



# Client Bulletin

Smart Tax, Business & Planning Ideas *from your Trusted Business Advisor*<sup>SM</sup>

## Income Tax Rates Hold Steady

March 2011



Tax legislation passed at the end of 2010—the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010—maintains the personal income tax rates that have been in effect since 2003. In 2011 and 2012, those rates range from 10% to 35%. In 2012, we might see yet another debate on future tax rates.

### Capital gains and dividends

The 2011 and 2012 tax rates ranging from 10% to 35% are on ordinary income: earnings, interest on savings accounts, pensions, and so on. For long-term capital gains and qualified dividend income (which includes most dividends received by investors), the top tax rate remains at 15% for this year and the next. Therefore, investors are likely to continue to seek dividend-paying stocks and all types of investments that may eventually

produce long-term gains, such as stocks and real estate.

What's more, the tax rate on long-term gains and qualified dividends remains at 0% for taxpayers in the 10% and 15% tax brackets. In 2011, those brackets apply to single individuals with taxable income up to \$34,500 and to married couples filing joint tax returns with taxable income up to \$69,000.

Consequently, some tax strategies remain effective. Suppose a retired couple projects they will have \$50,000 of taxable income in 2011. If this couple holds appreciated securities, they could take as much as \$19,000 of their long-term capital gains and owe 0% in tax on those gains.

In addition, individual investors now can exclude from tax 100% of any gains from investments in certain small business stock. This tax exclusion had been 50% until a law passed in 2009 increased it to 75%, and a law passed in 2010 created a 100% tax exclusion. Under the new tax law, investors may qualify for a 100% tax exclusion on gains from certain small business stock acquired after September 27, 2010, and before January 1, 2012.

### Other income tax benefits

Beyond tax rates, the new law extends many income tax benefits that were scheduled to end after 2010. For example,

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### Special Report on the New Tax Law

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## Still a Bargain

*In 1980, the highest personal income tax rate was twice as high as it is today: 70% then vs. 35% now.*

all taxpayers will be able to fully use their itemized deductions and personal exemptions in 2011 and 2012. If the new law had not been passed, certain high-income taxpayers would have lost some of those tax breaks. Similarly, some tax credits that had been scheduled to end or lose value are still available in 2011 and 2012 at 2010 levels. These include the earned income credit, the child tax credit, the dependent care credit, the adoption credit, and the American Opportunity Tax Credit for higher education. The research tax credit, which expired at the end of 2009, was reinstated retroactively for 2010 and remains in effect for 2011.

Coverdell Education Savings Accounts still have a \$2,000 annual contribution limit, not the \$500 cap that would have returned. Some individual tax provisions were reinstated retroactively, so they apply to 2010 as well as 2011. This list includes optional deductions for state and local sales taxes, higher education tuition deductions, teachers' deductions for classroom expenses, IRA charitable rollovers for taxpayers age 70½ and older, and enhanced tax advantages for some donations of conservation easements.

### Addressing the AMT

The new law also includes another "patch" for the alternative minimum tax (AMT). Every year or two, a patch has increased the AMT exemption amount and allows nonrefundable personal credits to offset both regular tax and AMT liability. Here are the new AMT exemption amounts:

	2010 Amount	2011 Amount
Singles and heads of households	\$47,450	\$48,450
Married persons filing jointly	\$72,450	\$74,450
Married persons filing separately	\$36,225	\$37,225

If Congress had not addressed the AMT issue, the AMT exemption amounts would have been \$45,000 for joint filers, \$33,750 for singles and heads of households, and \$22,500 for married persons filing separately. As a result of the new law, fewer taxpayers will be subject to the AMT.

### Payroll tax holiday

Although the new tax law generally does not change income taxes from 2010, it does provide a significant break in payroll taxes. During 2011, employees will contribute 4.2% of compensation for Social Security instead of the normal 6.2%. In 2011, employees pay Social Security tax on the first \$106,800 of earned income. Thus, taxpayers who earn at least \$106,800 in 2011 will save \$2,136 in payroll tax: 2% of \$106,800. Self-employed individuals will enjoy similar tax savings.

Employers will continue to pay 6.2% of an employee's earnings, up to \$106,800. Under current law, the employee's share of Social Security tax will go back to 6.2% in 2012. ■

### Did You Know?

**O**ut of households with annual income of \$50,000 or more, 58% have IRAs, whereas only 24% of other households have IRAs.

Source: Investment Company Institute

## Easing the Burden of Estate Tax

The new tax law relieves many taxpayers from concerns about federal estate tax for the next two years. What's more, the law clarifies the treatment of estates of the people who died last year.

### New rules

For 2011 and 2012, the federal estate tax exemption is set at \$5 million. That's a significant increase over the \$3.5 million exemption for deaths in 2009 and a huge jump from the \$1 million exemption that would

have taken effect if a new law had not been passed. Excess assets are now taxed at 35%, down from 45% in 2009. As before, bequests to charities and to surviving spouses who are American citizens are not subject to estate tax, regardless of the amount.

Perhaps most important, the new law includes "portability" of the estate tax exemption between spouses. Any exemption amount not used by the first spouse



to die can be used by the estate of the surviving spouse in addition to their own allowed exemption.

**Example:** George Wilson has a \$5 million net worth and his wife, May, has \$3 million of assets. In a traditional plan, George's will calls for his assets to be left in trust for May and their children up to the amount of the federal estate tax exemption with the balance of George's estate going to May. This arrangement enables George's estate to maximize his estate tax exemption. However, this plan also moves \$5 million out of May's easy reach.

In an alternate plan, George might leave all of his assets to May, which would be a tax-free bequest. George could then name either a trust or their children as secondary beneficiaries. At George's death, May could disclaim (relinquish) some or all of the inheritance to the backup beneficiary, depending on how much she needs.

This type of disclaimer strategy, though, relies upon the ability of the surviving spouse to make an astute decision. If the survivor fails to do so, the plan might go awry. In this example, if May neglects to disclaim any assets and subsequently dies with an \$8 million estate, assuming a \$5 million estate tax exemption and a 35% estate tax, the estate could owe more than \$1 million in tax on the excess \$3 million.

Under the new rules, married couples can avoid such dilemmas. George, with a \$5 million estate, can leave as much as he wants to May and as much as he wants to his children. Any unused tax exemption will go to May.

Say that George leaves \$2 million to his children and \$3 million to May, and May subsequently dies with \$6 million in a year that the federal estate tax exemption is \$5 million. Because George used only \$2 million of his exemption with the bequest to their children, the \$3 million that wasn't used passes to May's estate. This brings the total exemption for May up to \$8 million at her death.

Even though May dies with \$6 million, her estate has an \$8 million exemption to offset any estate tax due. In essence, the new law provides married couples with a total estate tax exemption of \$10 million and reduces the need for complicated estate tax strategies.

### Clarity for 2010 estates

Throughout 2010, the federal estate tax was not in effect. Many people expected this tax to be reinstated retroactively. Thus, there was a great deal of uncertainty for the estates of people who died last year. The new tax law sets the rules for federal estate tax in 2011 and 2012. In addition, it gives 2010 estates the choice of using the 2011 law or the law as it applied during 2010.

- **The 2011 law.** Decedents have a \$5 million federal estate tax exemption. Excess assets are taxed at 35%. Inherited assets have the date-of-death value as their basis, although executors can choose to use the value of estate assets exactly six months after death. As a result, heirs generally do not owe capital gains tax on the appreciation of the assets during the decedent's lifetime.
- **The 2010 law.** As mentioned, estates owe no federal estate tax for deaths last year. There may be a capital gains tax, though, when heirs sell appreciated assets. Assets passed at death retain the decedent's basis, plus a step-up in basis of no more than \$1.3 million, or \$4.3 million for assets placed to a surviving spouse, allocated by the executor of the estate among the decedent's properties.

The bottom line is that estates under \$5 million need not worry about federal estate tax. They can use the 2011 rules and avoid paying estate tax while minimizing future capital gains tax.

## Trusted Advice

### Income Shifting

- ❖ The annual gift tax exclusion for 2011 is \$13,000. A middle-aged man could give his retired parents up to \$26,000 worth of appreciated securities with no gift tax consequences. If he is married, the man and his wife could give up to \$52,000 worth of appreciated securities to his parents and another \$52,000 to her parents this year.
- ❖ The parents in this scenario would retain the original investor's basis (cost for tax purposes) of the appreciated securities, if they are sold for a gain, and the original investor's holding period. The new owners would have a long-term gain on a sale of appreciated assets held more than one year.
- ❖ As long as the retired couple's taxable income remains under \$69,000 this year, the gains would be taxed at 0%. The retired couple could help pay for their grandchildren's college tuition, with no gift tax consequences.
- ❖ It may be difficult to reap substantial tax advantage by giving appreciated assets to youngsters, including full-time students under age 24.

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Executors of estates over \$5 million face a more difficult choice. They can use the 2011 rules and pay 35% tax on amounts over \$5 million, \$350,000 on a \$6 million estate, for example. Alternatively, they can choose the 2010 rules and avoid federal estate tax. If they choose the 2010 rules, executors will have to track the decedent's basis in all the assets passed on to beneficiaries who might owe tax on future sales. Our office can help

executors of 2010 estates make the choice that is better for heirs.

### Triple play

Just as the new law sets the federal estate tax exemption for 2011 and 2012 at \$5 million, it also raises the federal gift tax exemption to \$5 million during those two years, up from \$1 million in 2010. Excess lifetime gifts will be taxed at 35%. The same \$5 million exemption and 35% rate also are set for the

generation-skipping transfer tax in 2011 and 2012. Therefore, wealthy taxpayers will find planning easier now that all three taxes have the same exemption amount and tax rate, at least for this year and next.

Altogether, few taxpayers will have to face federal estate, gift, or generation-skipping transfer tax because of the expanded exemption amounts. However, state taxes might be a concern so you should consider them in your estate planning. ■

## TAX CALENDAR

### MARCH 2011

#### March 15

**Corporations.** File a 2010 calendar year income tax return (Form 1120) and pay any tax due. If you want an automatic six-month extension of time to file the return, file Form 7004 and deposit what you estimate you owe.

**S corporations.** File a 2010 calendar year income tax return (Form 1120S) and pay any tax due. Provide each shareholder with a copy of Schedule K-1 (Form 1120S), Shareholder's Share of Income, Deductions, Credits, etc., or a substitute Schedule K-1. If you want an automatic six-month extension of time to file the return, file Form 7004 and deposit what you estimate you owe.

**S corporation election.** File Form 2553, Election by a Small Business Corporation, to choose to be treated as an S corporation beginning with calendar year 2011. If Form 2553 is filed late, S corporation treatment will begin with calendar year 2012.

**Electing large partnerships.** Provide each partner with a copy of Schedule K-1 (Form 1065-B), Partner's Share of Income (Loss) From an Electing Large Partnership, or a substitute Schedule K-1. This due date applies even if the partnership requests an extension of time to file Form 1065-B by filing Form 7004.

**Employers.** For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in February if the monthly rule applies.

### APRIL 2011

#### April 18

**Individuals.** File a 2010 income tax return. If you want an automatic six-month extension of time to file the return, file Form 4868,

*Application for Automatic Extension of Time To File U.S. Individual Income Tax Return*, or you can get an extension by phone or over the Internet. Then, file Form 1040, 1040A, or 1040EZ by October 17.

If you are not paying your 2011 income tax through withholding (or will not pay in enough tax during the year that way), pay the first installment of your 2011 estimated tax. Use Form 1040-ES.

**Employers.** For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in March if the monthly rule applies.

**Household employers.** If you paid cash wages of \$1,700 or more in 2010 to a household employee, file Schedule H (Form 1040) with your income tax return and report any household employment taxes. Report any federal unemployment tax on Schedule H if you paid total cash wages of \$1,000 or more in any calendar quarter of 2009 or 2010 to household employees. Also report any income tax you withheld for your household employees.

**Partnerships.** File a 2010 calendar year return (Form 1065). Provide each partner with a copy of Schedule K-1 (Form 1065), Partner's Share of Income, Deductions, Credits, etc., or a substitute Schedule K-1. If you want an automatic five-month extension of time to file the return and provide Schedule K-1 or a substitute Schedule K-1, file Form 7004. Then file Form 1065 by September 15.

**Electing large partnerships.** File a 2010 calendar year return (Form 1065-B). If you want an automatic six-month extension of time to file the return, file Form 7004. Then file Form 1065-B by October 17.

**Corporations.** Deposit the first installment of estimated income tax for 2011.