

EGTRRA sunsets and President's budget proposals cloud the tax planning picture for 2011

Long-range income-tax planning for individuals is always a challenge, but this year it's especially daunting. Even if Congress makes no changes at all, the federal income tax landscape will change dramatically next year under automatic sunset provisions in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA, P.L. 107-16). And as part of the effort to rein in a mushrooming debt, the President's FY 2011 budget proposals include many revenue raising proposals, some of which adopt or modify EGTRRA automatic sunsets. This compares and contrasts current law with what's in store under the EGTRRA sunsets and under the President's budget proposals in three areas: tax rates; taxation of capital gains and qualified dividends; and deductions in general.

Tax rate structure. Under current tax rules, the first slice of taxable income is taxed at 10%, and the second slice at 15%. The size of the 15% tax bracket for married taxpayers filing joint returns (and qualified surviving spouses) is twice the 15% tax bracket for individual filers. The top four tax brackets are 25%, 28%, 33%, and 35%. (Code Sec. 1(i), Code Sec. 1(f))

Beginning in 2011, if Congress doesn't make changes, the following rules automatically will be in place under the EGTRRA sunset rule:

- The first slice of taxable income will be taxed at 15%; in other words, the bottom 10% bracket will disappear.
- The size of the 15% tax bracket for married taxpayers filing joint returns (and qualified surviving spouses) will be 167% of the 15% tax bracket for individual filers.
- The top four brackets will be 28%, 31%, 36%, and 39.6%.

Under the Administration's FY 2011 budget proposals, these rules would apply beginning in 2011:

- (1) The bottom four brackets would remain at 10%, 15%, 25%, and 28%. The size of the 15% tax bracket for married taxpayers filing joint returns would continue to be twice the 15% tax bracket for individual filers, and the 28% bracket would be expanded to assure that taxpayers won't see their taxes rise as a result of the increase in the top two brackets (see below).
- (2) The top two brackets (currently 33% and 35%) would rise to 36% and 39.6%.
- (3) For married taxpayers filing jointly, the 36% rate would apply to taxable income above \$250,000 less the standard deduction and two personal exemptions, indexed from 2009; and for single taxpayers it would apply to taxable income above \$200,000 less the standard deduction and one personal exemption, indexed from 2009.
- (4) The 39.6% bracket would apply to taxable incomes over \$373,650 for married taxpayers filing jointly, heads of household and single filers, with the taxable income level indexed for inflation for 2011 and subsequent years.

What about the AMT? Under Code Sec. 55(a), the alternative minimum tax (AMT) exemption amounts for 2010 dropped to \$33,750 for unmarried taxpayers, \$45,000 for joint filers, and \$22,500 for marrieds filing separately (by contrast, for 2009, they were \$46,700, \$70,950, and \$35,475 respectively). Also, many nonrefundable personal credits claimed after 2009 are subject to the limitation of Code Sec. 26(a)(1) : they can't exceed the excess of: (a) the individual's regular tax liability, over (b) the individual's tentative minimum tax, determined without regard to the AMT foreign tax credit. For 2009, this limitation didn't apply.

It seems a safe bet (at this writing, at least) that the AMT will continue more or less in the form it existed in 2009. At the very least, Congress will enact another one-year "patch" to restore AMT exemption amounts for 2010 to their 2009 levels (as indexed for inflation), and to allow nonrefundable personal credits to offset the AMT as well as regular tax. And under the President's FY 2011 budget proposals, the 2009 AMT exemption amounts for individuals, as indexed for inflation, would apply for 2010 and future years, and nonrefundable personal credits would offset the AMT as well as regular tax.

Taxation of capital gains and qualified dividends. Under current rules, most long-term capital gain (more technically, net capital gain, that is adjusted net capital gain) is taxed at a maximum rate of 15%. If the long-term capital gain would otherwise be taxed at a rate below 25% if it were ordinary income, it is taxed at a zero percent rate. (Code Sec. 1(h)(1)(B), Code Sec. 1(h)(1)(C)) Qualified dividends are taxed to noncorporate shareholders at the same rates that apply to long-term capital gain. (Code Sec. 1(h)(11))

Beginning in 2011, if Congress doesn't make changes, long-term capital gains will be taxed at 20%. Additionally, dividends paid to individuals will be taxed at the same rates that apply to ordinary income. (Sec. 303 of the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA, P.L. 108-27), as amended by Sec. 102 of the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA, P.L. 109222).

Under the Administration's proposals, beginning in 2011, a 20% tax rate would apply to long-term capital gains and qualified dividends of married taxpayers filing jointly with income over \$250,000 less the standard deduction and two personal exemptions (indexed from 2009) and for single taxpayers with income over \$200,000 less the standard deduction and one personal exemption (indexed from 2009). Taxpayers below these income levels would be subject to the rates that currently apply (i.e., 0% or 15% rate) to long term capital gains and qualified dividends.

Deductions. Under current rules, the standard deduction for married taxpayers filing jointly (and qualified surviving spouses) is 200% of the standard deduction for single taxpayers. (Code Sec. 63(c)(2)(A)) For 2010, higher-income taxpayers don't face an AGI-based reduction of itemized deductions (Code Sec. 68(g)), or an AGI-based phaseout of personal exemptions. (Code Sec. 151(d)(3)(F))

Beginning in 2011, if Congress doesn't act, under the EGTRRA sunset rule the standard deduction for married taxpayers filing jointly (and qualified surviving spouses) will be 167% of the standard deduction for single taxpayers. A higher-income taxpayer's itemized deductions (except for deductions for medical expenses, investment interest, casualty, theft or wagering losses) will be reduced by 3% of AGI above an inflation-adjusted figure, but deductions won't be reduced by more than 80%. Also, a higher-income taxpayer's personal exemptions will be phased out when AGI exceeds an inflation-adjusted threshold.

Under the Administration's FY 2011 proposals:

- The standard deduction for married taxpayers filing jointly (and qualified surviving spouses) would remain at 200% of the standard deduction for single taxpayers.
- The AGI-based reduction of itemized deductions and the AGI-based personal exemption phaseout would be reinstated for higher income taxpayers.
- The tax value of all itemized deductions would be limited to 28% whenever they would otherwise reduce taxable income in the 36% or 39.6% tax brackets. A similar limitation also would apply under the AMT.

Observation: The President's 2011 budget proposals would make a number of other deduction and credit changes. For example, it would extend through 2011 the optional deduction for state and local general sales taxes, and make permanent the American Opportunity Credit for higher education expenses.

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