2010 has been one strange year for the U.S. tax code.

We have a huge tax issue that is still not fully resolved, the usual annual array of tweaks and changes to the Internal Revenue Code … and a chance that some tax breaks from 2009 could yet be extended for 2010, if an abbreviated version of the American Jobs and Closing Tax Loopholes Act (H.R. 4213) becomes law. This bill was passed by the House of Representatives in late May, with a June vote expected in the Senate.[1] Many analysts think it will be signed by President Obama this summer.

It's the middle of the year, so let's take a look at where things stand for TY 2010 in terms of changes, amendments, additions and question marks. If you see an asterisk, you are seeing an expired 2009 tax break that might come back for 2010. At the end of this document, you'll see a summary of the tax breaks that could be extended into 2010 if H.R. 4213 passes.

And by the way, if you are a contractor, a real estate developer or a partner in an investment or venture capital firm, be sure to take a look at the very last item.

Here we go …

1 The estate tax and GSTT have been repealed for 2010, and they probably won't be enforced retroactively.

Even though the Obama administration preferred having an estate tax in 2010, Congress was preoccupied with other matters as 2009 drew to a close. So no action was taken, and as EGGTRA stipulated in 2001, the estate tax is 0% in 2010.[2]

So far, anyway. The longer we go with no action taken, the harder it gets for Congress to take action and put a retroactive estate tax in place. (You could easily argue that a retroactive estate tax would be unconstitutional.)

Of course, the estate tax and the generation-skipping transfer tax (GSTT) are scheduled to return in 2011. Most estate planners think that Congress will restore things to 2009 levels ($3.5 million exemption for estate tax and GSTT with 45% estate, GSTT, and gift tax rates). Alternately, estate taxes would reset to pre-EGGTRA levels in 2011 (the exemption level at just $1 million with 55% estate, GSTT, and gift tax rates).[2]

2 With no estate tax in place for 2010, the step-up basis rules have been replaced by carryover basis rules.

This year, assets in an estate are subject to capital gains taxes when sold based on the original price paid for the asset. This could mean some big problems for heirs if an asset was bought by Mom or Dad 20 or 30 years ago. Let's say the asset is a stock. If Mom or Dad purchased shares off and on through the years, you'll have quite an assignment to find that paper trail, and you may end up paying capital gains tax on the appreciation if the estate is really large. Fortunately, each estate can exempt $1.3 million of gains from the carryover basis rule, and another $3 million exemption applies to assets inherited from a spouse – so as much as $4.3 million of an estate can retain the step-up in 2010.[3]

3 The federal gift tax rate is 35% for 2010, not 45%.

Yes, there is still a gift tax in 2010 on gifts above the lifetime exemption amount of $1 million. However, the tax bite is just 35% for 2010. Of course, if you end up gifting less than $1 million during your lifetime, you won't have to worry about the gift tax at all.[4]

For the record, IRS Publication 950 (issued 12/09) states: "In 2010, any transfer of money or property in trust is a taxable gift unless the trust is treated as wholly owned by the donor or the donor's spouse."[5]

4 No income limits on Roth IRA conversions.

To recap, anyone can convert a traditional IRA to a Roth IRA in 2010 – the old income limits that were in the way have been repealed. Anyone who does this also has the option of paying the taxes resulting from the conversion over two tax years – 2011 and 2012.[6]

There are still income limits preventing certain taxpayers from actively *contributing* to a Roth IRA, but there is no stopping those taxpayers from contributing to their traditional IRAs one more time in 2010 and then converting them to Roth IRAs.[7]

5 You can no longer opt to deduct state and local sales taxes on your federal return (for the moment).*

Prior to 2010, you could choose to deduct state sales tax payments instead of state and local income taxes. Congress let this option expire at the start of this year. However, Sen. Maria Cantwell (D-WA) has been spearheading a provision to extend the state and local sales tax deduction – so we have a chance that this option may return for tax year 2010.[7,8]

6 Tax brackets have been (barely) adjusted for (minimal) inflation.

The adjustments are very minor (for single filers, for example, they are as little as $50 for the 25% bracket and $700 for the 35% bracket). Here are the ordinary taxable income brackets in TY 2010:

- Single Taxpayers:
  - 10% bracket has a ceiling of $8,375
  - 15% bracket starts @ $8,376
  - 25% bracket starts @ $34,001
  - 28% bracket starts @ $82,401
  - 33% bracket starts @ $171,851
  - 35% bracket starts @ $373,651

- Married Filing Jointly or Qualifying Widow/Widower:
  - 10% bracket has a ceiling of $16,750
  - 15% bracket starts @ $16,751
  - 25% bracket starts @ $68,001
  - 28% bracket starts @ $137,301
  - 33% bracket starts @ $209,251
  - 35% bracket starts @ $373,651

- Married Filing Separately:
  - 10% bracket has a ceiling of $8,375
  - 15% bracket starts @ $8,376
  - 25% bracket starts @ $34,001
  - 28% bracket starts @ $68,651
  - 33% bracket starts @ $104,626
  - 35% bracket starts @ $186,826

- Head of Household:
  - 10% bracket has a ceiling of $11,950
  - 15% bracket starts @ $11,951
  - 25% bracket starts @ $45,551
  - 28% bracket starts @ $117,651
  - 33% bracket starts @ $190,551
  - 35% bracket starts @ $373,651[9]

This isn't a change, but it is worth noting: for the first year in who knows when, there is no COLA adjustment to the personal exemption ($3,650) and the standard deduction for most taxpayers ($5,700/$11,400, except for a $50 increase for heads of household).[10]

7 AMT exemption amounts drop way below 2009 levels.

Last year's levels were adjusted for the economic stimulus arranged by the Obama administration. In all probability, Congress will patch the tax before the end of 2010 and set AMT exemption amounts much higher. Currently, AMT amounts are set as follows for tax year 2010:

- Single/Head of Household: $33,750
- Married Filing Separately: $22,500
- Married Filing Jointly: $45,000[6]

8 Business mileage deduction rates have gone down.

If you are using a personal vehicle for business, the business mileage deduction is 50¢ a mile in 2010. That's about 9% below the 2009 deduction of 55¢ per mile. You can chalk it up to reduced transportation costs. If you use a personal vehicle for medical reasons or to move in 2010, well that deduction is also reduced – it was 24¢ per mile in 2009, and it is just 16.5¢ a mile this year. If you use a personal vehicle for charitable purposes (driving it for the purpose of working for a charity), the deduction is 14¢ a mile – same as in 2009.[11]

9 The foreign earned income exclusion rises by $100.

The exclusion was $91,400 in 2009, now it is $91,500 for 2010.[6]

10 The domestic production activities deduction is now 9%.

That's a notable leap from 6% in 2009, though it comes with one asterisk. What types of businesses can take advantage of this? Construction and architectural firms, film production companies, engineering firms, or businesses that rent, lease or sell equipment they build. The asterisk? The deduction is still 6% this year for oil and gas companies.[6]

11 The IRA distribution to charity option expired after December 31, 2009.*

Will it come back? Some tax analysts think it might. It was great while it lasted, and it was a real boon to universities and assorted non-profits. Yet Congress did not extend the provision allowing IRA distributions to charity into 2010. Here's hoping they restore it.[6]

12 No additional standard deduction for property taxes.*

In 2010, you can't boost a standard federal deduction by up to $1,000 of state or local property taxes you have paid. There is the possibility that Congress will get around to reinstating this perk designed to encourage home sales. But so far in 2010, you can't increase your standard deduction in this way.[6]

13 No more excluding jobless benefits from your taxable income.

In 2009, you could exclude up to $2,400 of unemployment benefits. The way it is now, you get no such break for 2010.[7]

14 Changes to the Earned Income Credit (EIC).

This tax break is primarily designed for low- and middle-income families. In 2010, the maximum EIC for working families with three or more children was set at $5,666, subject to phase-outs when AGI surpasses $43,352 ($48,362 if married filing jointly). Total advance EIC payments for 2010 are limited to $1,880. By the way, you can earn $3,100 in investment income during 2010 and still claim the credit in 2010.[12]

15 Non-taxable combat pay can't be used to figure earned income for the Earned Income Credit.

That was the case in 2009, but combat pay can't be used in the calculation for 2010.[6]

16 A cap on farm losses used to offset non-farm income.

In 2010, the limit on farm losses you can take is either a) $300,000 or b) your net farm income over the past five years, whichever is greater. And yes, this limit goes for S corporation owners and partners as well. However, it will only apply if you get federal farm payments or Commodity Credit Corporation (CCC) loans. You may take suspended losses in subsequent tax years.[6]

17 No sales tax breaks if you buy a new car.

You could deduct sales tax on a new car purchase from your 2009 federal return. You can't get such a tax benefit in 2010, unless Congress gives you back the chance to deduct sales taxes instead of state income taxes (see #5 above).[7]

18 No higher education tuition deduction for 2010.*

In 2009, some qualifying taxpayers could take an above-the-line deduction for college tuition and expenses. If your AGI was $65,000 or less ($130,000 for joint filers), the limit of the deduction was $4,000. Taxpayers with AGI up to $80,000 ($160,000 for joint filers) could take a reduced deduction of as much as $2,000. But not in 2010 … not so far, anyway.[13]

19 No classroom supplies deduction for teachers.*

In 2009, K-12 teachers, principals, guidance counselors and other education professionals could take a $250 above-the-line deduction to offset out-of-pocket classroom expenses. That deduction expired at the end of 2009, but it may return if H.R. 4213 is made law.[13]

**Now, if H.R. 4213 becomes law:*

5a The state and local sales tax deduction option would be restored for 2010.

This would help you if you live in a state that doesn't levy state income tax. Taxpayers would have the option of taking an itemized deduction for either state and local income taxes, or state and local general sales taxes.[13]

11a The IRA distribution to charity option would come back.

If it does, individuals age 70½ or older could once again distribute as much as $100,000 from their IRAs to charitable organizations through the end of 2010, and the money would not be characterized as income or be subject to itemization rules. (By the way, you would not be able to do this with an inherited IRA if you, the beneficiary, turn age 70 1/2 before such a charitable rollover. That was also true before 2010.)[13,14]

12a The additional standard deduction for property taxes would be extended through 2010.

The limit would be $500 for single filers and $1,000 for joint filers. This deduction would not lower your AGI; you would add it to the standard deduction.[13]

18a The higher education tuition deduction would return for 2010.

A reminder: this is for higher education tuition and expenses only, not elementary or secondary school costs. If your AGI is $65,000 or less ($130,000 for joint filers), the limit of the deduction would be $4,000. If it is between $65,000-80,000 ($135,000-160,000 for joint filers) you could be eligible for a deduction of as much as $2,000.[13]

19a The classroom expenses deduction would be restored.

The $250 above-the-line deduction to help K-12 teachers/educators would return for 2010.[13]

Additionally, if H.R. 4213 passes in its current form:

- **Tax breaks for land donations would be extended.**
  That is, the special rules and provisions under the "4-H Act" (the Heartland, Habitat, Harvest, and Horticulture Act of 2008) would be extended through 2010 to help qualifying farmers and ranchers donate land to organizations such as the Nature Conservancy. The 2010 tax break could be as large as 100% of the excess of the taxpayer's contribution base over the total of all other allowable charitable contributions.[13,14]

- **All hybrid vehicle tax credits would be in place until the end of 2010.**
  Some of these credits expired in 2009, and others sunset this year and in 2014 (there are different credits for different classes of hybrids). H.R. 4213 would forward the expiration dates on all three classes of credits ahead by one year.[13,14]

- **The provisions of the National Disaster Relief Act of 2008 would be extended.**
  Prior to this law, Congress and the IRS pretty much issued tax breaks for taxpayers affected by disasters on a case-by-case basis. H.R. 4213 would extend the Act through the end of 2010, allowing higher loss limits on personal casualty losses from natural disasters, a special depreciation allowance for property that rehabilitates or replaces qualified business

property, and current deductions for disaster repair and clean-up expenses.[13]

- **Tax credits for alternative fuels and energy-efficient windows would remain in place.**
  In 2009, the IRS offered a biodiesel credit, a biodiesel small producer credit and a biodiesel excise credit. H.R. 4213 would restore them for 2010. It would also revise the language concerning tax credits for energy-efficient windows to recognize different climate patterns in different regions of the country.[13,14]

- **We would see a "carried interest" tax hike.**
  Real estate investors know the concept of "carried interest" well. Let's say a real estate partnership buys a forlorn shopping center and hires a contractor to pretty it up. Those real estate investors may offer the contractor a 15% or 20% cut of their future net when they sell the center. That's called "carried interest", and this income is usually taxed as a capital gain.

  But on January 1, 2011, that could change. In a phase-in provision included in the House version of H.R. 4213, 50% of the amounts paid on the carried interests of individual partners would initially be taxed as ordinary income. So would the gain on the sale or exchange of a carried interest.

  So instead of carried interest being taxed as capital gains at rates up to 15% or 20%, carried interest would be taxed at ordinary income rates up to 35% or even 39.6% in 2011. (And if you are a real estate developer, venture capitalist or entrepreneur, you may find yourself in one of the two highest tax brackets.)

  CCH, the tax research firm, projects this as the biggest revenue generator from H.R. 4213 over the next decade if the bill becomes law. Congress hopes that hiking taxes on carried interest would raise $1.7 billion for the federal government annually.[13,15]

This Special Report is an update of 2010 tax law changes, and is not intended as a guide for the preparation of tax returns. The information contained herein is general in nature and is not intended, and should not be construed, as legal, accounting or tax advice or opinion provided by LPL Financial, its Investment Representatives and Peter Montoya Inc. to recipients. No information herein was intended or written to be used by readers for the purpose of avoiding penalties that may be imposed under the Internal Revenue Code or applicable state or local tax law provisions. Readers are cautioned that this material may not be applicable to, or suitable for, their specific circumstances or needs, and may require consideration of non-tax and other tax factors if any action is to be contemplated. Readers are encouraged to consult with professional advisors for advice concerning specific matters before making any decision, and LPL Financial,

its Investment Representatives and Peter Montoya Inc. disclaim any responsibility for positions taken by taxpayers in their individual cases or for any misunderstanding on the part of readers. LPL Financial, its Investment Representatives and Peter Montoya Inc. assume no obligation to inform readers of any changes in tax laws or other factors that could affect the information contained herein.

Citations.

[1] investmentadvisor.com/News/2010/6/Pages/Tax-Extenders-Bill-Passes-House-Heads-for-Senate.aspx [6/1/10]
[2] moneywatch.bnet.com/retirement-planning/article/estate-tax-what-you-need-to-know-for-2010/378294/ [1/5/10]
[3] articles.moneycentral.msn.com/RetirementandWills/PlanYourEstate/5bigMythsAboutTheEstateTax.aspx [4/14/10]
[4] moneywatch.bnet.com/retirement-planning/blog/financial-independence/why-is-everyone-afraid-of-the-gift-tax/843/ [4/14/10]
[5] irs.gov/pub/irs-pdf/p950.pdf [12/09]
[6] turbotax.intuit.com/tax-tools/tax-tips/irs-tax-return/5519.html#2010 [4/19/10]
[7] boston.com/business/personalfinance/managingyourmoney/archives/2009/12/summary_of_tax.html [12/4/09]
[8] cantwell.senate.gov/issues/sales_tax.cfm [4/19/09]
[9] bankrate.com/finance/taxes/2010-tax-bracket-rates.aspx [1/5/10]
[10] online.wsj.com/article/SB125322006352820593.html [9/17/09]
[11] bloomberg.com/apps/news?pid=20603037&sid=aHY2qdL6oTsM [12/3/09]
[12] irs.gov/formspubs/article/0,,id=180803,00.html [12/4/09]
[13] tax.cchgroup.com/legislation/Tax-extenders-bill.pdf [6/1/10]
[14] usnews.com/money/blogs/the-best-life/2010/05/24/10-tax-breaks-likely-to-be-extended [5/24/10]
[15] lvrj.com/opinion/-carried-interest--95678939.html [6/5/10]