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SPECIAL TAX ISSUE

SPECIAL ISSUE 2011

NUMEROUS INDIVIDUAL TAX PROVISIONS EXTENDED

While the 2010 Tax Act extended numerous tax provisions related to individuals, providing some certainty in tax planning, that certainty only extends for two years in most cases. Originally enacted in 2001 and 2003, many of these tax provisions were scheduled to expire at the end of 2010, reverting to the original tax laws. Some of the more significant changes include:

- **INDIVIDUAL INCOME TAX RATES** — The current marginal income tax rates of 10%, 15%, 25%, 28%, 33%, and 35% are extended for two

years, until December 31, 2012. The rates will not revert to 15%, 28%, 31%, 36%, and 39.6%. In addition, the 15% tax bracket for joint filers and qualified surviving spouses will remain at 200% of the amount for individual filers, rather than reverting to 167%.

- **CAPITAL GAINS AND DIVIDENDS** — Qualified capital gains and dividends will continue to be taxed at a maximum income tax rate of 15% (0% for taxpayers in the 10% or 15% income tax bracket) for another two years, through December 31, 2012. The capital gains tax rate will not revert to 20% (10% for taxpayers in

the 15% tax bracket), and dividends will not be taxed as ordinary income subject to a maximum tax rate of 39.6%.

- **ITEMIZED DEDUCTION LIMITATION** — The elimination of the itemized deduction limitation will be extended for two years, until December 31, 2012. It was scheduled to revert to a reduction in the total amount of itemized deductions by 3% of the amount by which the taxpayers' adjusted gross income (AGI) exceeds the threshold amount (\$169,550 in 2011), with the reduction not to exceed 80% of itemized deductions.
- **PERSONAL EXEMPTION PHASEOUT** — The elimination of the phaseout of personal exemptions (\$3,650 in 2010 and \$3,700 in 2011) was extended for two additional years, until December 31, 2012. It was scheduled to revert to a reduction of 2% for each \$2,500 of AGI over the threshold (\$169,550 for singles, \$254,350 for married couples filing jointly, and \$211,950 for heads of household in 2011).
- **STANDARD DEDUCTION** — The standard deduction for married couples used if deductions are not itemized will continue to be twice the amount for single taxpayers for an additional two years, until

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MAJOR (TEMPORARY) CHANGES FOR THE ESTATE TAX

As background, the federal estate tax had been gradually reduced over a number of years and was abolished for 2010 only. In 2011, the estate tax was set to return based on 2001 tax laws, which included a 55% maximum tax rate and \$1 million estate tax exclusion. The 2010 Tax Act made major changes to the estate tax as well as the gift tax and generation-skipping transfer tax, although those changes are only in effect through December 31, 2012.

ESTATE TAX — For estates of individuals dying after December 31, 2009, the maximum estate tax rate is 35%

with an exclusion amount of \$5 million. The exclusion amount will be adjusted for inflation in 2012. Inherited property will receive a stepped-up basis equal to the property's fair market value on the date of the decedent's death.

2010 ESTATE TAX OPTION — For individuals who die in 2010, their estate has the option to elect not to be subject to the new estate tax rules. Instead, the estate can elect to pay no estate tax, but heirs will receive property based on the modified carryover basis rules. Under those rules, the executor can increase

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INDIVIDUAL TAX

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December 31, 2012. Thus, the standard deduction for married couples will be \$11,600 in 2011, rather than reverting to \$9,650.

- **CHILD TAX CREDIT** — The \$1,000 child tax credit for each qualifying child under age 17, including numerous enhancements to the credit, will be extended for another two years, through December 31, 2012. The child tax credit continues to phase out for taxpayers with AGI starting at \$110,000 for married couples filing jointly and \$75,000 for other taxpayers. The child tax credit was scheduled to revert to \$500, and more restrictive refundable rules were scheduled to apply.
- **EARNED INCOME TAX CREDIT** — The simplification provisions that began in 2010 for the earned income tax credit are extended for two years, through December 31, 2012. Also extended is the 45% credit rate for taxpayers with three or more qualifying children and higher phase-out thresholds for married couples filing jointly.
- **ADOPTION CREDIT** — The dollar limitation for the adoption credit and the income exclusion for employer-paid or reimbursed adoption expenses, currently at \$13,170 in 2010 and \$13,360 in 2011 per eligible child, will remain and continue to be adjusted for inflation for both nonspecial-needs and special-needs adoptions, for one year, through December 31, 2012. However, a \$1,000 increase in the credit was not extended, so that the credit for 2012 will be \$12,170 indexed for inflation after 2010. This benefit is phased out for taxpayers with modified

AGI over \$185,210 in 2011 and is completely eliminated at modified AGI of \$225,210. The adoption credit and income exclusion was scheduled to be reduced to \$6,000, applied only to special-needs adoptions, and reduced phase-out ranges.

- **DEPENDENT CARE CREDIT** — A dependent care credit can be claimed by a taxpayer who incurs expenses for a child under age 13 or for an incapacitated dependent or spouse so that the taxpayer can work. The maximum dependent care credit is \$1,050 (35% of up to \$3,000 of eligible expenses) for one qualifying individual and \$2,100 (35% of up to \$6,000 of eligible expenses) for two or more qualifying individuals. The credit percentage can go as low as 20% for individuals with AGI over \$43,000. The dependent care credit has been extended for two years, through December 31, 2012. The credit was scheduled to be substantially reduced.
- **ALTERNATIVE MINIMUM TAX (AMT)** — The 2010 Tax Act contains an AMT patch designed to prevent the AMT from encroaching on middle-income taxpayers through higher exemption amounts and other relief for 2010 and 2011. The patch had expired at the end of 2009; and without it, the AMT was expected to subject an additional 21 million households to the AMT. The exemption amounts are \$47,450 in 2010 and \$48,450 in 2011 for single taxpayers (up from \$33,750), \$72,450 in 2010 and \$74,450 in 2011 for married couples filing jointly (up from \$45,000), and \$36,225 in 2010 and \$37,225 in 2011 for married couples filing separately (up from \$22,500).
- **TAX-FREE INDIVIDUAL RETIREMENT ACCOUNT (IRA) DISTRIBUTIONS** — This provision had expired at the end of 2009 and has been extended for two years, through December 31, 2011. Taxpayers age 70½ and older can make tax-free distributions, up to \$100,000 each year, from traditional and Roth IRAs for charitable purposes. ○○○



PAYROLL TAX CUT FOR 2011

In an effort to inject spending money into the economy, the 2010 Tax Act provides for a reduction in Social Security taxes for 2011. The Federal Insurance Contributions Act (FICA) imposes two taxes on employers and employees — the old age, survivors, and disability insurance (OASDI) tax equal to 6.2% of wages up to the limit of \$106,800 in 2010 and 2011 and the Medicare hospital insurance (HI) tax of 1.45% of all covered wages, for a total tax of 7.65%. Both the employer and employee pay these amounts for a combined total of 15.3% of covered wages. The Self-Employment Contributions Act (SECA) taxes self-employment income of self-employed individuals at the same percentages as the combined employer and employee rates, totaling 15.3% of covered wages. When computing income taxes, self-employed individuals are allowed an above-the-line deduction of 50% of the amount of the SECA tax.

For 2011, the employee portion of the OASDI tax is reduced from 6.2% to 4.2%, while self-employed individuals will pay 10.4% rather than 12.4%. Employers continue to pay 6.2% on covered wages. Thus, the maximum savings for 2011 will be \$2,136, or 2% of the wage limit of \$106,800 per taxpayer. Self-employed individuals will be able to deduct 59.6% of OASDI tax paid plus 50% of HI tax paid. This change is required to ensure that self-employed individuals receive a 50% deduction of the employer portion of SECA taxes.

The reduction in payroll taxes is expected to inject \$110 billion into the economy in 2011. The reduction is available to all wage earners and is not phased out for high-income levels. Individuals who do not pay into the Social Security system, including some public employees, will not benefit from the payroll tax reduction. The 2010 Tax Act contains a hold harmless provision for the Social Security Trust Fund, replacing the amount of revenue lost with a general fund transfer of the same amount from the U.S. Treasury. ○○○

ESTATE TAX

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the basis of estate property by a total of \$1.3 million (an additional \$3 million can be added to property inherited by a surviving spouse), with other estate property having a carryover basis equal to the lesser of the decedent's basis or the fair market value of the property on the decedent's date of death. The executor will need to carefully assess which option provides the lowest combined estate and income tax result for the estate and its beneficiaries. In order to provide executors with enough time to file tax returns and make tax payments, estates of decedents dying after December 31, 2009, and before the date of enactment have an extended time, typically nine months, to perform certain acts.

GIFT TAXES — No changes are made to the annual gift tax exclusion. For 2010 and 2011, the annual exclusion amount is \$13,000, with married couples able to split their gift to make a combined gift of \$26,000. For gifts made in 2010, the gift tax has a top rate of 35% and a maximum applicable exclusion amount of \$1 million. For gifts made after 2010, the gift tax is reunified with the estate tax, providing a maximum gift tax rate of 35% and a maximum applicable exclusion amount of \$5 million.

GENERATION-SKIPPING TRANSFER (GST) TAX — For 2010, the GST exemption amount is \$5 million, the same amount as the estate tax exclusion, with a GST tax of 0%. After 2010, the GST tax rate is equal to the highest estate and gift tax rate in effect for that year, which would be 35% for 2011 and 2012.

PORTABILITY OF UNUSED EXEMPTION — The unused portion of the estate tax exclusion of a predeceased spouse can be used by the surviving spouse. To do so, the surviving spouse must make an election on a timely filed estate tax return. This provision is available after December 31, 2010. This additional exclusion can be used for taxable transfers during life or at death. For instance, if one spouse dies and uses \$3 million of his \$5 million exclusion, his surviving spouse's exclusion would equal \$7 million (her \$5 million exclu-

MANY EDUCATION INCENTIVES EXTENDED

The 2010 Tax Act has extended several education incentives for two years, through December 31, 2012:

AMERICAN OPPORTUNITY TAX CREDIT — The American Opportunity Tax Credit equals 100% of the first \$2,000 of tuition and fees and 25% of the next \$2,000 paid for a taxpayer, spouse, or dependent, for a maximum credit of \$2,500 per year per student. The credit applies to all four years of college. The credit is 40% refundable. If the taxpayer claiming the credit is a child under age 18 or a student under age 24 providing less than one-half of his/her support, has at least one living parent, and does not file a joint return, no portion of the credit is refundable. In 2010, the credit is phased out for single taxpayers with modified AGI between \$80,000 and \$90,000 and for married couples filing jointly with modified AGI between \$160,000 and \$180,000. The credit was scheduled to be reduced to a maximum of \$1,800, only for the first two years of college.

EMPLOYER-PROVIDED EDUCATION ASSISTANCE — Employees can exclude up to \$5,250 annually in employer-provided education assistance from income and employment taxes, while employers can deduct up to \$5,250 annually for qualified education expenses paid on behalf of an employee, including graduate studies.

SCHOLARSHIP — The National Health Services Corps Scholarship Program and the Armed Forces Scholarship Program remain qualified scholarships that are excluded from income for income tax purposes.

STUDENT LOAN INTEREST DEDUCTION — Taxpayers can deduct a maximum of \$2,500 annually for interest paid on qualified higher education loans. For 2010, the deduction phases out for single taxpayers with modified AGI between \$60,000 and \$75,000 and for married couples filing jointly with modified AGI between \$120,000 and \$150,000.

COVERDELL EDUCATION SAVINGS ACCOUNTS — Taxpayers can contribute \$2,000 per year (this was scheduled to decrease to \$500) to Coverdell Education Savings Accounts for beneficiaries under age 18 and special-needs beneficiaries of any age. The account is exempt from income taxes, while earnings distributions are tax free if used for qualified education expenses. Qualified education expenses include elementary and secondary school expenses in addition to post-secondary school expenses. The contribution limit is phased out for single taxpayers with modified AGI between \$95,000 and \$110,000 and for married couples filing jointly with modified AGI between \$190,000 and \$220,000.

HIGHER EDUCATION TUITION DEDUCTION — This provision had expired on December 31, 2009, so it is extended for two years until December 31, 2011. The maximum deduction is \$4,000 for single taxpayers with modified AGI below \$65,000 and married couples filing jointly with modified AGI below \$130,000. Single taxpayers with modified AGI not exceeding \$80,000 and married couples filing jointly with modified AGI not exceeding \$160,000 are entitled to a maximum deduction of \$2,000. ○○○

sion plus her spouse's unused \$2 million exclusion). Thus, with careful planning, couples are able to avoid estate taxes on up to \$10 million of property, without the need for trusts or other sophisticated estate planning vehicles.

If the surviving spouse is predeceased by more than one spouse, the additional exclusion amount carried

over to the surviving spouse is limited to the lesser of \$5 million or the unused exclusion of the last deceased spouse.

While the 2010 Tax Act made major changes to the estate and gift tax planning area, planning will remain difficult since the provisions are only in effect until December 31, 2012. ○○○

BUSINESSES

ENCOURAGED TO SPEND

The 2010 Tax Act extends numerous business tax provisions that had expired at the end of 2009, extending them for two years until December 31, 2011. However, the bigger news for businesses is the expansion of tax incentives for purchasing property:

100% BONUS DEPRECIATION — For certain new property acquired after September 8, 2010, and before January 1, 2012, businesses can elect 100% bonus depreciation, in essence writing off the entire cost of the asset in the year of purchase. A 50% bonus depreciation is available for qualified property placed in service in 2012, with only certain long-lived property and transportation property eligible for 100% expensing. This provision is not limited to small businesses and is not capped at a certain dollar value. In lieu of claiming additional first-year depreciation, a company can elect to claim additional research or minimum tax credits through December 31, 2012.

CODE SECTION 179 EXPENSING — To encourage business spending, for 2010 and 2011, businesses can expense, rather than depreciate, up to \$500,000 of new or used tangible personal property. That limit is reduced dollar-for-dollar by the amount of property placed in service in excess of the limit of \$2,000,000. While the 2010 Tax Act did not change those limits for 2010 and 2011, it did provide for a \$125,000 property limit indexed for inflation (instead of \$25,000) and a \$500,000 investment limit indexed for inflation (instead of \$200,000) for 2012. ○○○



WHAT'S THE COST?

The official cost of the 2010 Tax Act for the years 2011 to 2020 is \$858 billion, comprised of the following (in billions of dollars):

	Amount	% of Total
Extension of reduced individual tax rates	\$207	24.1%
Alternative minimum tax relief	137	16.0
Payroll tax reduction	112	13.1
Other individual tax relief extensions	76	8.9
Extension of child tax credit	72	8.4
Estate and gift tax relief	68	7.9
Extension of unemployment insurance	57	6.6
Extension of expiring tax provisions	54	6.3
Extension of reduced capital gains and dividend tax rates	53	6.2
Extension of business investment incentives	22	2.5
Total	858	100.0

(Source: Joint Committee on Taxation, December 2010)

Who will benefit from the 2010 Tax Act? The Tax Policy Center analyzed the 2010 Tax Act and determined the average federal tax change and percent change in after-tax income by income level:

	Average Federal Tax Change	% Change After-Tax Income
Less than \$10,000	\$140	-2.3%
\$10–20,000	121	-0.8
\$20–30,000	36	-0.2
\$30–40,000	-86	0.3
\$40–50,000	-198	0.5
\$50–75,000	-369	0.7
\$75–100,000	-679	0.9
\$100–200,000	-1,307	1.1
\$200–500,000	-1,897	0.8
\$500–1,000,000	45	0.0
Over \$1,000,000	14,157	-0.6
Overall	-269	0.5

(Source: Tax Policy Center, December 2010) ○○○

2011 MARGINAL TAX RATES BY TAX FILING STATUS

	Married Filing Jointly and Surviving Spouse	Single	Married Filing Separately	Head of Household
10%	\$0–17,000	\$0–8,500	\$0–8,500	\$0–12,150
15%	17,000–69,000	8,500–34,500	8,500–34,500	12,150–46,250
25%	69,000–139,350	34,500–83,600	34,500–69,675	46,250–119,400
28%	139,350–212,300	83,600–174,400	69,675–106,150	119,400–193,350
33%	212,300–379,150	174,400–379,150	106,150–189,575	193,350–379,150
35%	over 379,150	over 379,150	over 189,575	over 379,150

PLEASE CALL

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (2010 Tax Act) was signed into law on December 17, 2010. Many of the provisions extend the effective dates of current tax laws, but some significant new provisions were also enacted. The articles in this newsletter cover major provisions in the 2010 Tax Act in the areas of individual tax relief, estate tax changes, the payroll tax cut, education provisions, and business incentives. There are many more provisions in the 2010 Tax Act that may apply to individual situations. If you'd like to review your situation to determine how specific provisions may impact you, please call. ○○○