credit for certain plug-in electric vehicles, the credit for alternative motor vehicles, the credit for new qualified plug-in electric drive motor vehicles, and the D.C. first-time homebuyer credit).

For taxable years beginning before 2010, the nonrefundable personal credits are allowed to the extent of the full amount of the individual's regular tax and alternative minimum tax.

For taxable years beginning after 2009, the nonrefundable personal credits (other than the child credit, the credit for savers, the credit for residential energy efficient property, the credit for certain plug-in electric drive motor vehicles, the credit for alternative motor vehicles, and credit for new qualified plug-in electric drive motor vehicles) are allowed only to the extent that the individual's regular income tax liability exceeds the individual's tentative minimum tax, determined without regard to the minimum tax foreign tax credit. The remaining nonrefundable personal credits are allowed to the full extent of the individual's regular tax and alternative minimum tax.

Comment: The rule applicable to the child credit after 2010 is subject to the EGTRRA sunset. The adoption credit is refundable in 2010 and 2011 and beginning in 2012 is nonrefundable and treated for purposes of the AMT in the same manner as the child credit.

TRUIRJCA

The Act allows an individual to offset the entire regular tax liability and alternative minimum tax liability by the nonrefundable personal credits for 2010 and 2011.

In addition, the Act provides that the individual AMT exemption amount for taxable years beginning in 2010 is:

- (1) \$72,450, in the case of married individuals filing a joint return and surviving spouses;
- (2) \$47,450 in the case of other unmarried individuals; *and*
- (3) \$36,225 in the case of married individuals filing separate returns.

Finally, the Act provides that the individual AMT exemption amount for taxable years beginning in 2011 is:

- (1) \$74,450, in the case of married individuals filing a joint return and surviving spouses;
- (2) \$48,450 in the case of other unmarried individuals; *and*
- (3) \$37,225 in the case of married individuals filing separate returns.

Effective Date

The provision is effective for taxable years beginning after 2009.

Dividends & Capital Gains - §1(h)

Prior or Existing Law

Dividends

A dividend is the distribution of property made by a corporation to its shareholders out of its after-tax earnings and profits. An individual's qualified dividend income is taxed at the same rates that apply to net capital gain. This treatment applies for purposes of both the regular tax and the alternative minimum tax. Thus,

for taxable years beginning before 2011, an individual's qualified dividend income is taxed at rates of zero and 15 percent. The zero-percent rate applies to qualified dividend income which otherwise would be taxed at a 10- or 15-percent rate if the special rates did not apply.

Qualified dividend income generally includes dividends received from domestic corporations and qualified foreign corporations. The term "qualified foreign corporation" includes a foreign corporation that is eligible for the benefits of a comprehensive income tax treaty with the United States which the Treasury Department determines to be satisfactory and which includes an exchange of information program. In addition, a foreign corporation is treated as a qualified foreign corporation for any dividend paid by the corporation with respect to stock that is readily tradable on an established securities market in the United States.

If a shareholder does not hold a share of stock for more than 60 days during the 121-day period beginning 60 days before the ex-dividend date (as measured under section 246(c)), dividends received on the stock are not eligible for the reduced rates. Also, the reduced rates are not available for dividends to the extent that the taxpayer is obligated to make related payments with respect to positions in substantially similar or related property.

Dividends received from a corporation that is a passive foreign investment company (as defined in section 1297) in either the taxable year of the distribution, or the preceding taxable year, are not qualified dividends.

Special rules apply in determining a taxpayer's foreign tax credit limitation under section 904 in the case of qualified dividend income. For these purposes, rules similar to the rules of section 904(b)(2)(B) concerning adjustments to the foreign tax credit limitation to reflect any capital gain rate differential will apply to any qualified dividend income.

If a taxpayer receives an extraordinary dividend (within the meaning of section 1059(c)) eligible for the reduced rates with respect to any share of stock, any loss on the sale of the stock is treated as a long-term capital loss to the extent of the dividend.

A dividend is treated as investment income for purposes of determining the amount of deductible investment interest only if the taxpayer elects to treat the dividend as not eligible for the reduced rates.

The amount of dividends qualifying for reduced rates that may be paid by a regulated investment company ("RIC") for any taxable year in which the qualified dividend income received by the RIC is less than 95 percent of its gross income (as specially computed) may not exceed the sum of:

- (1) the qualified dividend income of the RIC for the taxable year, *and*
- (2) the amount of earnings and profits accumulated in a non-RIC taxable year that were distributed by the RIC during the taxable year.

The amount of dividends qualifying for reduced rates that may be paid by a real estate investment trust ("REIT") for any taxable year may not exceed the sum of:

- (1) the qualified dividend income of the REIT for the taxable year,
- (2) an amount equal to the excess of the income subject to the taxes imposed by section 857(b)(1) and the regulations prescribed under section 337(d) for the preceding taxable year over the amount of these taxes for the preceding taxable year, *and*
- (3) the amount of earnings and profits accumulated in a non-REIT taxable year that were distributed by the REIT during the taxable year.

The reduced rates do not apply to dividends received from an organization that was exempt from tax under section 501 or was a tax-exempt farmers' cooperative in either the taxable year of the distribution or the preceding taxable year; dividends received from a mutual savings bank that received a deduction under section 591; or deductible dividends paid on employer securities.

Comment: In addition, for taxable years beginning before 2011, amounts treated as ordinary income on the disposition of certain preferred stock (sec. 306) are treated as dividends for purposes of applying the reduced rates; the tax rate for the accumulated earnings tax (sec. 531) and the personal holding company tax (sec. 541) is reduced to 15 percent; and the collapsible corporation rules (sec. 341) are repealed.

For taxable years beginning after 2010, dividends received by an individual are taxed at ordinary income tax rates.

Capital Gains

In general, gain or loss reflected in the value of an asset is not recognized for income tax purposes until a taxpayer disposes of the asset. On the sale or exchange of a capital asset, any gain generally is included in income. Any net capital gain of an individual generally is taxed at rates lower than rates applicable to ordinary income. Net capital gain is the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for the year. Gain or loss is treated as long-term if the asset is held for more than one year.

Capital losses generally are deductible in full against capital gains. In addition, individual taxpayers may deduct capital losses against up to \$3,000 of ordinary income in each year. Any remaining unused capital losses may be carried forward indefinitely to another taxable year.

A capital asset generally means any property except:

- (1) inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business,
- (2) depreciable or real property used in the taxpayer's trade or business,
- (3) specified literary or artistic property,
- (4) business accounts or notes receivable,
- (5) certain U.S. publications,
- (6) certain commodity derivative financial instruments,
- (7) hedging transactions, *and*

(8) business supplies.

In addition, the net gain from the disposition of certain property used in the taxpayer's trade or business is treated as long-term capital gain. Gain from the disposition of depreciable personal property is not treated as capital gain to the extent of all previous depreciation allowances. Gain from the disposition of depreciable real property is generally not treated as capital gain to the extent of the depreciation allowances in excess of the allowances available under the straight-line method of depreciation.

Under present law, for taxable years beginning before January 1, 2011, the maximum rate of tax on the adjusted net capital gain of an individual is 15 percent. Any adjusted net capital gain which otherwise would be taxed at a 10- or 15-percent rate is taxed at a zero rate. These rates apply for purposes of both the regular tax and the AMT.

Under present law, the "adjusted net capital gain" of an individual is the net capital gain reduced (but not below zero) by the sum of the 28-percent rate gain and the unrecaptured section 1250 gain. The net capital gain is reduced by the amount of gain that the individual treats as investment income for purposes of determining the investment interest limitation under section 163(d).

The term "28-percent rate gain" means the excess of the sum of the amount of net gain attributable to long-term capital gains and losses from the sale or exchange of collectibles (as defined in section 408(m) without regard to paragraph (3) thereof) and the amount of gain equal to the additional amount of gain that would be excluded from gross income under section 1202 (relating to certain small business stock) if the percentage limitations of section 1202(a) did not apply, over the sum of the net short-term capital loss for the taxable year and any long-term capital loss carryover to the taxable year.

"Unrecaptured section 1250 gain" means any long-term capital gain from the sale or exchange of section 1250 property (i.e., depreciable real estate) held more than one year to the extent of the gain that would have been treated as ordinary income if section 1250 applied to all depreciation, reduced by the net loss (if any) attributable to the items taken into account in computing 28-percent rate gain. The amount of unrecaptured section 1250 gain (before the reduction for the net loss) attributable to the disposition of property to which section 1231 (relating to certain property used in a trade or business) applies may not exceed the net section 1231 gain for the year.

An individual's unrecaptured section 1250 gain is taxed at a maximum rate of 25 percent, and the 28-percent rate gain is taxed at a maximum rate of 28 percent. Any amount of unrecaptured section 1250 gain or 28-percent rate gain otherwise taxed at a 10- or 15-percent rate is taxed at the otherwise applicable rate.

For taxable years beginning after December 31, 2010, the maximum rate of tax on the adjusted net capital gain of an individual is 20 percent. Any adjusted net capital gain which otherwise would be taxed at the 15-percent rate is taxed at a 10-percent rate.

In addition, any gain from the sale or exchange of property held more than five years that would otherwise have been taxed at the 10-percent capital gain rate is taxed at an 8-percent rate. Any gain from the sale or exchange of property held more than five years and the holding period for which began after December 31, 2000, that would otherwise have been taxed at a 20-percent rate is taxed at an 18-percent rate.

The tax rates on 28-percent gain and unrecaptured section 1250 gain are the same as for taxable years beginning before 2011.

TRUIRJCA

Under the Act, the regular and minimum tax rates for qualified dividend income and capital gain in effect before 2011 are extended for two additional years (through 2012).

Effective Date

The provision applies to taxable years beginning after December 31, 2010.

Deduction for School Teachers - §62

Prior or Existing Law

While ordinary and necessary business expenses are deductible, unreimbursed employee business expenses generally are deductible only as an itemized deduction and only to the extent that the individual's total miscellaneous deductions (including employee business expenses) exceed two percent of adjusted gross income. With the exception of taxable years beginning in 2010, an individual's otherwise allowable itemized deductions may be further limited by the overall limitation on itemized deductions, which reduces itemized deductions for taxpayers with adjusted gross income in excess of a threshold amount. In addition, miscellaneous itemized deductions are not allowable under the alternative minimum tax.

Certain expenses of eligible educators are allowed as an above-the-line deduction. Specifically, for taxable years beginning prior to January 1, 2010, an above-the-line deduction is allowed for up to \$250 annually of expenses paid or incurred by an eligible educator for books, supplies (other than nonathletic supplies for courses of instruction in health or physical education), computer equipment (including related software and services) and other equipment, and supplementary materials used by the eligible educator in the classroom. To be eligible for this deduction, the expenses must be otherwise deductible under section 162 as a trade or business expense. A deduction is allowed only to the extent the amount of expenses exceeds the amount excludable from income under section 135 (relating to education savings bonds), 529(c)(1) (relating to qualified tuition programs), and section 530(d)(2) (relating to Coverdell education savings accounts).

An eligible educator is a kindergarten through grade twelve teacher, instructor, counselor, principal, or aide in a school for at least 900 hours during a school year. A school means any school that provides elementary education or secondary education, as determined under State law.

The above-the-line deduction for eligible educators is not allowed for taxable years beginning after December 31, 2009.

TRUIRJCA

The Act extends the deduction for eligible educator expenses for two years so that it is available for taxable years beginning before January 1, 2012.

Effective Date

The provision is effective for expenses incurred in taxable years beginning after December 31, 2009.

State & Local Sales Tax Deduction - §164

Prior or Existing Law

For purposes of determining regular tax liability, an itemized deduction is permitted for certain State and local taxes paid, including individual income taxes, real property taxes, and personal property taxes. The itemized deduction is not permitted for purposes of determining a taxpayer's alternative minimum taxable income. For taxable years beginning in 2004-2009, at the election of the taxpayer, an itemized deduction may be taken for State and local general sales taxes in lieu of the itemized deduction provided under present law for State and local income taxes. As is the case for State and local income taxes, the itemized deduction for State and local general sales taxes is not permitted for purposes of determining a taxpayer's alternative minimum taxable income. Taxpayers have two options with respect to the determination of the sales tax deduction amount. Taxpayers may deduct the total amount of general State and local sales taxes paid by accumulating receipts showing general sales taxes paid. Alternatively, taxpayers may use tables created by the Secretary that show the allowable deduction. The tables are based on average consumption by taxpayers on a State-by-State basis taking into account number of dependents, modified adjusted gross income and rates of State and local general sales taxation. Taxpayers who live in more than one jurisdiction during the tax year are required to pro-rate the table amounts based on the time they live in each jurisdiction. Taxpayers who use the tables created by the Secretary may, in addition to the table amounts, deduct eligible general sales taxes paid with respect to the purchase of motor vehicles, boats and other items specified by the Secretary. Sales taxes for items that may be added to the tables are not reflected in the tables themselves.

The term "general sales tax" means a tax imposed at one rate with respect to the sale at retail of a broad range of classes of items. However, in the case of items of food,

clothing, medical supplies, and motor vehicles, the fact that the tax does not apply with respect to some or all of such items is not taken into account in determining whether the tax applies with respect to a broad range of classes of items, and the fact that the rate of tax applicable with respect to some or all of such items is lower than the general rate of tax is not taken into account in determining whether the tax is imposed at one rate. Except in the case of a lower rate of tax applicable with respect to food, clothing, medical supplies, or motor vehicles, no deduction is allowed for any general sales tax imposed with respect to an item at a rate other than the general rate of tax. However, in the case of motor vehicles, if the rate of tax exceeds the general rate, such excess shall be disregarded and the general rate is treated as the rate of tax.

A compensating use tax with respect to an item is treated as a general sales tax, provided such tax is complementary to a general sales tax and a deduction for sales taxes is allowable with respect to items sold at retail in the taxing jurisdiction that are similar to such item.

TRUIRJCA

The Act extends the provision allowing taxpayers to elect to deduct State and local sales taxes in lieu of State and local income taxes for two years (through December 31, 2011).

Effective Date

The provision applies to taxable years beginning after December 31, 2009.

Deduction for Qualified Tuition - §222

Prior or Existing Law

An individual is allowed an above-the-line deduction for qualified tuition and related expenses for higher education paid by the individual during the taxable year (§222). The term qualified tuition and related expenses is defined in the same manner as for the Hope and Lifetime Learning credits, and includes tuition and fees required for the enrollment or attendance of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer with respect to whom the taxpayer may claim a personal exemption, at an eligible institution of higher education for courses of instruction of such individual at such institution.

Note: The deduction generally is not available for expenses with respect to a course or education involving sports, games, or hobbies, and is not available for student activity fees, athletic fees, insurance expenses, or other expenses unrelated to an individual's academic course of instruction.

The expenses must be in connection with enrollment at an institution of higher education during the taxable year, or with an academic period beginning during the taxable year or during the first three months of the next taxable year. The deduction is not available for tuition and related expenses paid for elementary or secondary education.

The maximum deduction is \$4,000 for an individual whose adjusted gross income for the taxable year does not exceed \$65,000 (\$130,000 in the case of a joint return), or \$2,000 for other individuals whose adjusted gross income does not exceed \$80,000 (\$160,000 in the case of a joint return). No deduction is allowed for an individual whose adjusted gross income exceeds the relevant adjusted gross income limitations, for a married individual who does not file a joint return, or for an individual with respect to whom a personal exemption deduction may be claimed by another taxpayer for the taxable year. The deduction is not available for taxable years beginning after December 31, 2009.

The amount of qualified tuition and related expenses must be reduced by certain scholarships, educational assistance allowances, and other amounts paid for the benefit of such individual, and by the amount of such expenses taken into account for purposes of determining any exclusion from gross income of:

- (1) income from certain U.S. savings bonds used to pay higher education tuition and fees; *and*
- (2) income from a Coverdell education savings account.

Additionally, such expenses must be reduced by the earnings portion (but not the return of principal) of distributions from a qualified tuition program if an exclusion under section 529 is claimed with respect to expenses eligible for the qualified tuition deduction. No deduction is allowed for any expense for which a deduction is otherwise allowed or with respect to an individual for whom a Hope or Lifetime Learning credit is elected for such taxable year.

TRUIRJCA

The Act extends the qualified tuition deduction for two years so that it is generally available for taxable years beginning before January 1, 2012.

Effective Date

The provision is effective for taxable years beginning after December 31, 2009.

Deduction & Exemption Phase-Out - §68 & §151

Prior or Existing Law

Overall Limitation on Itemized Deductions

Unless an individual elects to claim the standard deduction for a taxable year, the taxpayer is allowed to deduct his or her itemized deductions. Itemized deductions generally are those deductions which are not allowed in computing adjusted gross income ("AGI"). Itemized deductions include unreimbursed medical expenses, investment interest, casualty and theft losses, wagering losses, charitable contributions, qualified residence interest, State and local income and property taxes, un-

reimbursed employee business expenses, and certain other miscellaneous expenses.

Prior to 2010, the total amount of otherwise allowable itemized deductions (other than medical expenses, investment interest, and casualty, theft, or wagering losses) was limited for upper-income taxpayers. In computing this reduction of total itemized deductions, all limitations applicable to such deductions (such as the separate floors) were first applied and, then, the otherwise allowable total amount of itemized deductions was reduced by three percent of the amount by which the taxpayer's AGI exceeded a threshold amount which was indexed annually for inflation. The otherwise allowable itemized deductions could not be reduced by more than 80 percent.

EGTRRA repealed this overall limitation on itemized deductions with the repeal phased-in over five years. EGTRRA provided:

- (1) a one-third reduction of the otherwise applicable limitation in 2006 and 2007;
- (2) a two-thirds reduction in 2008, and 2009; *and*
- (3) no overall limitation on itemized deductions in 2010.

Thus in 2009, for example, the total amount of otherwise allowable itemized deductions (other than medical expenses, investment interest, and casualty, theft, or wagering losses) was reduced by three percent of the amount of the taxpayer's AGI in excess of \$166,800 (\$83,400 for married couples filing separate returns). Then the overall reduction in itemized deductions was phased-down to 1/3 of the full reduction amount (that is, the limitation was reduced by two-thirds).

Pursuant to the general EGTRRA sunset, the phased-in repeal of the Pease limitation sunsets and the limitation becomes fully effective again in 2011. Adjusting for inflation, the AGI threshold is \$169,550 for 2011.

Personal Exemption Phase-Out for Certain Taxpayers (“PEP”)

Personal exemptions generally are allowed for the taxpayer, his or her spouse, and any dependents. For 2010, the amount deductible for each personal exemption is \$3,650. This amount is indexed annually for inflation.

Prior to 2010, the deduction for personal exemptions was reduced or eliminated for taxpayers with incomes over certain thresholds, which were indexed annually for inflation. Specifically, the total amount of exemptions that could be claimed by a taxpayer was reduced by two percent for each \$2,500 (or portion thereof) by which the taxpayer's AGI exceeded the applicable threshold. (The phase-out rate was two percent for each \$1,250 for married taxpayers filing separate returns.) Thus, the deduction for personal exemptions was phased out over a \$122,500 range (which was not indexed for inflation), beginning at the applicable threshold. In 2009, for example, the applicable thresholds were \$166,800 for single individuals, \$250,200 for married individuals filing a joint return and surviving spouses, \$208,500 for heads of households, and \$125,100 for married individuals filing separate returns.

EGTRRA repealed PEP with the repeal phased-in over five years. EGTRRA provided:

- (1) a one-third reduction of the otherwise applicable limitation in 2006 and 2007;
- (2) a two-thirds reduction in 2008, and 2009; *and*
- (3) no PEP in 2010. However, under the EGTRRA sunset, the PEP becomes fully effective again in 2011.

Adjusted for inflation, the PEP thresholds for 2011 are:

- (1) \$169,550 for unmarried individuals;
- (2) \$254,350 for married couples filing joint returns; *and*
- (3) \$211,950 for heads of households.

TRUIRJCA

Under the Act the overall limitation on itemized deductions and the personal exemption phase-out do not apply for two additional years (through 2012).

Effective Date

The provision applies to taxable years beginning after December 31, 2010.

Educational Incentives - §117, §127, §221, & §530

Prior or Existing Law

Scholarships (§117)

Section 117 excludes from gross income amounts received as a qualified scholarship by an individual who is a candidate for a degree and used for tuition and fees required for the enrollment or attendance (or for fees, books, supplies, and equipment required for courses of instruction) at a primary, secondary, or post-secondary educational institution. The tax-free treatment provided by section 117 does not extend to scholarship amounts covering regular living expenses, such as room and board. In addition to the exclusion for qualified scholarships, section 117 provides an exclusion from gross income for qualified tuition reductions for certain education provided to employees (and their spouses and dependents) of certain educational organizations. Amounts excludable from gross income under section 117 are also excludable from wages for payroll tax purposes (§3121(a)(20)).

NHSC Scholarship & Armed Forces Scholarship Programs

The exclusion for qualified scholarships and qualified tuition reductions does not apply to any amount received by a student that represents payment for teaching, research, or other services by the student required as a condition for

receiving the scholarship or tuition reduction. An exception to this rule applies in the case of the National Health Service Corps Scholarship Program (the "NHSC Scholarship Program") and the F. Edward Hebert Armed Forces Health Professions Scholarship and Financial Assistance Program (the "Armed Forces Scholarship Program").

The NHSC Scholarship Program and the Armed Forces Scholarship Program provide education awards to participants on the condition that the participants provide certain services. In the case of the NHSC Scholarship Program, the recipient of the scholarship is obligated to provide medical services in a geographic area (or to an underserved population group or designated facility) identified by the Public Health Service as having a shortage of health care professionals. In the case of the Armed Forces Scholarship Program, the recipient of the scholarship is obligated to serve a certain number of years in the military at an armed forces medical facility.

EGTRRA Sunset

Under the sunset provisions of EGTRRA, the exclusion from gross income and wages for the NHSC Scholarship Program and the Armed Forces Scholarship Program will no longer apply for taxable years beginning after December 31, 2010.

Employer-provided Educational Assistance (§127)

If certain requirements are satisfied, up to \$5,250 annually of educational assistance provided by an employer to an employee is excludable from gross income for income tax purposes and from wages for employment tax purposes (§127 & §3121(a)(18)). This exclusion applies to both graduate and undergraduate courses.

Note: The exclusion has not always applied to graduate courses. The exclusion was first made inapplicable to graduate-level courses by the Technical and Miscellaneous Revenue Act of 1988. The exclusion was reinstated with respect to graduate-level courses by the Omnibus Budget Reconciliation Act of 1990, effective for taxable years beginning after December 31, 1990. The exclusion was again made inapplicable to graduate-level courses by the Small Business Job Protection Act of 1996, effective for courses beginning after June 30, 1996. The exclusion for graduate-level courses was reinstated by EGTRRA, although that change does not apply to taxable years beginning after December 31, 2010 (under EGTRRA's sunset provision).

For the exclusion to apply, certain requirements must be satisfied. The educational assistance must be provided pursuant to a separate written plan of the employer. The employer's educational assistance program must not discriminate in favor of highly compensated employees. In addition, no more than five percent of the amounts paid or incurred by the employer during the year for educational assistance under a qualified educational assistance program can be provided for the class of individuals consisting of more than five-percent owners of the employer and the spouses or dependents of such more than five-percent owners.

For purposes of the exclusion, educational assistance means the payment by an employer of expenses incurred by or on behalf of the employee for education of the employee including, but not limited to, tuition, fees, and similar payments, books, supplies, and equipment. Educational assistance also includes the provision by the employer of courses of instruction for the employee (including books, supplies, and equipment). Educational assistance does *not* include:

- (1) tools or supplies that may be retained by the employee after completion of a course,
- (2) meals, lodging, or transportation, *or*
- (3) any education involving sports, games, or hobbies.

The exclusion for employer-provided educational assistance applies only with respect to education provided to the employee (e.g., it does not apply to education provided to the spouse or a child of the employee).

In the absence of the specific exclusion for employer-provided educational assistance under section 127, employer-provided educational assistance is excludable from gross income and wages only if the education expenses qualify as a working condition fringe benefit (§132(d)). In general, education qualifies as a working condition fringe benefit if the employee could have deducted the education expenses under section 162 if the employee paid for the education. Education expenses are deductible by an individual under section 162 if the education:

- (1) maintains or improves a skill required in a trade or business currently engaged in by the taxpayer, *or*
- (2) meets the express requirements of the taxpayer's employer, applicable law, or regulations imposed as a condition of continued employment.

However, education expenses are generally not deductible if they relate to certain minimum educational requirements or to education or training that enables a taxpayer to begin working in a new trade or business. In determining the amount deductible for this purpose, the two-percent floor on miscellaneous itemized deductions is disregarded.

The specific exclusion for employer-provided educational assistance was originally enacted on a temporary basis and was subsequently extended 10 times. EGTRRA deleted the exclusion's explicit expiration date and extended the exclusion to graduate courses. However, those changes are subject to EGTRRA's sunset provision so that the exclusion will not be available for taxable years beginning after December 31, 2010. Thus, at that time, educational assistance will be excludable from gross income only if it qualifies as a working condition fringe benefit (i.e., the expenses would have been deductible as business expenses if paid by the employee). As previously discussed, to meet such requirement, the expenses must be related to the employee's current job (Treas. Reg. §1.162-5).

Student Loan Interest (§221)

Certain individuals who have paid interest on qualified education loans may claim an above-the-line deduction for such interest expenses, subject to a maximum an-

nual deduction limit (§221). Required payments of interest generally do not include voluntary payments, such as interest payments made during a period of loan forbearance. No deduction is allowed to an individual if that individual is claimed as a dependent on another taxpayer's return for the taxable year.

A qualified education loan generally is defined as any indebtedness incurred solely to pay for the costs of attendance (including room and board) of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer as of the time the indebtedness was incurred in attending an eligible educational institution on at least a half-time basis. Eligible educational institutions are:

- (1) post-secondary educational institutions and certain vocational schools defined by reference to section 481 of the Higher Education Act of 1965, *or*
- (2) institutions conducting internship or residency programs leading to a degree or certificate from an institution of higher education, a hospital, or a health care facility conducting postgraduate training.

Note: Additionally, to qualify as an eligible educational institution, an institution must be eligible to participate in Department of Education student aid programs.

The maximum allowable deduction per year is \$2,500. For 2010, the deduction is phased out ratably for single taxpayers with AGI between \$60,000 and \$75,000 and between \$120,000 and \$150,000 for married taxpayers filing a joint return. The income phaseout ranges are indexed for inflation and rounded to the next lowest multiple of \$5,000.

Effective for taxable years beginning after December 31, 2010, the changes made by EGTRRA to the student loan provisions no longer apply. The EGTRRA changes scheduled to expire are:

- (1) increases that were made in the AGI phaseout ranges for the deduction, *and*
- (2) rules that extended deductibility of interest beyond the first 60 months that interest payments are required.

With the expiration of EGTRRA, the phaseout ranges will revert to a base level of \$40,000 to \$55,000 (\$60,000 to \$75,000 in the case of a married couple filing jointly), but with an adjustment for inflation occurring since 2002.

Coverdell Education Savings Accounts (§530)

A Coverdell education savings account is a trust or custodial account created exclusively for the purpose of paying qualified education expenses of a named beneficiary (§530). Annual contributions to Coverdell education savings accounts may not exceed \$2,000 per designated beneficiary and may not be made after the designated beneficiary reaches age 18 (except in the case of a special needs beneficiary). The contribution limit is phased out for taxpayers with modified AGI between \$95,000 and \$110,000 (\$190,000 and \$220,000 for married taxpayers filing a joint return); the AGI of the contributor, and not that of the beneficiary, controls whether a contribution is permitted by the taxpayer.

Earnings on contributions to a Coverdell education savings account generally are subject to tax when withdrawn. In addition, Coverdell education savings accounts are subject to the unrelated business income tax imposed by section 511. However, distributions from a Coverdell education savings account are excludable from the gross income of the distributee (i.e., the student) to the extent that the distribution does not exceed the qualified education expenses incurred by the beneficiary during the year the distribution is made. The earnings portion of a Coverdell education savings account distribution not used to pay qualified education expenses is includible in the gross income of the distributee and generally is subject to an additional 10-percent tax.

Note: The 10-percent additional tax does not apply if a distribution from an education savings account is made on account of the death or disability of the designated beneficiary, or if made on account of a scholarship received by the designated beneficiary.

Tax-free (including free of additional 10-percent tax) transfers or rollovers of account balances from one Coverdell education savings account benefiting one beneficiary to another Coverdell education savings account benefiting another beneficiary (as well as redesignations of the named beneficiary) are permitted, provided that the new beneficiary is a member of the family of the prior beneficiary and is under age 30 (except in the case of a special needs beneficiary). In general, any balance remaining in a Coverdell education savings account is deemed to be distributed within 30 days after the date that the beneficiary reaches age 30 (or, if the beneficiary dies before attaining age 30, within 30 days of the date that the beneficiary dies).

Qualified education expenses include "qualified higher education expenses" and "qualified elementary and secondary education expenses."

The term "qualified higher education expenses" includes tuition, fees, books, supplies, and equipment required for the enrollment or attendance of the designated beneficiary at an eligible education institution, regardless of whether the beneficiary is enrolled at an eligible educational institution on a full-time, half-time, or less than half-time basis.

Note: Qualified higher education expenses are defined in the same manner as for qualified tuition programs.

Moreover, qualified higher education expenses include certain room and board expenses for any period during which the beneficiary is at least a half-time student. Qualified higher education expenses include expenses with respect to undergraduate or graduate-level courses. In addition, qualified higher education expenses include amounts paid or incurred to purchase tuition credits (or to make contributions to an account) under a qualified tuition program for the benefit of the beneficiary of the Coverdell education savings account (§530(b)(2)(B)).

The term "qualified elementary and secondary education expenses," means expenses for:

(1) tuition, fees, academic tutoring, special needs services, books, supplies, and other equipment incurred in connection with the enrollment or attendance of the beneficiary at a public, private, or religious school providing elementary or secondary education (kindergarten through grade 12) as determined under State law;

(2) room and board, uniforms, transportation, and supplementary items or services (including extended day programs) required or provided by such a school in connection with such enrollment or attendance of the beneficiary; *and*

(3) the purchase of any computer technology or equipment (as defined in section 170(e)(6)(F)(i)) or Internet access and related services, if such technology, equipment, or services are to be used by the beneficiary and the beneficiary's family during any of the years the beneficiary is in elementary or secondary school.

Note: Computer software primarily involving sports, games, or hobbies is not considered a qualified elementary and secondary education expense unless the software is predominantly educational in nature.

Qualified education expenses generally include only out-of-pocket expenses. Such qualified education expenses do not include expenses covered by employer-provided educational assistance or scholarships for the benefit of the beneficiary that are excludable from gross income. Thus, total qualified education expenses are reduced by scholarship or fellowship grants excludable from gross income under section 117, as well as any other tax-free educational benefits, such as employer-provided educational assistance, that are excludable from the employee's gross income under section 127.

Effective for taxable years beginning after December 31, 2010, the changes made by EGTRRA to Coverdell education savings accounts no longer apply. The EGTRRA changes scheduled to expire are:

(1) the increase in the contribution limit to \$2,000 from \$500;

(2) the increase in the phaseout range for married taxpayers filing jointly to \$190,000-\$220,000 from \$150,000-\$160,000;

(3) the expansion of qualified expenses to include elementary and secondary education expenses;

(4) special age rules for special needs beneficiaries;

(5) clarification that corporations and other entities are permitted to make contributions, regardless of the income of the corporation or entity during the year of the contribution;

(6) certain rules regarding when contributions are deemed made and extending the time during which excess contributions may be returned without additional tax;

(7) certain rules regarding coordination with the Hope and Lifetime Learning credits; *and*

(8) certain rules regarding coordination with qualified tuition programs.

TRUIRJCA

The Act delays the EGTRRA sunset as it applies to the NHSC Scholarship Program and the Armed Forces Scholarship Program, the section 127 exclusion from income and wages for employer-provided educational assistance, the student loan interest deduction, and Coverdell education savings accounts for two years. The provision also delays the EGTRRA sunset as it applies to the expansion of the small government unit exception to arbitrage rebate and allowing issuance of tax-exempt private activity bonds for public school facilities. Thus, all of these tax benefits for education continue to be available through 2012.

Effective Date

The provision is effective on December 17, 2010.

Energy Efficient Home Credit - §45L

Prior or Existing Law

The Code provides a credit to an eligible contractor for each qualified new energy-efficient home that is constructed by the eligible contractor and acquired by a person from such eligible contractor for use as a residence during the taxable year (§45L). To qualify as a new energy-efficient home, the home must be:

- (1) a dwelling located in the United States,
- (2) substantially completed after August 8, 2005, *and*
- (3) certified in accordance with guidance prescribed by the Secretary to have a projected level of annual heating and cooling energy consumption that meets the standards for either a 30-percent or 50-percent reduction in energy usage, compared to a comparable dwelling constructed in accordance with the standards of chapter 4 of the 2003 International Energy Conservation Code as in effect (including supplements) on August 8, 2005, and any applicable Federal minimum efficiency standards for equipment.

With respect to homes that meet the 30-percent standard, one-third of such 30-percent savings must come from the building envelope, and with respect to homes that meet the 50-percent standard, one-fifth of such 50-percent savings must come from the building envelope.

Manufactured homes that conform to Federal manufactured home construction and safety standards are eligible for the credit provided all the criteria for the credit are met. The eligible contractor is the person who constructed the home, or in the case of a manufactured home, the producer of such home.

The credit equals \$1,000 in the case of a new home that meets the 30-percent standard and \$2,000 in the case of a new home that meets the 50-percent standard. Only manufactured homes are eligible for the \$1,000 credit.

In lieu of meeting the standards of chapter 4 of the 2003 International Energy Conservation Code, manufactured homes certified by a method prescribed by the Administrator of the Environmental Protection Agency under the Energy Star Labeled Homes program are eligible for the \$1,000 credit provided criteria (1) and (2), above, are met.

The credit applies to homes that are purchased prior to January 1, 2010. The credit is part of the general business credit.

TRUIRJCA

The Act extends the credit to homes that are purchased prior to January 1, 2012.

Effective Date

The provision applies to homes acquired after December 31, 2009.

Nonbusiness Energy Property Credit - §25C

Prior or Existing Law

Section 25C provides a 30-percent credit for the purchase of qualified energy efficiency improvements to the envelope of existing homes. Additionally, section 25C provides a 30 percent credit for the purchase of:

- (1) qualified natural gas, propane, or oil furnace or hot water boilers,
- (2) qualified energy efficient property, *and*
- (3) advanced main air circulating fans.

The credit applies to expenditures made after December 31, 2008, for property placed in service after December 31, 2008, and prior to January 1, 2011. The aggregate amount of the credit allowed for a taxpayer for taxable years beginning in 2009 and 2010 is \$1,500.

The taxpayer's basis in the property is reduced by the amount of the credit. Special proration rules apply in the case of jointly owned property, condominiums, and tenant-stockholders in cooperative housing corporations. If less than 80 percent of the property is used for nonbusiness purposes, only that portion of expenditures that is used for nonbusiness purposes is taken into account.

TRUIRJCA

The Act extends the credits for one year but utilizes the credit structure and credit rates that existed prior to the enactment of the American Recovery and Reinvestment Act of 2009. The provision reinstates the rule that expenditures made from subsidized energy financing are not qualifying expenditures. Additionally, certain efficiency

standards that were weakened in the American Recovery and Reinvestment Act are restored to their prior levels. Lastly, the provision provides that windows, skylights, and doors that meet the Energy Star standards are qualified improvements.

Description of the operation of the credit under the Act: Section 25C provides a 10-percent credit for the purchase of qualified energy efficiency improvements to existing homes. A qualified energy efficiency improvement is any energy efficiency building envelope component:

- (1) that meets or exceeds the prescriptive criteria for such a component established by the 2009 International Energy Conservation Code as such Code (including supplements) is in effect on the date of the enactment of the American Recovery and Reinvestment Tax Act of 2009 (February 17, 2009) (or, in the case of windows, skylights and doors, and metal roofs with appropriate pigmented coatings or asphalt roofs with appropriate cooling granules, meets the Energy Star program requirements);
- (2) that is installed in or on a dwelling located in the United States and owned and used by the taxpayer as the taxpayer's principal residence;
- (3) the original use of which commences with the taxpayer; and
- (4) that reasonably can be expected to remain in use for at least five years. The credit is nonrefundable.

Building envelope components are:

- (1) insulation materials or systems which are specifically and primarily designed to reduce the heat loss or gain for a dwelling and which meet the prescriptive criteria for such material or system established by the 2009 International Energy Conservation Code, as such Code (including supplements) is in effect on the date of the enactment of the American Recovery and Reinvestment Tax Act of 2009 (February 17, 2009);
- (2) exterior windows (including skylights) and doors; *and*
- (3) metal or asphalt roofs with appropriate pigmented coatings or cooling granules that are specifically and primarily designed to reduce the heat gain for a dwelling.

Additionally, section 25C provides specified credits for the purchase of specific energy efficient property originally placed in service by the taxpayer during the taxable year. The allowable credit for the purchase of certain property is:

- (1) \$50 for each advanced main air circulating fan,

Note: An advanced main air circulating fan is a fan used in a natural gas, propane, or oil furnace and which has an annual electricity use of no more than two percent of the total annual energy use of the furnace (as determined in the standard Department of Energy test procedures).

- (2) \$150 for each qualified natural gas, propane, or oil furnace or hot water boiler, *and*

Note: A qualified natural gas, propane, or oil furnace or hot water boiler is a natural gas, propane, or oil furnace or hot water boiler with an annual fuel utilization efficiency rate of at least 95.

(3) \$300 for each item of qualified energy efficient property.

Note: Qualified energy-efficient property is: (1) an electric heat pump water heater which yields an energy factor of at least 2.0 in the standard Department of Energy test procedure, (2) an electric heat pump which achieves the highest efficiency tier established by the Consortium for Energy Efficiency, as in effect on January 1, 2009, (3) a central air conditioner which achieves the highest efficiency tier established by the Consortium for Energy Efficiency as in effect on Jan. 1, 2009, (4) a natural gas, propane, or oil water heater which has an energy factor of at least 0.82 or thermal efficiency of at least 90 percent, and (5) biomass fuel property.

Under section 25C, the maximum credit for a taxpayer for all taxable years is \$500, and no more than \$200 of such credit may be attributable to expenditures on windows.

The taxpayer's basis in the property is reduced by the amount of the credit. Special proration rules apply in the case of jointly owned property, condominiums, and tenant-stockholders in cooperative housing corporations. If less than 80 percent of the property is used for nonbusiness purposes, only that portion of expenditures that is used for nonbusiness purposes is taken into account.

For purposes of determining the amount of expenditures made by any individual with respect to any dwelling unit, expenditures which are made from subsidized energy financing are not taken into account. The term "subsidized energy financing" means financing provided under a Federal, State, or local program a principal purpose of which is to provide subsidized financing for projects designed to conserve or produce energy.

Effective Date

The provision applies to property placed in service after December 31, 2010.

Energy Efficient Home Credit - §45L

Prior or Existing Law

The Code provides a credit to an eligible contractor for each qualified new energy-efficient home that is constructed by the eligible contractor and acquired by a person from such eligible contractor for use as a residence during the taxable year. To qualify as a new energy-efficient home, the home must be:

- (1)** a dwelling located in the United States,
- (2)** substantially completed after August 8, 2005, *and*
- (3)** certified in accordance with guidance prescribed by the Secretary to have a projected level of annual heating and cooling energy consumption that meets the standards for either a 30-percent or 50-percent reduction in energy usage, compared to a comparable dwelling constructed in accordance with the standards of chapter 4 of the 2003 International Energy Conservation Code as in effect (includ-

ing supplements) on August 8, 2005, and any applicable Federal minimum efficiency standards for equipment.

With respect to homes that meet the 30-percent standard, one-third of such 30-percent savings must come from the building envelope, and with respect to homes that meet the 50-percent standard, one-fifth of such 50-percent savings must come from the building envelope.

Manufactured homes that conform to Federal manufactured home construction and safety standards are eligible for the credit provided all the criteria for the credit are met. The eligible contractor is the person who constructed the home, or in the case of a manufactured home, the producer of such home.

The credit equals \$1,000 in the case of a new home that meets the 30-percent standard and \$2,000 in the case of a new home that meets the 50-percent standard. Only manufactured homes are eligible for the \$1,000 credit.

In lieu of meeting the standards of chapter 4 of the 2003 International Energy Conservation Code, manufactured homes certified by a method prescribed by the Administrator of the Environmental Protection Agency under the Energy Star Labeled Homes program are eligible for the \$1,000 credit provided criteria (1) and (2), above, are met.

The credit applies to homes that are purchased prior to January 1, 2010. The credit is part of the general business credit.

TRUIRJCA

The Act extends the credit to homes that are purchased prior to January 1, 2012.

Effective Date

The provision applies to homes acquired after December 31, 2009.

Research Credit - §41

Prior or Existing Law

A taxpayer may claim a research credit equal to 20 percent of the amount by which the taxpayer's qualified research expenses for a taxable year exceed its base amount for that year (§41). Thus, the research credit is generally available with respect to incremental increases in qualified research.

A 20-percent research tax credit is also available with respect to the excess of:

- (1) 100 percent of corporate cash expenses (including grants or contributions) paid for basic research conducted by universities (and certain nonprofit scientific research organizations), *over*
- (2) the sum of:
 - (a) the greater of two minimum basic research floors, *plus*

(b) an amount reflecting any decrease in nonresearch giving to universities by the corporation as compared to such giving during a fixed-base period, as adjusted for inflation.

This separate credit computation is commonly referred to as the university basic research credit (§41(e)).

Finally, a research credit is available for a taxpayer's expenditures on research undertaken by an energy research consortium. This separate credit computation is commonly referred to as the energy research credit. Unlike the other research credits, the energy research credit applies to all qualified expenditures, not just those in excess of a base amount.

The research credit, including the university basic research credit and the energy research credit, expires for amounts paid or incurred after December 31, 2009 (§41(h)).

Computation of Allowable Credit

Except for energy research payments and certain university basic research payments made by corporations, the research tax credit applies only to the extent that the taxpayer's qualified research expenses for the current taxable year exceed its base amount. The base amount for the current year generally is computed by multiplying the taxpayer's fixed-base percentage by the average amount of the taxpayer's gross receipts for the four preceding years. If a taxpayer both incurred qualified research expenses and had gross receipts during each of at least three years from 1984 through 1988, then its fixed-base percentage is the ratio that its total qualified research expenses for the 1984-1988 period bears to its total gross receipts for that period (subject to a maximum fixed-base percentage of 16 percent). All other taxpayers (so-called start-up firms) are assigned a fixed-base percentage of three percent.

Comment: The Small Business Job Protection Act of 1996 expanded the definition of start-up firms under section 41(c)(3)(B)(i) to include any firm if the first taxable year in which such firm had both gross receipts and qualified research expenses began after 1983. A special rule (enacted in 1993) is designed to gradually recompute a start-up firm's fixed-base percentage based on its actual research experience. Under this special rule, a start-up firm is assigned a fixed-base percentage of three percent for each of its first five taxable years after 1993 in which it incurs qualified research expenses. A start-up firm's fixed-base percentage for its sixth through tenth taxable years after 1993 in which it incurs qualified research expenses is a phased-in ratio based on the firm's actual research experience. For all subsequent taxable years, the taxpayer's fixed-base percentage is its actual ratio of qualified research expenses to gross receipts for any five years selected by the taxpayer from its fifth through tenth taxable years after 1993 (§41(c)(3)(B)).

In computing the credit, a taxpayer's base amount cannot be less than 50 percent of its current-year qualified research expenses.

To prevent artificial increases in research expenditures by shifting expenditures among commonly controlled or otherwise related entities, a special aggregation rule provides that all members of the same controlled group of corporations are

treated as a single taxpayer (§41(f)(1)). Under regulations prescribed by the Secretary, special rules apply for computing the credit when a major portion of a trade or business (or unit thereof) changes hands, under which qualified research expenses and gross receipts for periods prior to the change of ownership of a trade or business are treated as transferred with the trade or business that gave rise to those expenses and receipts for purposes of recomputing a taxpayer's fixed-base percentage (§41(f)(3)).

Alternative Simplified Credit

Taxpayers may elect to claim an alternative simplified credit for qualified research expenses. The alternative simplified research credit is equal to 14 percent of qualified research expenses that exceed 50 percent of the average qualified research expenses for the three preceding taxable years. The rate is reduced to six percent if a taxpayer has no qualified research expenses in any one of the three preceding taxable years. An election to use the alternative simplified credit applies to all succeeding taxable years unless revoked with the consent of the Secretary.

Eligible Expenses

Qualified research expenses eligible for the research tax credit consist of:

- (1) in-house expenses of the taxpayer for wages and supplies attributable to qualified research;
- (2) certain time-sharing costs for computer use in qualified research; *and*
- (3) 65 percent of amounts paid or incurred by the taxpayer to certain other persons for qualified research conducted on the taxpayer's behalf (so-called contract research expenses).

Comment: Under a special rule, 75 percent of amounts paid to a research consortium for qualified research are treated as qualified research expenses eligible for the research credit (rather than 65 percent under the general rule under section 41(b)(3) governing contract research expenses) if (1) such research consortium is a tax-exempt organization that is described in section 501(c)(3) (other than a private foundation) or section 501(c)(6) and is organized and operated primarily to conduct scientific research, and (2) such qualified research is conducted by the consortium on behalf of the taxpayer and one or more persons not related to the taxpayer. Sec. 41(b)(3)(C).

Notwithstanding the limitation for contract research expenses, qualified research expenses include 100 percent of amounts paid or incurred by the taxpayer to an eligible small business, university, or Federal laboratory for qualified energy research.

To be eligible for the credit, the research not only has to satisfy the requirements of present-law section 174 (described below) but also must be undertaken for the purpose of discovering information that is technological in nature, the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and substantially all of the activities of which

constitute elements of a process of experimentation for functional aspects, performance, reliability, or quality of a business component. Research does not qualify for the credit if substantially all of the activities relate to style, taste, cosmetic, or seasonal design factors (§41(d)(3)). In addition, research does not qualify for the credit:

- (1) if conducted after the beginning of commercial production of the business component;
- (2) if related to the adaptation of an existing business component to a particular customer's requirements;
- (3) if related to the duplication of an existing business component from a physical examination of the component itself or certain other information; *or*
- (4) if related to certain efficiency surveys, management function or technique, market research, market testing, or market development, routine data collection or routine quality control (§41(d)(4)).

Research does not qualify for the credit if it is conducted outside the United States, Puerto Rico, or any U.S. possession.

Relation to §174 Deduction

Under section 174, taxpayers may elect to deduct currently the amount of certain research or experimental expenditures paid or incurred in connection with a trade or business, notwithstanding the general rule that business expenses to develop or create an asset that has a useful life extending beyond the current year must be capitalized.

Note: Taxpayers may elect 10-year amortization of certain research expenditures allowable as a deduction under section 174(a) – see §174(f)(2) and §59(e).

However, deductions allowed to a taxpayer under section 174 (or any other section) are reduced by an amount equal to 100 percent of the taxpayer's research tax credit determined for the taxable year (§280C(c)). Taxpayers may alternatively elect to claim a reduced research tax credit amount under section 41 in lieu of reducing deductions otherwise allowed (§280C(c)(3)).

TRUIRJCA

The Act extends the research credit for two years, through December 31, 2011.

Effective Date

The provision is effective for amounts paid or incurred after December 31, 2009.

Uniformed Services Wage Credit - §45P

Prior or Existing Law

In general, compensation paid by an employer to an employee is deductible by the employer under section 162(a)(1), unless the expense must be capitalized. In the case of an employee who is called to active duty with respect to the armed forces of the United States, some employers voluntarily pay the employee the difference between the compensation that the employer would have paid to the employee during the period of military service less the amount of pay received by the employee from the military. This payment by the employer is often referred to as "differential pay."

If an employer qualifies as an eligible small business employer, the employer is allowed to take a credit against its income tax liability for a taxable year in an amount equal to 20 percent of the sum of the eligible differential wage payments for each of the employer's qualified employees for the taxable year (§45P).

The credit is not allowable against a taxpayer's alternative minimum tax liability. The amount of credit otherwise allowable under the income tax rules for compensation paid to any employee must be reduced by the differential wage payment credit with respect to that employee. The credit is available with respect to amounts paid after June 17, 2008 and before January 1, 2010.

TRUIRJCA

The Act extends the availability of the credit to amounts paid before January 1, 2012.

Effective Date

The provision applies to payments made after December 31, 2009.

15-Year Qualified Improvements - §168

Prior or Existing Law

A taxpayer generally must capitalize the cost of property used in a trade or business and recover such cost over time through annual deductions for depreciation or amortization. Tangible property generally is depreciated under the modified accelerated cost recovery system ("MACRS"), which determines depreciation by applying specific recovery periods, placed-in-service conventions, and depreciation methods to the cost of various types of depreciable property (§168). The cost of nonresidential real property is recovered using the straight-line method of depreciation and a recovery period of 39 years. Nonresidential real property is subject to the mid-month placed-in-service convention. Under the mid-month convention, the depreciation allowance for the first year property is placed in service is based on the number of months the

property was in service, and property placed in service at any time during a month is treated as having been placed in service in the middle of the month.

Depreciation of Leasehold Improvements

Generally, depreciation allowances for improvements made on leased property are determined under MACRS, even if the MACRS recovery period assigned to the property is longer than the term of the lease. This rule applies regardless of whether the lessor or the lessee places the leasehold improvements in service. If a leasehold improvement constitutes an addition or improvement to nonresidential real property already placed in service, the improvement generally is depreciated using the straight-line method over a 39-year recovery period, beginning in the month the addition or improvement was placed in service. However, exceptions exist for certain qualified leasehold improvements, qualified restaurant property, and qualified retail improvement property.

Qualified Leasehold Improvement Property

Section 168(e)(3)(E)(iv) provides a statutory 15-year recovery period for qualified leasehold improvement property placed in service before January 1, 2010. Qualified leasehold improvement property is recovered using the straight-line method and a half-year convention. Leasehold improvements placed in service after December 31, 2009 will be subject to the general rules described above.

Qualified leasehold improvement property is any improvement to an interior portion of a building that is nonresidential real property, provided certain requirements are met. The improvement must be made under or pursuant to a lease either by the lessee (or sublessee), or by the lessor, of that portion of the building to be occupied exclusively by the lessee (or sublessee). The improvement must be placed in service more than three years after the date the building was first placed in service. Qualified leasehold improvement property does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator, or escalator, any structural component benefiting a common area, or the internal structural framework of the building.

If a lessor makes an improvement that qualifies as qualified leasehold improvement property, such improvement does not qualify as qualified leasehold improvement property to any subsequent owner of such improvement. An exception to the rule applies in the case of death and certain transfers of property that qualify for non-recognition treatment.

Qualified Retail Improvement Property

Section 168(e)(3)(E)(ix) provides a statutory 15-year recovery period and for qualified retail improvement property placed in service after December 31, 2008 and before January 1, 2010. Qualified retail improvement property is any improvement to an interior portion of a building which is nonresidential real property if such portion is open to the general public and is used in the retail trade or

business of selling tangible personal property to the general public, and such improvement is placed in service more than three years after the date the building was first placed in service. Qualified retail improvement property does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator, or escalator, or the internal structural framework of the building. In the case of an improvement made by the owner of such improvement, the improvement is a qualified retail improvement only so long as the improvement is held by such owner.

Retail establishments that qualify for the 15-year recovery period include those primarily engaged in the sale of goods. Examples of these retail establishments include, but are not limited to, grocery stores, clothing stores, hardware stores, and convenience stores. Establishments primarily engaged in providing services, such as professional services, financial services, personal services, health services, and entertainment, do not qualify. It is generally intended that businesses defined as a store retailer under the current North American Industry Classification System (industry sub-sectors 441 through 453) qualify while those in other industry classes do not qualify.

Qualified retail improvement property is recovered using the straight-line method and a half-year convention. Additionally, qualified retail improvement property is not eligible for bonus depreciation. Qualified retail improvement property placed in service on or after January 1, 2010 is subject to the general rules described above.

TRUIRJCA

The Act extends present law provisions for qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property for two years to apply to property placed in service on or before December 31, 2011.

Effective Date

The provision is effective for property placed in service after December 31, 2009.

Bonus Depreciation - §168(k)

Prior or Existing Law

An additional first-year depreciation deduction is allowed equal to 50 percent of the adjusted basis of qualified property placed in service during 2008, 2009, and 2010 (2009, 2010, and 2011 for certain longer-lived and transportation property) [§168(k)].

Comment: The additional first-year depreciation deduction is subject to the general rules regarding whether an item must be capitalized under section 263 or section 263A.

The additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes, but is not allowed for purposes of computing earnings and profits. The basis of the property and the depreciation allowances in the year of purchase and later years are appropriately adjusted to reflect the additional first-year depreciation deduction. In addition, there are no adjustments to the allowable amount of depreciation for purposes of computing a taxpayer's alternative minimum taxable income with respect to property to which the provision applies. The amount of the additional first-year depreciation deduction is not affected by a short taxable year. The taxpayer may elect out of additional first-year depreciation for any class of property for any taxable year.

Example 1

Assume that in 2009, a taxpayer purchased new depreciable property (not eligible for expensing) and placed it in service. The property's cost is \$1,000, and it is five-year property subject to the half-year convention. The amount of additional first-year depreciation allowed is \$500. The remaining \$500 of the cost of the property is depreciable under the rules applicable to five-year property. Thus, 20 percent, or \$100, is also allowed as a depreciation deduction in 2009. The total depreciation deduction with respect to the property for 2009 is \$600. The remaining \$400 adjusted basis of the property generally is recovered through otherwise applicable depreciation rules.

Property qualifying for the additional first-year depreciation deduction must meet all of the following requirements:

First, the property must be:

- (1) property to which MACRS applies with an applicable recovery period of 20 years or less;
 - (2) water utility property (as defined in section 168(e)(5));
 - (3) computer software other than computer software covered by section 197;
- or*
- (4) qualified leasehold improvement property (as defined in section 168(k)(3)).

Note: The additional first-year depreciation deduction is not available for any property that is required to be depreciated under the alternative depreciation system of MACRS. The additional first-year depreciation deduction is also not available for qualified New York Liberty Zone leasehold improvement property as defined in section 1400L(c)(2).

Second, the original use of the property must commence with the taxpayer after December 31, 2007. A special rule applies in the case of certain leased property. In the case of any property that is originally placed in service by a person and that is sold to the taxpayer and leased back to such person by the taxpayer within three

months after the date that the property was placed in service, the property would be treated as originally placed in service by the taxpayer not earlier than the date that the property is used under the leaseback.

If property is originally placed in service by a lessor (including by operation of section 168(k)(2)(E)(i)), such property is sold within three months after the date that the property was placed in service, and the user of such property does not change, then the property is treated as originally placed in service by the taxpayer not earlier than the date of such sale.

Note: The term "original use" means the first use to which the property is put, whether or not such use corresponds to the use of such property by the taxpayer. If in the normal course of its business a taxpayer sells fractional interests in property to unrelated third parties, then the original use of such property begins with the first user of each fractional interest (i.e., each fractional owner is considered the original user of its proportionate share of the property).

Third, the taxpayer must purchase the property within the applicable time period.

Finally, the property must be placed in service after December 31, 2007, and before January 1, 2011. An extension of the placed in service date of one year (i.e., to January 1, 2012) is provided for certain property with a recovery period of 10 years or longer and certain transportation property. Transportation property is defined as tangible personal property used in the trade or business of transporting persons or property.

To qualify, property must be acquired:

- (1) after December 31, 2007, and before January 1, 2011, but only if no binding written contract for the acquisition is in effect before January 1, 2008, *or*
- (2) pursuant to a binding written contract which was entered into after December 31, 2007, and before January 1, 2011.

However, property does not fail to qualify for the additional first-year depreciation merely because a binding written contract to acquire a component of the property is in effect prior to January 1, 2008.

With respect to property that is manufactured, constructed, or produced by the taxpayer for use by the taxpayer, the taxpayer must begin the manufacture, construction, or production of the property after December 31, 2007, and before January 1, 2011. Property that is manufactured, constructed, or produced for the taxpayer by another person under a contract that is entered into prior to the manufacture, construction, or production of the property is considered to be manufactured, constructed, or produced by the taxpayer. For property eligible for the extended placed in service date, a special rule limits the amount of costs eligible for the additional first-year depreciation. With respect to such property, only the portion of the basis that is properly attributable to the costs incurred before January 1, 2011 ("progress expenditures") is eligible for the additional first-year depreciation.

Property does not qualify for the additional first-year depreciation deduction when the user of such property (or a related party) would not have been eligible for the additional first-year depreciation deduction if the user (or a related party) were treated as

the owner. For example, if a taxpayer sells to a related party property that was under construction prior to January 1, 2008, the property does not qualify for the additional first-year depreciation deduction. Similarly, if a taxpayer sells to a related party property that was subject to a binding written contract prior to January 1, 2008, the property does not qualify for the additional first-year depreciation deduction. As a further example, if a taxpayer (the lessee) sells property in a sale-leaseback arrangement, and the property otherwise would not have qualified for the additional first-year depreciation deduction if it were owned by the taxpayer-lessee, then the lessor is not entitled to the additional first-year depreciation deduction.

The limitation under section 280F on the amount of depreciation deductions allowed with respect to certain passenger automobiles is increased in the first year by \$8,000 for automobiles that qualify (and for which the taxpayer does not elect out of the additional first-year deduction). The \$8,000 increase is not indexed for inflation.

Note: A corporation otherwise eligible for additional first year depreciation under section 168(k) may elect to claim additional research or minimum tax credits in lieu of claiming depreciation under section 168(k) for "eligible qualified property" placed in service after March 31, 2008 and before December 31, 2008 (§168(k)(4)).

TRUIRJCA

The Act extends and expands the additional first-year depreciation to equal 100 percent of the cost of qualified property placed in service after September 8, 2010 and before January 1, 2012 (before January 1, 2013 for certain longer-lived and transportation property), and provides for a 50 percent first-year additional depreciation deduction for qualified property placed in service after December 31, 2011 and before January 1, 2013 (after December 31, 2012 and before January 1, 2014 for certain longer-lived and transportation property). Rules similar to those in section 168(k)(2)(A)(ii) and (iii), which provide that qualified property does not include property acquired pursuant to a written binding contract that was in effect prior to January 1, 2008, apply for purposes of determining whether property is eligible for the temporary 100 percent additional first-year depreciation deduction. Thus under the Act, property acquired pursuant to a written binding contract entered into after December 31, 2007 is qualified property for purposes of the 100 percent additional first-year depreciation deduction assuming all other requirements of section 168(k)(2) are met.

The Act generally permits a corporation to increase the minimum tax credit limitation by the bonus depreciation amount with respect to certain property placed in service after December 31, 2010 and before January 1, 2013 (January 1, 2014 in the case of certain longer-lived and transportation property).

Effective Date

The provision generally applies to property placed in service by the taxpayer after December 31, 2010, in taxable years ending after such date. The provision expanding the additional first-year depreciation deduction to 100 percent of the ba-

sis of qualified property applies to property placed in service by the taxpayer after September 8, 2010, in taxable years ending after such date.

Expensing - §179

Prior or Existing Law

Subject to certain limitations, a taxpayer that invests in certain qualifying property may elect under section 179 to deduct (or "expense") the cost of qualifying property, rather than to recover such costs through depreciation deductions. For taxable years beginning in 2010 and 2011, the maximum amount that a taxpayer may expense is \$500,000 of the cost of qualifying property placed in service for the taxable year.

Note: The definition of qualifying property was temporarily (for 2010 and 2011) expanded to include up to \$250,000 of qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property (§179(f)(2)).

The \$500,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds \$2,000,000. Off-the-shelf computer software placed in service in taxable years beginning before 2012 is treated as qualifying property.

The amount eligible to be expensed for a taxable year may not exceed the taxable income for a taxable year that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation generally may be carried forward to succeeding taxable years (subject to similar limitations). No general business credit under section 38 is allowed with respect to any amount for which a deduction is allowed under section 179. An expensing election is made under rules prescribed by the Secretary.

For taxable years beginning in 2012 and thereafter, a taxpayer with a sufficiently small amount of annual investment may elect to deduct up to \$25,000 of the cost of qualifying property placed in service for the taxable year. The \$25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds \$200,000. The \$25,000 and \$200,000 amounts are not indexed. In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business (not including off-the-shelf computer software).

TRUIRJCA

Under the Act, for taxable years beginning in 2012, the maximum amount a taxpayer may expense is \$125,000 of the cost of qualifying property placed in service for the taxable year. The \$125,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds \$500,000. The \$125,000 and \$500,000 amounts are indexed for inflation.

In addition, the provision extends the treatment of off-the-shelf computer software as qualifying property, as well as the provision permitting a taxpayer to amend or irrevocably revoke an election for a taxable year under section 179 without the consent of the Commissioner for one year (through 2012).

Comment: The temporary extension of the definition of qualifying property to include qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property is not extended.

For taxable years beginning in 2013, and thereafter, the maximum amount a taxpayer may expense is \$25,000 of the cost of qualifying property placed in service for the taxable year. The \$25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds \$200,000.

Effective Date

The provision is effective for taxable years beginning after December 31, 2011.

Special Film & TV Production Expensing - §181

Prior or Existing Law

The modified accelerated cost recovery system ("MACRS") does not apply to certain property, including any motion picture film, video tape, or sound recording, or to any other property if the taxpayer elects to exclude such property from MACRS and the taxpayer properly applies a unit-of-production method or other method of depreciation not expressed in a term of years. Section 197 does not apply to certain intangible property, including property produced by the taxpayer or any interest in a film, sound recording, video tape, book or similar property not acquired in a transaction (or a series of related transactions) involving the acquisition of assets constituting a trade or business or substantial portion thereof. Thus, the recovery of the cost of a film, video tape, or similar property that is produced by the taxpayer or is acquired on a "stand-alone" basis by the taxpayer may not be determined under either the MACRS depreciation provisions or under the section 197 amortization provisions. The cost recovery of such property may be determined under section 167, which allows a depreciation deduction for the reasonable allowance for the exhaustion, wear and tear, or obsolescence of the property. A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. Section 167(g) provides that the cost of motion picture films, sound recordings, copyrights, books, and patents are eligible to be recovered using the income forecast method of depreciation.

Under section 181, taxpayers may elect (see Treas. Reg. §1.181-2T) to deduct the cost of any qualifying film and television production, commencing prior to January 1, 2010, in the year the expenditure is incurred in lieu of capitalizing the cost and recovering it through depreciation allowances. Taxpayers may elect to deduct up to \$15

million of the aggregate cost of the film or television production under this section (§181(a)(2)(A)). The threshold is increased to \$20 million if a significant amount of the production expenditures are incurred in areas eligible for designation as a low-income community or eligible for designation by the Delta Regional Authority as a distressed county or isolated area of distress (§181(a)(2)(B)).

A qualified film or television production means any production of a motion picture (whether released theatrically or directly to video cassette or any other format) or television program if at least 75 percent of the total compensation expended on the production is for services performed in the United States by actors, directors, producers, and other relevant production personnel (§181(d)(3)(A)). The term "compensation" does not include participations and residuals (as defined in section 167(g)(7)(B)). With respect to property which is one or more episodes in a television series, each episode is treated as a separate production and only the first 44 episodes qualify under the provision (§181(d)(2)(B)). Qualified property does not include sexually explicit productions as defined by section 2257 of title 18 of the U.S. Code.

For purposes of recapture under section 1245, any deduction allowed under section 181 is treated as if it were a deduction allowable for amortization (§1245(a)(2)(C)).

TRUIRJCA

The Act extends the present law expensing provision for two years, to qualified film and television productions commencing prior to January 1, 2012.

Effective Date

The provision applies to qualified film and television productions commencing after December 31, 2009.

Environmental Remediation Cost Expensing - §198

Prior or Existing Law

Present law allows a deduction for ordinary and necessary expenses paid or incurred in carrying on any trade or business (§162). Treasury regulations provide that the cost of incidental repairs that neither materially add to the value of property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted currently as a business expense (Treas. Reg. §1.162-4). Section 263(a)(1) limits the scope of section 162 by prohibiting a current deduction for certain capital expenditures. Treasury regulations define "capital expenditures" as amounts paid or incurred to materially add to the value, or substantially prolong the useful life, of property owned by the taxpayer, or to adapt property to a new or different use (Treas. Reg. sec. 1.263(a)-1(b)). Amounts paid for repairs and maintenance do not constitute

capital expenditures. The determination of whether an expense is deductible or capitalizable is based on all relevant facts and circumstances.

Taxpayers may elect to treat certain environmental remediation expenditures paid or incurred before January 1, 2010, that would otherwise be chargeable to capital account as deductible in the year paid or incurred (§198). The deduction applies for both regular and alternative minimum tax purposes. The expenditure must be incurred in connection with the abatement or control of hazardous substances at a qualified contaminated site. In general, any expenditure for the acquisition of depreciable property used in connection with the abatement or control of hazardous substances at a qualified contaminated site does not constitute a qualified environmental remediation expenditure. However, depreciation deductions allowable for such property that would otherwise be allocated to the site under the principles set forth in *Commissioner v. Idaho Power Co.*, 418 U.S. 1 (1974) and section 263A are treated as qualified environmental remediation expenditures.

A "qualified contaminated site" (a so-called "brownfield") generally is any property that is held for use in a trade or business, for the production of income, or as inventory and is certified by the appropriate State environmental agency to be an area at or on which there has been a release (or threat of release) or disposal of a hazardous substance. Both urban and rural property may qualify. However, sites that are identified on the national priorities list under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 ("CERCLA") cannot qualify as targeted areas. Hazardous substances generally are defined by reference to sections 101(14) and 102 of CERCLA, subject to additional limitations applicable to asbestos and similar substances within buildings, certain naturally occurring substances such as radon, and certain other substances released into drinking water supplies due to deterioration through ordinary use, as well as petroleum products defined in section 4612(a)(3) of the Code.

In the case of property to which a qualified environmental remediation expenditure otherwise would have been capitalized, any deduction allowed under section 198 is treated as a depreciation deduction and the property is treated as section 1245 property. Thus, deductions for qualified environmental remediation expenditures are subject to recapture as ordinary income upon a sale or other disposition of the property. In addition, sections 280B (demolition of structures) and 468 (special rules for mining and solid waste reclamation and closing costs) do not apply to amounts that are treated as expenses under section 198.

TRUIRJCA

The Act extends the present law expensing for two years to include expenditures paid or incurred before January 1, 2012.

Effective Date

The provision is effective for expenditures paid or incurred after December 31, 2009.

Payroll Taxes - §3111 & §3121

Prior or Existing Law

The *FICA* tax applies to employers based on the amount of covered wages paid to an employee during the year (§3111). Generally, covered wages means all remuneration for employment, including the cash value of all remuneration paid in any medium other than cash (§3121). Certain exceptions from covered wages are also provided. The tax imposed is composed of two parts:

- (1) the old age, survivors, and disability insurance ("OASDI") tax equal to 6.2 percent of covered wages up to the taxable wage base (\$106,800 in 2010); *and*
- (2) the Medicare hospital insurance ("HI") tax amount equal to 1.45 percent of covered wages.

In addition to the tax on employers, each employee is subject to FICA taxes equal to the amount of tax imposed on the employer (the "employee portion") [§3101]. The employee portion generally must be withheld and remitted to the Federal government by the employer.

As a parallel to FICA taxes, the *SECA* tax applies to the self-employment income of self-employed individuals (§1401). The rate of the OASDI portion of SECA taxes is 12.4 percent, which is equal to the combined employee and employer OASDI FICA tax rates, and applies to self-employment income up to the FICA taxable wage base. Similarly, the rate of the HI portion is 2.9 percent, the same as the combined employer and employee HI rates under the FICA tax, and there is no cap on the amount of self-employment income to which the rate applies.

An individual may deduct, in determining net earnings from self-employment under the SECA tax, the amount of the net earnings from self-employment (determined without regard to this deduction) for the taxable year multiplied by one half of the combined OASDI and HI rates (§1402(a)(12)).

Additionally, a deduction, for purposes of computing the income tax of an individual, is allowed for one half of the amount of the SECA tax imposed on the individual's self-employment income for the taxable year (§164(f)).

TRUIRJCA

The Act reduces the employee OASDI tax rate under the FICA tax by two percentage points to 4.2 percent for one year (2011). Similarly, the provision reduces the OASDI tax rate under the SECA tax by two percentage points to 10.4 percent for taxable years of individuals that begin in 2011.

The Act provides rules for coordination with deductions for employment taxes. The rate reduction is not taken into account in determining the SECA tax deduction allowed for determining the amount of the net earnings from self-employment for the taxable year. Thus, the deduction for 2011 remains at 7.65 percent of self-employment income (determined without regard to the deduction).

The income tax deduction allowed under section 164(f) for taxable years beginning in 2011 is computed at the rate of 59.6 percent of the OASDI tax paid, plus one half of the HI tax paid. This percentage replaces the rate of one half (50 percent) allowed under present law for this portion of the deduction. The new percentage is necessary to continue to allow the self-employed taxpayer to deduct the full amount of the employer portion of SECA taxes. The employer OASDI tax rate remains at 6.2 percent, while the employee portion falls to 4.2 percent. Thus, the employer share of total OASDI taxes is 6.2 divided by 10.4, or 59.6 percent of the OASDI portion of SECA taxes.

The Act provides that the Treasury Secretary is to notify employers of the payroll tax cut.

The Federal Old-Age and Survivors Trust Fund, the Federal Disability Insurance Trust Fund, and the Social Security Equivalent Benefit Account established under the Railroad Retirement Act of 1974⁸⁹ will receive transfers from the General Fund of the United States Treasury equal to any reduction in payroll taxes attributable to this provision. The amounts will be transferred from the General Fund at such times and in such a manner as to replicate to the extent possible the transfers which would have occurred to the Trust Funds or Benefit Account had the provision not been enacted.

For purposes of applying any provision of Federal law other than the provisions of the Internal Revenue Code of 1986, the rate of tax in effect under section 3101(a) is determined without regard to the reduction in that rate under this provision.

Effective Date

The provision is effective for remuneration received during 2011 and for self-employment income for taxable years beginning in 2011.

Conservation Contributions - §170

Prior or Existing Law

In general, a deduction is permitted for charitable contributions, subject to certain limitations that depend on the type of taxpayer, the property contributed, and the donee organization. The amount of deduction generally equals the fair market value of the contributed property on the date of the contribution. Charitable deductions are provided for income, estate, and gift tax purposes.

For individuals, the amount deductible is a percentage of the taxpayer's contribution base, (i.e., taxpayer's adjusted gross income computed without regard to any net operating loss carryback). The applicable percentage of the contribution base varies depending on the type of donee organization and property contributed. Cash contributions by an individual taxpayer to public charities, private operating foundations, and certain types of private nonoperating foundations may not exceed 50 percent of the taxpayer's contribution base. Cash contributions to private foundations and certain

other organizations generally may be deducted up to 30 percent of the taxpayer's contribution base.

Contributions of capital gain property to a qualified charity are deductible at fair market value within certain limitations. Contributions of capital gain property to charitable organizations described in section 170(b)(1)(A) (e.g., public charities, private foundations other than private non-operating foundations, and certain governmental units) generally are deductible up to 30 percent of the taxpayer's contribution base. An individual may elect, however, to bring all these contributions of capital gain property for a taxable year within the 50-percent limitation category by reducing the amount of the contribution deduction by the amount of the appreciation in the capital gain property. Contributions of capital gain property to charitable organizations described in section 170(b)(1)(B) (e.g., private non-operating foundations) are deductible up to 20 percent of the taxpayer's contribution base. Contributions of capital gain property that exceed the percentage limitation may be carried forward for five years.

In general, a charitable deduction is not allowed for income, estate, or gift tax purposes if the donor transfers an interest in property to a charity while also either retaining an interest in that property or transferring an interest in that property to a noncharity for less than full and adequate consideration. However, qualified conservation contributions are not subject to this "partial interest" rule.

Qualified Conservation Contribution

A qualified conservation contribution is a contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes. A qualified real property interest is defined as:

- (1) the entire interest of the donor other than a qualified mineral interest;
- (2) a remainder interest; *or*
- (3) a restriction (granted in perpetuity) on the use that may be made of the real property.

Qualified organizations include certain governmental units, public charities that meet certain public support tests, and certain supporting organizations. Conservation purposes include:

- (1) the preservation of land areas for outdoor recreation by, or for the education of, the general public;
- (2) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem;
- (3) the preservation of open space (including farmland and forest land) where such preservation will yield a significant public benefit and is either for the scenic enjoyment of the general public or pursuant to a clearly delineated Federal, State, or local governmental conservation policy; *and*
- (4) the preservation of an historically important land area or a certified historic structure.

Qualified conservation contributions of capital gain property are subject to the same limitations and carryover rules as other charitable contributions of capital gain property.

Special Rule

Under a temporary provision that is effective for contributions made in taxable years beginning after December 31, 2005, the 30-percent contribution base limitation on contributions of capital gain property by individuals does not apply to qualified conservation contributions (as defined under present law). Instead, individuals may deduct the fair market value of any qualified conservation contribution to an organization described in section 170(b)(1)(A) to the extent of the excess of 50 percent of the contribution base over the amount of all other allowable charitable contributions. These contributions are not taken into account in determining the amount of other allowable charitable contributions.

Individuals are allowed to carry over any qualified conservation contributions that exceed the 50-percent limitation for up to 15 years.

Example

Assume an individual with a contribution base of \$100 makes a qualified conservation contribution of property with a fair market value of \$80 and makes other charitable contributions subject to the 50-percent limitation of \$60. The individual is allowed a deduction of \$50 in the current taxable year for the non-conservation contributions (50 percent of the \$100 contribution base) and is allowed to carry over the excess \$10 for up to 5 years. No current deduction is allowed for the qualified conservation contribution, but the entire \$80 qualified conservation contribution may be carried forward for up to 15 years.

In the case of an individual who is a qualified farmer or rancher for the taxable year in which the contribution is made, a qualified conservation contribution is allowable up to 100 percent of the excess of the taxpayer's contribution base over the amount of all other allowable charitable contributions.

The special rule regarding contributions of capital gain real property for conservation purposes does not apply to contributions made in taxable years beginning after December 31, 2009.

TRUIRJCA

The Act extends the special rule regarding contributions of capital gain real property for conservation purposes for two years for contributions made in taxable years beginning before January 1, 2012.

Effective Date

The provision is effective for contributions made in taxable years beginning after December 31, 2009.

Charitable Food Inventory Contributions - §170

Prior or Existing Law

Under present law, a taxpayer's deduction for charitable contributions of inventory generally is limited to the taxpayer's basis (typically, cost) in the inventory, or if less the fair market value of the inventory.

For certain contributions of inventory, C corporations may claim an enhanced deduction equal to the lesser of:

- (1) basis plus one-half of the item's appreciation (i.e., basis plus one-half of fair market value in excess of basis), *or*
- (2) two times basis (§170(e)(3)).

In general, a C corporation's charitable contribution deductions for a year may not exceed 10 percent of the corporation's taxable income (§170(b)(2)). To be eligible for the enhanced deduction, the contributed property generally must be inventory of the taxpayer, contributed to a charitable organization described in section 501(c)(3) (except for private nonoperating foundations), and the donee must:

- (1) use the property consistent with the donee's exempt purpose solely for the care of the ill, the needy, or infants,
- (2) not transfer the property in exchange for money, other property, or services, *and*
- (3) provide the taxpayer a written statement that the donee's use of the property will be consistent with such requirements (§170(e)(3)(A)(i)-(iii)).

In the case of contributed property subject to the Federal Food, Drug, and Cosmetic Act, as amended, the property must satisfy the applicable requirements of such Act on the date of transfer and for 180 days prior to the transfer (§170(e)(3)(A)(iv)).

A donor making a charitable contribution of inventory must make a corresponding adjustment to the cost of goods sold by decreasing the cost of goods sold by the lesser of the fair market value of the property or the donor's basis with respect to the inventory (Treas. Reg. § 1.170A-4A(c)(3)). Accordingly, if the allowable charitable deduction for inventory is the fair market value of the inventory, the donor reduces its cost of goods sold by such value, with the result that the difference between the fair market value and the donor's basis may still be recovered by the donor other than as a charitable contribution.

To use the enhanced deduction, the taxpayer must establish that the fair market value of the donated item exceeds basis. The valuation of food inventory has been the subject of disputes between taxpayers and the IRS (e.g., *Lucky Stores Inc. v. Commis-*

sioner, 105 T.C. 420 (1995) holding that the value of surplus bread inventory donated to charity was the full retail price of the bread rather than half the retail price, as the IRS asserted).

Under a special temporary provision, any taxpayer, whether or not a C corporation, engaged in a trade or business is eligible to claim the enhanced deduction for donations of food inventory (§170(e)(3)(C)). For taxpayers other than C corporations, the total deduction for donations of food inventory in a taxable year generally may not exceed 10 percent of the taxpayer's net income for such taxable year from all sole proprietorships, S corporations, or partnerships (or other non C corporation) from which contributions of apparently wholesome food are made. For example, if a taxpayer is a sole proprietor, a shareholder in an S corporation, and a partner in a partnership, and each business makes charitable contributions of food inventory, the taxpayer's deduction for donations of food inventory is limited to 10 percent of the taxpayer's net income from the sole proprietorship and the taxpayer's interests in the S corporation and partnership. However, if only the sole proprietorship and the S corporation made charitable contributions of food inventory, the taxpayer's deduction would be limited to 10 percent of the net income from the trade or business of the sole proprietorship and the taxpayer's interest in the S corporation, but not the taxpayer's interest in the partnership. The 10 percent limitation does not affect the application of the generally applicable percentage limitations.

Example

If 10 percent of a sole proprietor's net income from the proprietor's trade or business was greater than 50 percent of the proprietor's contribution base, the available deduction for the taxable year (with respect to contributions to public charities) would be 50 percent of the proprietor's contribution base. Consistent with present law, such contributions may be carried forward because they exceed the 50 percent limitation. Contributions of food inventory by a taxpayer that is not a C corporation that exceed the 10 percent limitation but not the 50 percent limitation could not be carried forward.

Under the temporary provision, the enhanced deduction for food is available only for food that qualifies as "apparently wholesome food." Apparently wholesome food is defined as food intended for human consumption that meets all quality and labeling standards imposed by Federal, State, and local laws and regulations even though the food may not be readily marketable due to appearance, age, freshness, grade, size, surplus, or other conditions.

The temporary provision does not apply to contributions made after December 31, 2009.

TRUIRJCA

The Act extends the expansion of, and modifications to, the enhanced deduction for charitable contributions of food inventory to contributions made before January 1, 2012.

Effective Date

The provision is effective for contributions made after December 31, 2009.

Charitable Computer Inventory Contributions - §170

Prior or Existing Law

A taxpayer's deduction for charitable contributions of computer technology and equipment generally is limited to the taxpayer's basis (typically, cost) in the property. Under a special, temporary provision, certain corporations may claim a deduction in excess of basis for a "qualified computer contribution" (§170(e)(6)). This enhanced deduction is equal to the lesser of:

- (1) basis plus one-half of the item's appreciation (i.e., basis plus one half of fair market value in excess of basis), *or*
- (2) two times basis.

The enhanced deduction for qualified computer contributions expires for any contribution made during any taxable year beginning after December 31, 2009 (§170(e)(6)(G)).

A qualified computer contribution means a charitable contribution of any computer technology or equipment, which meets several requirements. The contribution must meet standards of functionality and suitability as established by the Secretary of the Treasury. The contribution must be to certain educational organizations or public libraries and made not later than three years after the taxpayer acquired the property (or, if the taxpayer constructed or assembled the property, the date construction or assembly of the property is substantially completed). The original use of the property must be by the donor or the donee, and substantially all of the donee's use of the property must be within the United States for educational purposes related to the function or purpose of the donee. The property must fit productively into the donee's education plan. The donee may not transfer the property in exchange for money, other property, or services, except for shipping, installation, and transfer costs. To determine whether property is constructed or assembled by the taxpayer, the rules applicable to qualified research contributions apply. Contributions may be made to private foundations under certain conditions (§170(e)(6)(C)).

TRUIRJCA

The Act extends the enhanced deduction for computer technology and equipment to contributions made before January 1, 2012.

Effective Date

The provision is effective for contributions made in taxable years beginning after December 31, 2009.

Charitable Book Inventory Contributions - §170

Prior or Existing Law

Under present law, a taxpayer's deduction for charitable contributions of inventory generally is limited to the taxpayer's basis (typically, cost) in the inventory, or if less the fair market value of the inventory.

For certain contributions of inventory, C corporations may claim an enhanced deduction equal to the lesser of:

- (1) basis plus one-half of the item's appreciation (i.e., basis plus one-half of fair market value in excess of basis), *or*
- (2) two times basis (§170(e)(3)).

In general, a C corporation's charitable contribution deductions for a year may not exceed 10 percent of the corporation's taxable income (§170(b)(2)). To be eligible for the enhanced deduction, the contributed property generally must be inventory of the taxpayer, contributed to a charitable organization described in section 501(c)(3) (except for private nonoperating foundations), and the donee must:

- (1) use the property consistent with the donee's exempt purpose solely for the care of the ill, the needy, or infants,
- (2) not transfer the property in exchange for money, other property, or services, *and*
- (3) provide the taxpayer a written statement that the donee's use of the property will be consistent with such requirements (§170(e)(3)(A)(i)-(iii)).

In the case of contributed property subject to the Federal Food, Drug, and Cosmetic Act, as amended, the property must satisfy the applicable requirements of such Act on the date of transfer and for 180 days prior to the transfer (§170(e)(3)(A)(iv)).

A donor making a charitable contribution of inventory must make a corresponding adjustment to the cost of goods sold by decreasing the cost of goods sold by the lesser of the fair market value of the property or the donor's basis with respect to the inventory (Treas. Reg. § 1.170A-4A(c)(3)). Accordingly, if the allowable charitable deduction for inventory is the fair market value of the inventory, the donor reduces its cost of goods sold by such value, with the result that the difference between the fair market value and the donor's basis may still be recovered by the donor other than as a charitable contribution.

To use the enhanced deduction, the taxpayer must establish that the fair market value of the donated item exceeds basis.

The generally applicable enhanced deduction for C corporations is expanded and modified to include certain qualified book contributions made after August 28, 2005, and before January 1, 2010 (§170(e)(3)(D)). A qualified book contribution means a charitable contribution of books to a public school that provides elementary education or secondary education (kindergarten through grade 12) and that is an educational organization that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on. The enhanced deduction for qualified book contributions is not allowed unless the donee organization certifies in writing that the contributed books are suitable, in terms of currency, content, and quantity, for use in the donee's educational programs and that the donee will use the books in such educational programs. The donee also must make the certifications required for the generally applicable enhanced deduction, i.e., the donee will:

- (1) use the property consistent with the donee's exempt purpose solely for the care of the ill, the needy, or infants,
- (2) not transfer the property in exchange for money, other property, or services,
and
- (3) provide the taxpayer a written statement that the donee's use of the property will be consistent with such requirements.

TRUIRJCA

The Act extends the expansion of, and modifications to, the enhanced deduction for contributions of book inventory to contributions made before January 1, 2012.

Effective Date

The provision is effective for contributions made after December 31, 2009.

Charitable IRA Distributions - §408

Prior or Existing Law

If an amount withdrawn from a traditional individual retirement arrangement ("IRA") or a Roth IRA is donated to a charitable organization, the rules relating to the tax treatment of withdrawals from IRAs apply to the amount withdrawn and the charitable contribution is subject to the normally applicable limitations on deductibility of such contributions. An exception applies in the case of a qualified charitable distribution.

Present law provides an exclusion from gross income for otherwise taxable IRA distributions from a traditional or a Roth IRA in the case of qualified charitable distributions (§408(d)(8)). The exclusion may not exceed \$100,000 per taxpayer per taxable

year. Special rules apply in determining the amount of an IRA distribution that is otherwise taxable. The otherwise applicable rules regarding taxation of IRA distributions and the deduction of charitable contributions continue to apply to distributions from an IRA that are not qualified charitable distributions. A qualified charitable distribution is taken into account for purposes of the minimum distribution rules applicable to traditional IRAs to the same extent the distribution would have been taken into account under such rules had the distribution not been directly distributed under the qualified charitable distribution provision. An IRA does not fail to qualify as an IRA as a result of qualified charitable distributions being made from the IRA.

A qualified charitable distribution is any distribution from an IRA directly by the IRA trustee to an organization described in section 170(b)(1)(A) (other than an organization described in section 509(a)(3) or a donor advised fund (as defined in section 4966(d)(2))). Distributions are eligible for the exclusion only if made on or after the date the IRA owner attains age 70-½ and only to the extent the distribution would be includible in gross income (without regard to this provision).

The exclusion applies only if a charitable contribution deduction for the entire distribution otherwise would be allowable (under present law), determined without regard to the generally applicable percentage limitations. Thus, for example, if the deductible amount is reduced because of a benefit received in exchange, or if a deduction is not allowable because the donor did not obtain sufficient substantiation, the exclusion is not available with respect to any part of the IRA distribution.

If the IRA owner has any IRA that includes nondeductible contributions, a special rule applies in determining the portion of a distribution that is includible in gross income (but for the qualified charitable distribution provision) and thus is eligible for qualified charitable distribution treatment. Under the special rule, the distribution is treated as consisting of income first, up to the aggregate amount that would be includible in gross income (but for the qualified charitable distribution provision) if the aggregate balance of all IRAs having the same owner were distributed during the same year. In determining the amount of subsequent IRA distributions includible in income, proper adjustments are to be made to reflect the amount treated as a qualified charitable distribution under the special rule.

Distributions that are excluded from gross income by reason of the qualified charitable distribution provision are not taken into account in determining the deduction for charitable contributions under section 170.

The exclusion for qualified charitable distributions applies to distributions made in taxable years beginning after December 31, 2005. Under present law, the exclusion does not apply to distributions made in taxable years beginning after December 31, 2009.

TRUIRJCA

The Act extends the exclusion for qualified charitable distributions to distributions made in taxable years beginning after December 31, 2009 and before January 1, 2012. The provision contains a special rule permitting taxpayers to elect (in such form and

manner as the Secretary may prescribe) to have qualified charitable distributions made in January 2011 treated as having been made on December 31, 2010 for purposes of sections 408(a)(6), 408(b)(3), and 408(d)(8). Thus, a qualified charitable distribution made in January 2011 is permitted to be:

- (1) treated as made in the taxpayer's 2010 taxable year and thus permitted to count against the 2010 \$100,000 limitation on the exclusion, *and*
- (2) treated as made in the 2010 calendar year and thus permitted to be used to satisfy the taxpayer's minimum distribution requirement for 2010.

Effective Date

The provision is effective for distributions made in taxable years beginning after December 31, 2009.

Employer-Provided Mass Transit & Parking - §132

Prior or Existing Law

Qualified transportation fringe benefits provided by an employer are excluded from an employee's gross income for income tax purposes and from an employee's wages for payroll tax purposes (§132(f), §3121(b)(2), §3306(b)(16) and §3401(a)(19)). Qualified transportation fringe benefits include parking, transit passes, vanpool benefits, and qualified bicycle commuting reimbursements. No amount is includible in the income of an employee merely because the employer offers the employee a choice between cash and qualified transportation fringe benefits (other than a qualified bicycle commuting reimbursement). Qualified transportation fringe benefits also include a cash reimbursement by an employer to an employee. In the case of transit passes, however, a cash reimbursement is considered a qualified transportation fringe benefit only if a voucher or similar item which may be exchanged only for a transit pass is not readily available for direct distribution by the employer to the employee.

Prior to February 17, 2009, the amount that could be excluded as qualified transportation fringe benefits was limited to \$100 per month in combined vanpooling and transit pass benefits and \$175 per month in qualified parking benefits. All limits were adjusted annually for inflation, using 1998 as the base year (in 2009 the limits were \$120 and \$230, respectively). The American Recovery and Reinvestment Act of 2009, however, temporarily increased the monthly exclusion for employer-provided vanpool and transit pass benefits to the same level as the exclusion for employer-provided parking (\$230 for 2010). The American Recovery and Reinvestment Act of 2009 limits are set to expire on December 31, 2010.

TRUIRJCA

The Act extends the parity in qualified transportation fringe benefits for one year (through December 31, 2011).

Effective Date

The provision is effective for months after December, 2010.

Estate, Gift, & GST Taxes - §2001, §2010, §2502, §2505, §2511 & §2631

Prior or Existing Law

In general, a gift tax is imposed on certain lifetime transfers and an estate tax is imposed on certain transfers at death. A generation skipping transfer tax generally is imposed on certain transfers, either directly or in trust or similar arrangement, to a "skip person" (i.e., a beneficiary in a generation more than one generation younger than that of the transferor). Transfers subject to the generation skipping transfer tax include direct skips, taxable terminations, and taxable distributions.

The estate and generation skipping transfers taxes are *repealed* for decedents dying and gifts made during 2010, but are reinstated for decedents dying and gifts made *after 2010*.

Exemption Amounts

Before 2004, the estate and gift taxes were fully unified, such that a single graduated rate schedule and a single effective exemption amount of the unified credit applied for purposes of determining the tax on cumulative taxable transfers made by a taxpayer during his or her lifetime and at death. For years 2004 through 2009, the gift tax and the estate tax continued to be determined using a single graduated rate schedule, but the effective exemption amount allowed for estate tax purposes was higher than the effective exemption amount allowed for gift tax purposes. In 2009, the highest estate and gift tax rate was 45 percent. The unified credit effective exemption amount was \$3.5 million for estate tax purposes and \$1 million for gift tax purposes.

For 2009 and after 2010, the generation skipping transfer tax is imposed using a flat rate equal to the highest estate tax rate on cumulative generation skipping transfers in excess of the exemption amount in effect at the time of the transfer. The generation skipping transfer tax exemption for a given year (prior to and after repeal, discussed below) is equal to the unified credit effective exemption amount for estate tax purposes.

Repeal of Estate & GST Taxes

Under EGTRRA, the estate and generation skipping transfer taxes are repealed for decedents dying and generation skipping transfers made during 2010. The gift tax remains in effect during 2010, with a \$1 million exemption amount and a gift tax rate of 35 percent. Also in 2010, except as provided in regulations, certain transfers in trust are treated as transfers of property by gift, unless the trust is treated as

wholly owned by the donor or the donor's spouse under the grantor trust provisions of the Code.

Scheduled 2011 Reinstatement

The estate, gift, and generation skipping transfer tax provisions of EGTRRA sunset at the end of 2010, such that those provisions (including repeal of the estate and generation skipping transfer taxes) do not apply to estates of decedents dying, gifts made, or generation skipping transfers made after December 31, 2010. As a result, in general, the estate, gift, and generation skipping transfer tax rates and exemption amounts that would have been in effect had EGTRRA not been enacted apply for estates of decedents dying, gifts made, or generation skipping transfers made in 2011 or later years. A single graduated rate schedule with a top rate of 55 percent and a single effective exemption amount of \$1 million applies for purposes of determining the tax on cumulative taxable transfers by lifetime gift or bequest.

Basis in Property Received

Gain or loss, if any, on the disposition of property is measured by the taxpayer's amount realized (i.e., gross proceeds received) on the disposition, less the taxpayer's basis in such property (§1001). Basis generally represents a taxpayer's investment in property, with certain adjustments required after acquisition. For example, basis is increased by the cost of capital improvements made to the property and decreased by depreciation deductions taken with respect to the property.

Lifetime Gift

Property received from a donor of a lifetime gift generally takes a carryover basis (§1015). "Carryover basis" means that the basis in the hands of the donee is the same as it was in the hands of the donor. The basis of property transferred by lifetime gift also is increased, but not above fair market value, by any gift tax paid by the donor. The basis of a lifetime gift, however, generally cannot exceed the property's fair market value on the date of the gift. If the basis of property is greater than the fair market value of the property on the date of the gift, then, for purposes of determining loss, the basis is the property's fair market value on the date of the gift.

Stepped Up Basis

Property passing from a decedent who died during 2009 generally takes a "stepped-up" basis (§1014). In other words, the basis of property passing from such a decedent's estate generally is the fair market value on the date of the decedent's death (or, if the alternate valuation date is elected, the earlier of six months after the decedent's death or the date the property is sold or distributed by the estate).

Comment: There is an exception to the rule that assets subject to the Federal estate tax receive stepped-up basis in the case of "income in respect of a decedent"

(§1014(c)). The basis of assets that are "income in respect of a decedent" is a carryover basis (i.e., the basis of such assets to the estate or heir is the same as it was in the hands of the decedent) increased by estate tax paid on that asset. Income in respect of a decedent includes rights to income that has been earned, but not recognized, by the date of death (e.g., wages that were earned, but not paid, before death), individual retirement accounts (IRAs), and assets held in accounts governed by section 401(k). Additionally, in community property states, a surviving spouse's one-half share of community property held by the decedent and the surviving spouse generally is treated as having passed from the decedent and, thus, is eligible for stepped-up basis. Under 2009 law, this rule applies if at least one-half of the whole of the community interest is includible in the decedent's gross estate.

This step up in basis generally eliminates the recognition of income on any appreciation of the property that occurred prior to the decedent's death. If the value of property on the date of the decedent's death was less than its adjusted basis, the property takes a stepped-down basis when it passes from a decedent's estate. This stepped-down basis eliminates the tax benefit from any unrealized loss.

Modified Carryover Basis

The rules providing for stepped-up basis in property acquired from a decedent are repealed for assets acquired from decedents dying in 2010, and a modified carryover basis regime applies.³⁶ Under this regime, recipients of property acquired from a decedent at the decedent's death receive a basis equal to the lesser of the decedent's adjusted basis or the fair market value of the property on the date of the decedent's death. The modified carryover basis rules apply to property acquired by bequest, devise, or inheritance, or property acquired by the decedent's estate from the decedent, property passing from the decedent to the extent such property passed without consideration, and certain other property to which the prior law rules apply, other than property that is income in respect of a decedent. Property acquired from a decedent is treated as if the property had been acquired by gift. Thus, the character of gain on the sale of property received from a decedent's estate is carried over to the heir. For example, real estate that has been depreciated and would be subject to recapture if sold by the decedent will be subject to recapture if sold by the heir.

An executor generally may increase the basis in assets owned by the decedent and acquired by the beneficiaries at death, subject to certain special rules and exceptions. Under these rules, each decedent's estate generally is permitted to increase the basis of assets transferred by up to a total of \$1.3 million. The \$1.3 million is increased by the amount of unused capital losses, net operating losses, and certain "built-in" losses of the decedent. Nonresidents who are not U.S. citizens may be allowed to increase the basis of property by up to \$60,000. In addition, the basis of property transferred to a surviving spouse may be increased by an additional \$3 million. Thus, the basis of property

transferred to surviving spouses generally may be increased by up to \$4.3 million.

As a result of the EGTRRA sunset at the end of 2010, the modified carryover basis regime in effect for determining basis in property passing from a decedent who dies during 2010 does not apply for purposes of determining basis in property received from a decedent who dies after December 31, 2010. Instead, the law in effect prior to 2010, which generally provides for stepped-up basis in property passing from a decedent, applies.

State Death Tax Credit

Before 2005, a credit was allowed against the Federal estate tax for any estate, inheritance, legacy, or succession taxes ("death taxes") actually paid to any State or the District of Columbia with respect to any property included in the decedent's gross estate (§2011). The maximum amount of credit allowable for State death taxes was determined under a graduated rate table, the top rate of which was 16 percent, based on the size of the decedent's adjusted taxable estate. Most States imposed a "pick-up" or "soak-up" estate tax, which served to impose a State tax equal to the maximum Federal credit allowed.

Under EGTRRA, the amount of allowable State death tax credit was reduced from 2002 through 2004. For decedents dying after 2004, the State death tax credit was repealed and replaced with a deduction for death taxes actually paid to any State or the District of Columbia, in respect of property included in the gross estate of the decedent (§2058). Such State taxes must have been paid and claimed before the later of:

- (1) four years after the filing of the estate tax return; *or*
- (2) (a) 60 days after a decision of the U.S. Tax Court determining the estate tax liability becomes final, (b) the expiration of the period of extension to pay estate taxes over time under section 6166, or (c) the expiration of the period of limitations in which to file a claim for refund or generally 60 days after a decision of a court in which such refund suit has become final.

The estate, gift, and generation skipping transfer tax provisions of EGTRRA sunset at the end of 2010, such that those provisions will not apply to estates of decedents dying, gifts made, or generation skipping transfers made after December 31, 2010. As a result, neither the EGTRRA modifications to the State death tax credit nor the replacement of the credit with a deduction applies for decedents dying after December 31, 2010. Instead, the State death tax credit as in effect for decedents who died prior to 2002 applies.

Annual Gift Tax Exclusion

Donors of lifetime gifts are provided an annual exclusion of \$13,000 (for 2010 and 2011) on transfers of present interests in property to each donee during the taxable year (§2503(b)). If the non-donor spouse consents to split the gift with the

donor spouse, then the annual exclusion is \$26,000 for 2010 and 2011. The dollar amounts are indexed for inflation.

Surviving Spouses

A 100-percent marital deduction generally is permitted for estate and gift tax purposes for the value of property transferred between spouses (§2056). Transfers of "qualified terminable interest property" are eligible for the marital deduction. "Qualified terminable interest property" is property:

- (1) that passes from the decedent;
- (2) in which the surviving spouse has a "qualifying income interest for life"; *and*
- (3) to which an election applies.

A "qualifying income interest for life" exists if:

- (1) the surviving spouse is entitled to all the income from the property (payable annually or at more frequent intervals) or has the right to use the property during the spouse's life; *and*
- (2) no person has the power to appoint any part of the property to any person other than the surviving spouse.

A marital deduction generally is denied for property passing to a surviving spouse who is not a citizen of the United States (§2056(d)(1) & §2523(i)(1)). A marital deduction is permitted, however, for property passing to a qualified domestic trust of which the noncitizen surviving spouse is a beneficiary. A qualified domestic trust is a trust that has as its trustee at least one U.S. citizen or U.S. corporation. No corpus may be distributed from a qualified domestic trust unless the U.S. trustee has the right to withhold any estate tax imposed on the distribution.

For years when the estate tax is in effect, the estate tax is imposed on:

- (1) any distribution from a qualified domestic trust before the date of the death of the noncitizen surviving spouse, *and*
- (2) the value of the property remaining in a qualified domestic trust on the date of death of the noncitizen surviving spouse.

The tax is computed as an additional estate tax on the estate of the first spouse to die.

Conservation Easements

For years when an estate tax is in effect, an executor generally may elect to exclude from the taxable estate 40 percent of the value of any land subject to a qualified conservation easement, up to a maximum exclusion of \$500,000 (§2031(c)). The exclusion percentage is reduced by two percentage points for each percentage point (or fraction thereof) by which the value of the qualified conservation easement is less than 30 percent of the value of the land (determined without regard to the value of such easement and reduced by the value of any retained development right).

Before 2001, a qualified conservation easement generally was one that met the following requirements:

- (1) the land was located within 25 miles of a metropolitan area (as defined by the Office of Management and Budget) or a national park or wilderness area, or within 10 miles of an Urban National Forest (as designated by the Forest Service of the U.S. Department of Agriculture);
- (2) the land had been owned by the decedent or a member of the decedent's family at all times during the three-year period ending on the date of the decedent's death; *and*
- (3) a qualified conservation contribution (within the meaning of sec. 170(h)) of a qualified real property interest (as generally defined in sec. 170(h)(2)(C)) was granted by the decedent or a member of his or her family.

Note: Preservation of a historically important land area or a certified historic structure does not qualify as a conservation purpose.

Effective for estates of decedents dying after December 31, 2000, EGTRRA expanded the availability of qualified conservation easements by eliminating the requirement that the land be located within a certain distance of a metropolitan area, national park, wilderness area, or Urban National Forest. A qualified conservation easement may be claimed with respect to any land that is located in the United States or its possessions. EGTRRA also clarifies that the date for determining easement compliance is the date on which the donation is made.

As a result of the EGTRRA sunset at the end of 2010, the EGTRRA modifications to expand the availability of qualified conservation contributions do not apply for decedents dying after December 31, 2010.

Special-use Valuation

For years when an estate tax is in effect, an executor may elect to value for estate tax purposes certain "qualified real property" used in farming or another qualifying closely-held trade or business at its current-use value, rather than its fair market value (§2032A). The maximum reduction in value for such real property was \$1 million for 2009. Real property generally can qualify for special-use valuation if at least 50 percent of the adjusted value of the decedent's gross estate consists of a farm or closely-held business assets in the decedent's estate (including both real and personal property) and at least 25 percent of the adjusted value of the gross estate consists of farm or closely-held business real property. In addition, the property must be used in a qualified use (e.g., farming) by the decedent or a member of the decedent's family for five of the eight years immediately preceding the decedent's death.

If, after a special-use valuation election is made, the heir who acquired the real property ceases to use it in its qualified use within 10 years of the decedent's death, an additional estate tax is imposed in order to recapture the entire estate-tax benefit of the special-use valuation.

Installment Payment of Estate Tax

Estate tax generally is due within nine months of a decedent's death. However, an executor generally may elect to pay estate tax attributable to an interest in a closely held business in two or more installments (but no more than 10) [§6166]. An estate is eligible for payment of estate tax in installments if the value of the decedent's interest in a closely held business exceeds 35 percent of the decedent's adjusted gross estate (i.e., the gross estate less certain deductions). If the election is made, the estate may defer payment of principal and pay only interest for the first five years, followed by up to 10 annual installments of principal and interest. This provision effectively extends the time for paying estate tax by 14 years from the original due date of the estate tax. A special two-percent interest rate applies to the amount of deferred estate tax attributable to the first \$1.34 million (as adjusted annually for inflation occurring after 1998; the original amount for 1998 was \$1 million; see R.P. 2009-50) in taxable value of a closely held business. The interest rate applicable to the amount of estate tax attributable to the taxable value of the closely held business in excess of \$1.34 million is equal to 45 percent of the rate applicable to underpayments of tax under section 6621 of the Code (i.e., 45 percent of the Federal short-term rate plus two percentage points). Interest paid on deferred estate taxes is not deductible for estate or income tax purposes.

Under pre-EGTRRA law, for purposes of these rules an interest in a closely held business was:

- (1) an interest as a proprietor in a sole proprietorship;
- (2) an interest as a partner in a partnership carrying on a trade or business if 20 percent or more of the total capital interest of such partnership was included in the decedent's gross estate or the partnership had 15 or fewer partners; *and*
- (3) stock in a corporation carrying on a trade or business if 20 percent or more of the value of the voting stock of the corporation was included in the decedent's gross estate or such corporation had 15 or fewer shareholders.

Under present and pre-EGTRRA law, the decedent may own the interest directly or, in certain cases, indirectly through a holding company. If ownership is through a holding company, the stock must be non-readily tradable. If stock in a holding company is treated as business company stock for purposes of the installment payment provisions, the five-year deferral for principal and the two-percent interest rate do not apply. The value of any interest in a closely held business does not include the value of that portion of such interest attributable to passive assets held by such business.

Effective for estates of decedents dying after December 31, 2001, EGTRRA expands the definition of a closely held business for purposes of installment payment of estate tax. EGTRRA increases from 15 to 45 the maximum number of partners in a partnership and shareholders in a corporation that may be treated as a closely held business in which a decedent held an interest, and thus will qualify the estate for installment payment of estate tax.

EGTRRA also expands availability of the installment payment provisions by providing that an estate of a decedent with an interest in a qualifying lending and financing business is eligible for installment payment of the estate tax. EGTRRA provides that an estate with an interest in a qualifying lending and financing business that claims installment payment of estate tax must make installment payments of estate tax (which will include both principal and interest) relating to the interest in a qualifying lending and financing business over five years.

EGTRRA clarifies that the installment payment provisions require that only the stock of holding companies, not the stock of operating subsidiaries, must be non-readily tradable to qualify for installment payment of the estate tax. EGTRRA provides that an estate with a qualifying property interest held through holding companies that claims installment payment of estate tax must make all installment payments of estate tax (which will include both principal and interest) relating to a qualifying property interest held through holding companies over five years.

As a result of the EGTRRA sunset at the end of 2010, the EGTRRA modifications to the estate tax installment payment rules described above do not apply for estates of decedents dying after December 31, 2010.

Generation-skipping Transfer Tax

For years before and after 2010, a generation skipping transfer tax generally is imposed on transfers, either directly or in trust or similar arrangement, to a "skip person" (§2601). Transfers subject to the generation skipping transfer tax include direct skips, taxable terminations, and taxable distributions (§2611). An exemption generally equal to the estate tax effective exemption amount is provided for each person making generation skipping transfers. The exemption may be allocated by a transferor (or his or her executor) to transferred property.

A direct skip is any transfer subject to estate or gift tax of an interest in property to a skip person (§2612(c)). Natural persons or certain trusts may be skip persons. All persons assigned to the second or more remote generation below the transferor are skip persons (e.g., grandchildren and great-grandchildren). Trusts are skip persons if:

- (1) all interests in the trust are held by skip persons, *or*
- (2) no person holds an interest in the trust and at no time after the transfer may a distribution (including distributions and terminations) be made to a non-skip person.

A taxable termination is a termination (by death, lapse of time, release of power, or otherwise) of an interest in property held in trust unless, immediately after such termination, a non-skip person has an interest in the property, or unless at no time after the termination may a distribution (including a distribution upon termination) be made from the trust to a skip person (§2612(a)). A taxable distribution is a distribution from a trust to a skip person (other than a taxable termination or direct skip) [§2612(b)]. If a transferor allocates generation skipping transfer tax ex-

emption to a trust prior to the taxable distribution, generation skipping transfer tax may be avoided.

The tax rate on generation skipping transfers is a flat rate of tax equal to the maximum estate and gift tax rate in effect at the time of the transfer multiplied by the "inclusion ratio." The inclusion ratio with respect to any property transferred in a generation skipping transfer indicates the amount of "generation skipping transfer tax exemption" allocated to a trust. The allocation of generation skipping transfer tax exemption effectively reduces the tax rate on a generation skipping transfer.

If an individual makes a direct skip during his or her lifetime, any unused generation-skipping transfer tax exemption is automatically allocated to a direct skip to the extent necessary to make the inclusion ratio for such property equal to zero. An individual can elect out of the automatic allocation for lifetime direct skips.

Under pre-EGTRRA law, for lifetime transfers made to a trust that were not direct skips, the transferor had to make an affirmative allocation of generation skipping transfer tax exemption; the allocation was not automatic. If generation skipping transfer tax exemption was allocated on a timely filed gift tax return, then the portion of the trust that was exempt from generation skipping transfer tax was based on the value of the property at the time of the transfer. If, however, the allocation was not made on a timely filed gift tax return, then the portion of the trust that was exempt from generation skipping transfer tax was based on the value of the property at the time the allocation of generation skipping transfer tax exemption was made.

An election to allocate generation skipping transfer tax to a specific transfer generally may be made at any time up to the time for filing the transferor's estate tax return.

EGTRRA Modifications to GST

Generally effective after 2000, EGTRRA modifies and adds certain mechanical rules related to the generation skipping transfer tax. First, EGTRRA generally provides that generation skipping transfer tax exemption will be allocated automatically to transfers made during life that are "indirect skips." An indirect skip is any transfer of property (that is not a direct skip) subject to the gift tax that is made to a generation skipping transfer trust, as defined in the Code. If any individual makes an indirect skip during the individual's lifetime, then any unused portion of such individual's generation skipping transfer tax exemption is allocated to the property transferred to the extent necessary to produce the lowest possible inclusion ratio for such property. An individual can elect out of the automatic allocation or may elect to treat a trust as a generation skipping transfer trust attracting the automatic allocation.

Second, EGTRRA provides that, under certain circumstances, generation skipping transfer tax exemption can be allocated retroactively when there is an unnatural order of death. In general, if a lineal descendant of the transferor predeceases the transferor, then the transferor can allocate any unused genera-

tion skipping transfer exemption to any previous transfer or transfers to the trust on a chronological basis.

Third, EGTRRA provides that a trust that is only partially subject to generation skipping transfer tax because its inclusion ratio is less than one can be severed in a "qualified severance." A qualified severance generally is defined as the division of a single trust and the creation of two or more trusts, one of which would be exempt from generation skipping transfer tax and another of which would be fully subject to generation skipping transfer tax, if:

- (1) the single trust was divided on a fractional basis, *and*
- (2) the terms of the new trusts, in the aggregate, provide for the same succession of interests of beneficiaries as are provided in the original trust.

Fourth, EGTRRA provides that in connection with timely and automatic allocations of generation skipping transfer tax exemption, the value of the property for purposes of determining the inclusion ratio shall be its finally determined gift tax value or estate tax value depending on the circumstances of the transfer. In the case of a generation skipping transfer tax exemption allocation deemed to be made at the conclusion of an estate tax inclusion period, the value for purposes of determining the inclusion ratio shall be its value at that time.

Fifth, under EGTRRA, the Secretary of the Treasury generally is authorized and directed to grant extensions of time to make the election to allocate generation skipping transfer tax exemption and to grant exceptions to the time requirement, without regard to whether any period of limitations has expired. If such relief is granted, then the gift tax or estate tax value of the transfer to trust would be used for determining generation skipping transfer tax exemption allocation.

Sixth, EGTRRA provides that substantial compliance with the statutory and regulatory requirements for allocating generation skipping transfer tax exemption will suffice to establish that generation skipping transfer tax exemption was allocated to a particular transfer or a particular trust. If a taxpayer demonstrates substantial compliance, then so much of the transferor's unused generation skipping transfer tax exemption will be allocated as produces the lowest possible inclusion ratio.

Sunset of EGTRRA Modifications to GST

The estate and generation skipping transfer taxes are repealed for decedents dying and gifts made in 2010. As a result of the EGTRRA sunset at the end of 2010, the generation skipping transfer tax again will apply after December 31, 2010. However, the EGTRRA modifications to the generation skipping transfer tax rules described above do not apply to generation skipping transfers made after December 31, 2010. Instead, in general, the rules as in effect prior to 2001 apply.

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The Act reinstates the estate and generation skipping transfer taxes effective for decedents dying and transfers made after December 31, 2009. The estate tax applicable exclusion amount is \$5 million under the Act and is indexed for inflation for decedents dying in calendar years after 2011, and the maximum estate tax rate is 35 percent. For gifts made in 2010, the applicable exclusion amount for gift tax purposes is \$1 million, and the gift tax rate is 35 percent. For gifts made after December 31, 2010, the gift tax is reunified with the estate tax, with an applicable exclusion amount of \$5 million and a top estate and gift tax rate of 35 percent.

Comment: The Act also clarifies current law regarding the computation of estate and gift taxes. Under present law, the gift tax on taxable transfers for a year is determined by computing a tentative tax on the cumulative value of current year transfers and all gifts made by a decedent after December 31, 1976, and subtracting from the tentative tax the amount of gift tax that would have been paid by the decedent on taxable gifts after December 31, 1976, if the tax rate schedule in effect in the current year had been in effect on the date of the prior-year gifts. Under the Act, for purposes of determining the amount of gift tax that would have been paid on one or more prior year gifts, the estate tax rates in effect under section 2001(c) at the time of the decedent's death are used to compute both (1) the gift tax imposed by chapter 12 with respect to such gifts, and (2) the unified credit allowed against such gifts under section 2505 (including in computing the applicable credit amount under section 2505(a)(1) and the sum of amounts allowed as a credit for all preceding periods under section 2505(a)(2)).

The generation skipping transfer tax exemption for decedents dying or gifts made after December 31, 2009, is equal to the applicable exclusion amount for estate tax purposes (e.g., \$5 million for 2010). The \$5 million generation skipping transfer tax exemption is available in 2010 regardless of whether the executor of an estate of a decedent who dies in 2010 makes the election described below to apply the EGTRRA 2010 estate tax rules and section 1022 basis rules.

Therefore, up to \$5 million in generation skipping transfer tax exemption may be allocated to a trust created or funded during 2010, depending upon the amount of such exemption used by the taxpayer before 2010. Although the generation skipping transfer tax is applicable in 2010, the generation skipping transfer tax rate for transfers made during 2010 is zero percent. The generation skipping transfer tax rate for transfers made after 2010 is equal to the highest estate and gift tax rate in effect for such year (35 percent for 2011 and 2012).

The Act allows a deduction for certain death taxes paid to any State or the District of Columbia for decedents dying after December 31, 2009.

The Act generally repeals the modified carryover basis rules that, under EGTRRA, would apply for purposes of determining basis in property acquired from a decedent who dies in 2010. Under the Act, a recipient of property acquired from a decedent who dies after December 31, 2009, generally will receive fair market value basis (i.e., "stepped up" basis) under the basis rules applicable to assets acquired from decedents who died in 2009 (§1014).

The Act extends the EGTRRA modifications to the rules regarding:

- (1) qualified conservation easements,
- (2) installment payment of estate taxes, *and*
- (3) various technical aspects of the generation skipping transfer tax, described in the present-law section, above.

2010 Election

In the case of a decedent who dies during 2010, the provision generally allows the executor of such decedent's estate to elect to apply the Internal Revenue Code as if the new estate tax and basis step-up rules described in the preceding section had not been enacted. In other words, instead of applying the above-described new estate tax and basis step-up rules of the provision, the executor may elect to have present law (as enacted under EGTRRA) apply. In general, if such an election is made, the estate would not be subject to estate tax, and the basis of assets acquired from the decedent would be determined under the modified carryover basis rules of section 1022.

Comment: As a result, an heir who acquires an asset from the estate of a decedent who died in 2010 and whose executor elected application of the 2010 EGTRRA rules has a basis in the asset determined under the modified carryover basis rules of section 1022. Such basis is applicable for the determination of any gain or loss on the sale or disposition of the asset in any future year regardless of the status of the sunset provision described below.

This election will have no effect on the continued applicability of the generation skipping transfer tax. In addition, in applying the definition of transferor in section 2652(a)(1), the determination of whether any property is subject to the tax imposed by chapter 11 of the Code is made without regard to an election made under this provision.

The Secretary of the Treasury or his delegate shall determine the time and manner for making the election. The election, once made, is revocable only with the consent of the Secretary or his delegate.

Extension of Filing Deadlines

The Act also provides for the extension of filing deadlines for certain transfer tax returns. Specifically, in the case of a decedent dying after December 31, 2009, and before the date of enactment, the due date shall not be earlier than the date which is nine months after the date of enactment for:

- (1) filing an estate tax return required under section 6018;
- (2) making the payment of estate tax under Chapter 11; *and*
- (3) making any disclaimer described in section 2518(b) of an interest in property passing by reason the death of such a decedent.

In the case of a generation skipping transfer made after December 31, 2009, and before the date of enactment, the due date for filing any return required under sec-

tion 2662 (including the making of any election required to be made on the return) shall not be earlier than the date which is nine months after the date of enactment.

Spousal Portability of Unused Exemption Amount

Under the Act, any applicable exclusion amount that remains unused as of the death of a spouse who dies after December 31, 2010 (the "deceased spousal unused exclusion amount"), generally is available for use by the surviving spouse, as an addition to such surviving spouse's applicable exclusion amount.

Note: The Act does not allow a surviving spouse to use the unused generation skipping transfer tax exemption of a predeceased spouse.

If a surviving spouse is predeceased by more than one spouse, the amount of unused exclusion that is available for use by such surviving spouse is limited to the lesser of \$5 million or the unused exclusion of the last such deceased spouse. This last deceased spouse limitation applies whether or not the last deceased spouse has any unused exclusion or the last deceased spouse's estate makes a timely election. A surviving spouse may use the predeceased spousal carryover amount in addition to such surviving spouse's own \$5 million exclusion for taxable transfers made during life or at death.

A deceased spousal unused exclusion amount is available to a surviving spouse only if an election is made on a timely filed estate tax return (including extensions) of the predeceased spouse on which such amount is computed, regardless of whether the estate of the predeceased spouse otherwise is required to file an estate tax return. In addition, notwithstanding the statute of limitations for assessing estate or gift tax with respect to a predeceased spouse, the Secretary of the Treasury may examine the return of a predeceased spouse for purposes of determining the deceased spousal unused exclusion amount available for use by the surviving spouse. The Secretary of the Treasury shall prescribe regulations as may be appropriate and necessary to carry out the rules described in this paragraph.

Example 1

Assume that Husband 1 dies in 2011, having made taxable transfers of \$3 million and having no taxable estate. An election is made on Husband 1's estate tax return to permit Wife to use Husband 1's deceased spousal unused exclusion amount. As of Husband 1's death, Wife has made no taxable gifts. Thereafter, Wife's applicable exclusion amount is \$7 million (her \$5 million basic exclusion amount plus \$2 million deceased spousal unused exclusion amount from Husband 1), which she may use for lifetime gifts or for transfers at death.

Example 2

Assume the same facts as in Example 1, except that Wife subsequently marries Husband 2. Husband 2 also predeceases Wife, having made \$4 million in taxable transfers and having no taxable estate. An election is made on Husband 2's estate tax return to permit Wife to use Husband 2's deceased spousal unused exclusion amount. Although the combined amount of unused exclusion of Husband 1 and Husband 2 is \$3 million (\$2 million for Husband 1 and \$1 million for Husband 2), only Husband 2's \$1 million unused exclusion is available for use by Wife, because the deceased spousal unused exclusion amount is limited to the lesser of the basic exclusion amount (\$5 million) or the unused exclusion of the last deceased spouse of the surviving spouse (here, Husband 2's \$1 million unused exclusion). Thereafter, Wife's applicable exclusion amount is \$6 million (her \$5 million basic exclusion amount plus \$1 million deceased spousal unused exclusion amount from Husband 2), which she may use for lifetime gifts or for transfers at death.

Example 3

Assume the same facts as in Examples 1 and 2, except that Wife predeceases Husband 2. Following Husband 1's death, Wife's applicable exclusion amount is \$7 million (her \$5 million basic exclusion amount plus \$2 million deceased spousal unused exclusion amount from Husband 1). Wife made no taxable transfers and has a taxable estate of \$3 million. An election is made on Wife's estate tax return to permit Husband 2 to use Wife's deceased spousal unused exclusion amount, which is \$4 million (Wife's \$7 million applicable exclusion amount less her \$3 million taxable estate). Under the provision, Husband 2's applicable exclusion amount is increased by \$4 million, i.e., the amount of deceased spousal unused exclusion amount of Wife.

Sunset Provision

Under the bill, the sunset of the EGTRRA estate, gift, and generation skipping transfer tax provisions, scheduled to apply to estates of decedents dying, gifts made, or generation skipping transfers after December 31, 2010, is extended to apply to estates of decedents dying, gifts made, or generation skipping transfers after December 31, 2012. The EGTRRA sunset, as extended by the bill, applies to the amendments made by the provision. Therefore, neither the EGTRRA rules nor the new rules of the provision will apply to estates of decedents dying, gifts made, or generation skipping transfers made after December 31, 2012.

Effective Date

The estate and generation skipping transfer tax provisions generally are effective for decedents dying, gifts made, and generation skipping transfers made after December 31, 2009. The modifications to the gift tax exemption and rate generally are effective for gifts made after December 31, 2010. The new rules providing for portability of unused exemption between spouses generally are effective for decedents dying and gifts made after December 31, 2010.

Glossary

Adjusted gross income (AGI): Total income reduced by allowable adjustments, such as for an IRA, student loan interest, alimony and Keogh deductions. The AGI is important in determining whether various tax benefits are phased out.

Alternative minimum tax: A tax triggered when certain tax benefits reduce regular income tax below a certain threshold.

Bankruptcy: Typically, a formal petition filed in Bankruptcy Court under Chapter 7, 11, or 13.

Earned income: Income from personal services as compared to income generated from property or other sources. It includes wages, salaries, tips, and self-employment earnings.

Expensing: A reference to §179 expense deduction.

Filing status: Determines the rate at which income is taxed. The five filing statuses are: single, married filing a joint return, married filing a separate return, head of household, and qualifying widow(er) with dependent child.

Gross income: Money, goods, services, and property a person receives that must be reported on a tax return. Includes unemployment compensation and certain scholarships. It does not include welfare benefits and nontaxable Social Security benefits.

Head of household: Head of household is a federal income tax filing status available to unmarried taxpayers that can claim a dependent as a "qualifying child" or qualifying relative."

Improvement: Expenditure for the correction of the defect in property that extends its useful life or improves its value. Unlike some repairs, improvements cannot be deducted by the taxpayer.

Net operating loss: A business loss that exceeds current income and may be carried back against income of prior years or carryforward as a deduction against future income.

Placed in service: When property is available for use.

Recapture: The forced recovery of depreciation taken as ordinary income.

S corporation: A particular type of corporation established under the Code that is taxed like but not as a partnership.

Standard deduction: Reduces the income subject to tax and varies depending on filing status, age, blindness, and dependency.

Tax year: The calendar, fiscal, or hybrid year adopted by the taxpayer or required by tax law for determining annual income.

Unemployment compensation: Funds received under federal or state law to compensate for unemployment. Unemployment compensation is now taxable.

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