

Client Tax Letter

Tax Saving and Planning Strategies from your Trusted Business Advisorsm

Income Tax Rates Hold Steady

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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.

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-

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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.

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Other income tax benefits

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

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. ■

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 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 his or her 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, as follows:

- **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

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 of appreciated securities with no gift tax consequences. If he is married, the man and his wife could give up to \$52,000 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 a substantial tax advantage by giving appreciated assets to youngsters, including full-time students under age 24.

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use the 2011 rules and avoid paying estate tax while minimizing future capital gains tax.

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 expanded gift tax exemption and 35% gift tax rate provide an excellent opportunity for wealthy taxpayers. At least for the next two years, people who are concerned about future estate tax can move large amounts to younger generations while owing little or no gift tax.

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. ■

Deduct, Don't Depreciate

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 focused mainly on personal income and estate tax. Nevertheless, some additional provisions may be helpful to businesses.

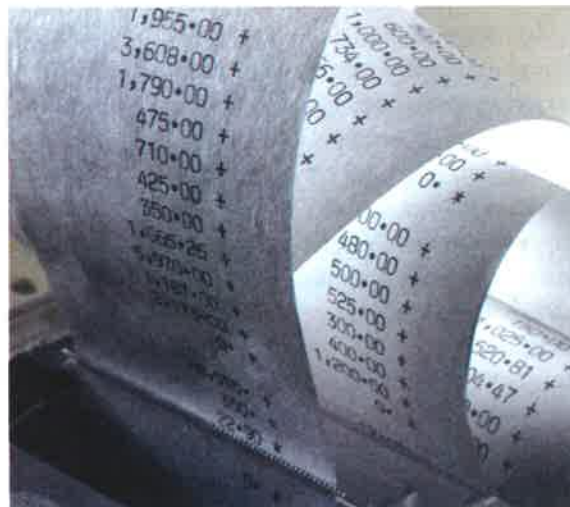
In particular, the new law enhances the Section 168(k) bonus depreciation provisions by temporarily allowing 100% first-year bonus depreciation of new business equipment that qualifies for bonus depreciation. That is, a company that purchases qualifying depreciable assets may deduct the entire cost of the assets right away. First-year deductions will immediately boost a company's cash flow, compared with taking depreciation deductions over several years. No limits exist on the amount of qualifying equipment purchased that is eligible for the 100% deduction.

This 100% deduction provision is effective for qualifying equipment placed in service from September 9, 2010, to the end of 2011. As a result, any company or self-employed individual who has

bought or might buy business equipment has several sets of rules to consider.

One law passed in 2010 set permitted first-year Section 179 deductions (expensing) at \$500,000 for equipment. The phaseout threshold was set at \$2 million, meaning that companies buying more than \$2 million of equipment in 2010 lost some expensing opportunities. Thus, you might be able to use Section 179 expensing for up to \$500,000 for equipment placed in service by September 8, 2010, and Section 168(k) 100% bonus depreciation for equipment placed in service after that date.

For 2011, equipment purchasers can use expensing (\$500,000 limit with a \$2 million phaseout threshold); 100% bonus depreciation; or some combination of the two.



The new law also calls for 50% bonus depreciation in 2012, along with a \$125,000 limit for expensing and a \$500,000 phaseout threshold.

The bottom line? The interaction of these two code sections (Section 179 expensing and Section 168(k) bonus depreciation) provides opportunities as well as complications. Our office can help you decide how to handle those decisions on your 2010 tax return (amended, if necessary) and plan for equipment purchases over the next two years. ■

Taxes on Bonds Bought at a Premium or Discount

The taxation of bond interest is relatively straightforward. Assuming the bonds are held in a taxable account, the interest on corporate bonds is generally subject to all income taxes: federal, state (if applicable), and local (if applicable). Treasury issues pay interest that's subject to federal income tax but not state or local tax. Most municipal bonds pay interest that's exempt from federal income tax. If you buy a bond issued in your home state, you probably will avoid all tax on the interest income.

Plus or minus

You may have a more difficult time figuring capital gain or loss on a bond, however. Bonds are issued at so-called par value (for example, \$1,000 per bond). Then prices fluctuate as interest rates move up or down. Therefore, when you buy a bond, you may be buying at a premium or discount to par.

Example 1: Corporation ABC issued bonds at a \$1,000 par value. The interest rate was 5%, or \$50 per year, per \$1,000 bond. Since then, interest rates on similar issues have moved up to 6%. Therefore, investors are less interested in ABC's bonds; they'll pay less for a bond with a below-market yield. To attract investors, ABC's bonds sell for \$940 in this hypothetical example. Investors can buy the bond at a discount to par value.

Example 2: Municipality XYZ issued bonds at \$1,000 par value. The interest rate was 4%, or \$40 per year, per \$1,000 bond. Since then, interest rates on similar issues have moved down to 3%. Therefore, investors are more interested in XYZ's bonds. They'll pay more for a bond with an



above-market yield. To reflect the increased demand from investors, XYZ's bonds sell for \$1,060 in this hypothetical example. Investors must pay a premium over par value to buy these bonds.

Paying a premium

Today, most bonds have low effective interest rates, reflecting a low-yield environment. If you buy a bond issued years ago, chances are that you're paying a premium.

Example 3: Sue Walker buys \$10,000 worth of Municipality XYZ's tax-exempt bonds for \$10,600. The bonds mature in six years. Each year, Sue's basis in the bonds drops. The actual calculation is complicated and will be done by Sue's broker. To simplify this example, assume that Sue's bonds are amortized (decline in basis) by \$100 per year. She gets no tax benefit for the amortization of her municipal bonds.

After two years, Sue's basis in the bonds will drop by \$200, from \$10,600 to \$10,400. If Sue sells those bonds then for \$10,500, she will have a \$100 long-term capital gain; if Sue sells them for \$10,100, she will have a \$300 long-term capital loss.

The rules on buying a taxable bond at a premium are different.

Example 4: Sue Walker buys \$10,000 worth of Corporation UVW's taxable bonds for \$10,600. These bonds mature in six years. With taxable bonds, you can choose to amortize the premium you've paid. If Sue chooses to amortize, she will recognize a partial loss each year, offsetting taxable interest income.

If you do not amortize a premium you've paid, the premium will be included in your basis, so you'll have a larger capital loss when you sell or redeem your bonds (or a smaller taxable gain if interest rates fall and you sell at a profit). You typically should make the election to amortize if you've bought taxable bonds at a premium because you'll get more tax savings.

Dealing with discounts

If interest rates rise from today's low levels, recently-issued bonds will lose value, and you'll be able to buy them at a discount. Bonds trading at a discount due to interest rate fluctuations are called *market discount bonds*. Regardless of whether you buy

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a taxable or tax-exempt bond at a discount, you'll owe tax at maturity, unless you elect to annually report the accrued market discount in your income.

Example 5: Jim Miller buys \$10,000 worth of bonds for \$9,400. They mature in 2017, and Jim collects \$10,000. He will have \$600 of ordinary income taxed at the same rate as he would pay on investment interest. That's true for tax-exempt or taxable bonds.

Suppose, though, that Jim sells his bonds before maturity. He may have a capital gain or a loss, depending on how much of Jim's \$600 discount has been accrued (reduced). Halfway to the maturity date, \$300 of Jim's \$600 discount will have accrued, so his basis in the bonds will have increased from the \$9,400 purchase price to \$9,700. Then, Jim would have a \$100 gain on a sale for \$9,800 and a \$100 loss on a sale for \$9,600. That gain or loss would be in addition to the \$300 of ordinary income Jim would recognize from the accrual of the discount.

Note that the rule illustrated in this example may not apply to a bond purchased before May 1, 1993. Tax-exempt bonds purchased before this date are not subject to the market discount rules; therefore, the accrued market discount on them will be treated as capital gain. The treatment of taxable bonds purchased before May 1, 1993, varies according to the bond's issue date. Bonds issued after July 18, 1984, are subject to the market discount rules. Taxable bonds purchased before that date are not.

As mentioned previously, investors who buy bonds at a discount have the option of recognizing the accrued income each year. The basis of the bonds is increased by the amount of market discount that you include in income each year, thus reducing the tax on sale or redemption of the bonds. Our office can help you determine if recognizing accrued income at the end of each year will be advantageous. ■

Trusted Advice

Capital Gains, Not Ordinary Income

- ❖ Tax-exempt bonds that were purchased with a market discount before May 1, 1993, are not treated as market discount bonds.
- ❖ Any gain on the sale of such bonds is treated as capital gain.
- ❖ For example, suppose you bought tax-exempt bonds that were issued with a \$10,000 par value. Before May 1, 1993, you paid \$9,000 for those bonds.
- ❖ If you sell the bonds now for \$9,500, you'll have a \$500 long-term capital gain.
- ❖ A similar example using tax-exempt bonds bought after April 30, 1993, would result in \$500 of ordinary income taxed at higher rates.