

tax-law extension preserves investor-friendly provisions



At last, taxpayers can plan for 2011 with some assurance they know the rules of the game.

The latest federal tax law extended the so-called Bush tax cuts, which were scheduled to expire at the end of 2010. Additional elements of the tax package are designed to help the economy continue to recover from a deep recession.

As noted in the below table, current marginal income tax rates were kept in place through 2012. Without Congressional action, those rates would have reverted in 2011 to where they were 10 years ago, with a maximum rate of 39.6%.

Among the other provisions, certain taxes on investments were clarified for 2011. For example, lower tax rates on qualified dividends and capital gains were also extended for 2 more years.

“It was very unusual to see tax rates for a new year resolved so close to the end of the previous year,” said Maria Bruno, a Vanguard investment strategy analyst. “But if there was a silver lining, it may be that it encouraged investors to look more closely at the tax-efficiency of their investments.”

Although short-term uncertainty regarding tax rates has been resolved, there’s growing talk in Washington, D.C., of broader tax reform down the road. Ms. Bruno noted that uncertainty about tax rates beyond 2012 underscores the need for investors to think about “tax diversification.”

“Many individuals could benefit from reevaluating where their investments are located across taxable and tax-advantaged accounts,” Ms. Bruno said. “There may be ways to reduce taxes on your investments while also maintaining the flexibility to make adjustments based on future tax changes.”

where key tax rates stand

	previous law	new tax law
marginal income tax rates	10%, 15%, 25%, 28%, 33%, 35%	Extended through 2012
long-term capital gains tax	<ul style="list-style-type: none"> 0% (lowest two brackets) 15% (all others) 	Extended through 2012
short-term capital gains tax	Taxed at ordinary income tax rates	Extended through 2012
qualified dividends tax*	<ul style="list-style-type: none"> 0% (lowest two brackets) 15% (all others) 	Extended through 2012
payroll tax	Employees pay 6.2% in Social Security tax	Tax reduced to 4.2% for 2011 only
estate tax	None	For decedents dying in 2010–2012, 35% rate on assets over \$5 million (to be adjusted for inflation in 2012). Additional details below.
gift tax	35% rate after \$1 million exemption	<ul style="list-style-type: none"> For 2010 gifts, 35% rate after \$1 million exemption. For 2011–2012 gifts, 35% rate after \$5 million exemption (to be adjusted for inflation in 2012).
generation-skipping transfer (GST) tax	None	Rate is 0% in 2010, 35% in 2011–2012. Exemption is \$5 million in 2010–2012 (to be adjusted for inflation tax in 2012).
child tax credit	\$1,000 per child living at home	Extended through 2012
tuition tax credit	\$2,500 per college student.	Extended through 2012.

Generally, for a dividend to be classified as qualified, you must have held that stock unhedged for at least 61 days out of the 121-day period that began 60 days before the ex-dividend date. For certain preferred stocks, the relevant holding period is at least 91 days out of the 181-day period beginning 90 days before the ex-dividend date if the dividends are due to periods totaling more than 366 days. If the preferred dividends are due to periods totaling less than 367 days, the holding period in the previous sentence applies.

estate tax resolved for 2 years

The legislation cleared away the cloud of uncertainty over the estate tax until the end of 2012. The tax had disappeared this year but, absent Congressional action, was going to return in 2011 with a top tax rate of 55% for assets over \$1 million. The new rate will be 35% for assets over \$5 million. In addition, estates filing tax returns for decedents dying in 2010 now have the choice of applying the new estate tax rules or the original 2010 rule, which imposed no estate tax but could result in beneficiaries paying additional capital gains tax.

“The unknowns surrounding the future of the estate tax have been causing some anxiety for estate planners and their clients,” said Ms. Bruno. “Although the estate tax has been resolved for the near term, it’s still a good idea to consult an estate planning professional to make sure your estate plan still fits your situation.”

a 1-year payroll tax cut

One important provision will put more money into the pockets of everyone paying a payroll tax for Social Security. For 2011 only, that tax will be reduced 2 percentage points, from 6.2% to 4.2%. For someone making \$100,000, that’s an extra \$2,000 for the year. The tax isn’t levied on income over \$106,800 in 2011.

“The intent may be to encourage consumer spending, but many investors will be inclined to set that money aside to strengthen their savings,” said Ms. Bruno. “This could be a good opportunity for many workers to build up an emergency fund or make additional contributions to an IRA or an employer-sponsored retirement plan.”

other tax items of interest

Alternative minimum tax (AMT): For 2010 and 2011, Congress temporarily raised the ceiling on exemptions and credits to avoid snaring millions of taxpayers in the AMT, which hasn’t been adjusted for inflation. The tax was originally designed to prevent those with the highest income levels from paying minimal or no income tax.

Tax-free IRA distributions to charity: Congress extended a benefit for IRA owners. For tax years 2010 and 2011, tax-free distributions of up to \$100,000 per taxpayer, per taxable year, can be made to charities by individuals 70½

and older. Because the law was passed so late in the year, individuals can make charitable transfers during January of 2011 and treat them as if they were made during 2010. These distributions can be used to satisfy annual required minimum distributions (RMDs).

IRA conversions: Congress didn’t tinker with the rules for IRA conversions. Beginning in 2010, anyone can convert a traditional IRA to a Roth IRA, no matter how high the income. For 2010 conversions, the resulting income could be spread across 2011–2012. Now that the tax rates have been set for two years, tax planning may be easier. Keep in mind that after 2010, the amount converted must be declared as income for the year in which it occurs.

Paying for college: The contribution limit to Coverdell education savings accounts remains at \$2,000, and tax-free withdrawals for precollege educational expenses will continue to be allowed.

Sales tax deduction: Individuals can claim a deduction for general sales taxes instead of a deduction for state and local income taxes through 2011.

Phase-out of deductions: For those with higher incomes, itemized deductions and personal exemptions will not be subject to phase-outs through 2012.

Notes:

- The information provided here is for educational purposes only and isn’t intended to be construed as legal or tax advice. We recommend that you consult a tax or financial advisor about your individual situation.
- When taking withdrawals from a retirement plan such as an IRA or 401(k) before age 59½, you may have to pay ordinary income tax plus a 10% federal penalty tax. Additionally, state taxes may apply.
- Investments are subject to risks.