

# Potential 2011 Tax Increases

## *Expiration of previous tax cuts would lead to across-the-board tax increases*

When President Bush signed into law a pair of tax cut packages in 2001 and 2003, they included a sunset provision – a clause that essentially repealed most aspects of the two packages after 2010. As the clock continues ticking toward that December 31, 2010 deadline, taxpayers are now beginning to realize the potential impact of those sunset provisions.

Because of the breadth and depth of the cuts made in those two tax acts, the sunset will result in tax increases for virtually every taxpayer. These will come in the form of higher tax rates, reduced deductions and credits and the return of the marriage penalty.

President Obama has pledged to limit the effect of this sunset. Both during his presidential campaign and in his 2011 revenue proposals, he vowed to limit the impact of many of these tax increases to married couples with income over \$250,000, and singles over \$200,000. However, Congress has yet to take any action up to this point that would protect taxpayers below those income levels.

The following is a summary of some of the significant tax law changes that are scheduled to take effect as of January 1, 2011.

### Increase in Tax Rates

The cornerstone of the 2001 tax cuts was a reduction in tax rates across all brackets. Those cuts would be repealed beginning in 2011, resulting in tax increases in for all taxpayers. The following table shows a comparison of tax rates for 2010 and the potential 2011 tax rates for married couples and single individuals. The 2011 rates are based on the 2010 tax brackets, although they would be subject to inflation adjustments.

Married Filing Joint	Single	2010 Tax Rate	2011 Tax Rate
\$0 – 16,750*	\$0 – 8,375	10%	15%
\$16,750 – 68,000	\$8,375 – 34,000	15%	
\$68,000 – 137,300	\$34,000 – 82,400	25%	28%
\$137,000 – 209,250	\$82,400 – 171,850	28%	31%
\$209,250 – 373,650	\$171,850 – 373,650	33%	36%
\$373,650 and up	\$373,650 and up	33%	39.6%

\* Does not reflect potential impact of return of marriage penalty

### Return of the Marriage Penalty

Married couples would often find their tax liability was greater than what their combined liabilities would have been as two single individuals. This is referred to as the “marriage penalty”. While the 2001 and 2003 Acts reduced the impact of this penalty, it will return beginning in 2011. As a result, the standard

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deduction for a married couple will be reduced to where it is less than twice that of a single person. Also, the size of the 15% tax bracket for married couples would no longer be twice that of a single person. Both of these changes will result in a tax increase for married couples.

### Changes to Capital Gain, Dividend Tax Rates

The 2003 Act reduced the top tax rate on long-term capital gains from 20% to 15%. For taxpayers in the 10% or 15% ordinary tax bracket, the top rate was reduced from 10% to 5%, and was further reduced to 0% for 2008-2010. Beginning in 2011, the top rate would return to 20%, or 10% for those in the lowest tax bracket. The 28% rate that applies to collectibles and the 25% rate on unrecaptured Section 1250 gains would remain in place.

The 2003 Act also changed the way dividends are treated for tax purposes. Rather than tax dividends as ordinary income, they became taxed at the same rates as long-term capital gains, making the top tax rate on dividends just 15%. Beginning 2011, all dividends would return to ordinary income treatment. When combined with the potential increase in the top tax brackets, the top rate on dividends would go from 15% to 39.6%.

In addition to these increases, the health care act passed during 2010 included a Medicare tax on investment income for married taxpayers with more than \$250,000 of modified Adjusted Gross Income (\$200,000 for singles). This 3.8% tax takes effect in 2013, and would drive the top tax rate on dividends to as high as 43.4% for taxpayers over those income levels.

### Phaseouts of Itemized Deductions, Personal Exemptions

Taxpayers whose Adjusted Gross Income exceeded certain thresholds have traditionally seen the benefit of their itemized deductions and personal exemptions reduced via a phaseout. The 2001 Act gradually eliminated these phase-outs, and for 2010 they no longer apply. Beginning in 2011, however, both phaseouts will return at their full levels.

In 2009, the last year both phaseouts were in place, gross itemized deductions began to be reduced for most taxpayers when AGI exceeded \$166,800. Personal exemptions were reduced for married couples with AGI over \$250,200, and for singles over \$166,800. The 2011 thresholds will be announced near the end of 2010, but they would likely be close to those same levels.

### Reductions in child-related credits

Two credits related to children, the Child Credit and Dependent Care Credit, will be modified beginning in 2011

- **Child Credit** – The 2001 Act included several graduated increases in the Child Credit, ultimately increasing it to \$1,000 per eligible child, based on family income levels. The 2003 Act accelerated those increases. Beginning in 2011, the maximum credit will return to the original level of \$500. The full

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credit is available for children under age 17, and for married couples with modified AGI below \$110,000 (\$75,000 for singles). The credit is phased out as income exceeds those thresholds.

- ***Dependent Care Credit*** – A tax credit is available to parents who must pay for dependent care in order to maintain employment. The credit is equal to a percentage of the total expenses paid, and the percentage varies based on the taxpayer's total income. For 2011, the maximum eligible expenses will be reduced from \$3,000 to \$2,400 for one child and from \$6,000 to \$4,800 for two or more children. Also, the maximum credit percentage will be reduced from 35% to 30%. As a result of these changes, the maximum credit will be reduced from \$1,050 per child to \$720.

### Return of the Estate Tax

The 2001 Act included a repeal of the Federal estate and generation skipping taxes beginning in 2010. Because the sunset provision brings back those taxes for 2011, this repeal is essentially a one-year hiatus. In addition, it's been expected that Congress would enact a patch of some kind to prevent the 2010 repeal. At the midpoint of 2010, Congress had yet to agree on a patch, although there is speculation it could still happen this year and that it would be retroactive to the beginning of 2010.

While that potential patch could also change the form of the estate tax for 2011 and beyond, returning to the pre-2001 Act law is becoming more and more possible. If that is the case, the following would occur:

- ***Reduction in the lifetime exemption*** – The lifetime exemption amount for 2009, the last year in which there was an estate tax, was \$3.5 million. Under the sunset rules, the 2011 exemption would be reduced to \$1 million. As a result, the estate tax would impact a significantly larger number of families than were impacted in recent years.
- ***Increase in the top tax rate*** – The top estate tax rate would increase from 45% in 2009 to 55% in 2011. This top rate would apply to estates of more than \$3 million.
- ***Return of automatic basis adjustments*** – As part of the repeal of the estate tax for 2010, the automatic basis adjustment rules for assets owned by a decedent were replaced with modified carryover basis rules. Under the sunset, these carryover rules would only apply for decedents dying in 2010. In 2011, the rules requiring all cost basis amounts to be adjusted to the asset's fair market value at death would return.

### Education Savings provisions

The 2001 Act made several changes to the rules applicable to Coverdell Education Savings Accounts, all of which will be repealed as of January 1, 2011:

- The maximum contribution to a Coverdell account will be reduced from \$2,000 to \$500.
- Eligibility to contribute is subject to a phaseout based on AGI. For 2010, couples with income below \$190,000 can make a full contribution, and those over \$220,000 are not eligible to contribute. For 2011, eligibility to contribute begins phasing out at AGI of \$150,000, and is fully eliminated once AGI reaches \$160,000. No changes are made to other filing statuses.



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- The accounts can only be used to fund undergraduate or graduate-level work for 2011 and beyond. They will no longer be able to be used for elementary or high school expenses.
- Qualified expenses of Coverdell account will no longer include transferring funds to a 529 qualified tuition plans.
- The deadline for making contributions to a Coverdell account for a particular year will be accelerated from April 15 of the following year to December 31 of that year. For example, a contribution applicable to calendar year 2011 must be made by December 31, 2011, not April 15, 2012.

In addition to the changes to Coverdell accounts, the following other education-related changes will take effect in 2011:

- The exclusion from income for employer-provided educational assistance will expire. Employees will now be taxed on any educational assistance provided by an employer in 2011.
- The AGI phaseout ranges for deducting interest on a student loan will be reduced, limiting the number of taxpayers eligible to take the deduction. The phaseout ranges for married couples will be \$60,000-\$75,000, and for singles will be \$40,000-\$55,000. These are decreased from the 2010 levels of \$100,000-\$130,000 and \$50,000-\$65,000, respectively.

### Provisions Made Permanent

Many of the provisions included in the 2001 and 2003 Acts have been made permanent as part of subsequent tax acts. The following items will not be affected by the sunset provisions of the earlier acts:

- Distributions from a 529 Qualified Tuition Plans are still exempt from Federal taxes, and distributions from one 529 plan to another plan for the same beneficiary will continue to be allowed.
- The increased contribution limits to retirement plans such as IRAs, 401(k)s and Simple IRAs will remain, as will “catch-up” contributions for individuals age 50 and over. In addition, employers will still be able to Roth 401(k) accounts to their employers.