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An Analysis of Potential 2011 Income Tax Changes for Individuals and Families

Life insurance due care requires an understanding of the factors that impact policy performance and drive product selection.

M Financial Group continues to lead the industry in life insurance due care and client advocacy, providing valuable insight and analysis that delivers significant value to clients.

In the past decade, Americans have benefitted from significantly lower taxes. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), the Tax Relief and Health Care Act of 2006, and the American Recovery and Reinvestment Act (ARRA) of 2009 reduced income taxes and increased the number of available deductions and credits. These tax changes are collectively referred to hereafter as the "tax cuts."

Absent any action from Congress, many of the tax cuts provided by these acts will expire at the end of 2010. A summary of the results of these expirations can be found in Appendix A of this document. Following is an analysis of the potential consequences for affluent clients and some suggestions as to what actions may be considered in light of these pending changes.

Overview

Uncertainty remains with regard to the tax cuts that will be allowed to expire at the end of 2010, and those that will be extended by Congress. Considerable debate has taken place as to the possible outcomes and will continue through the fall. Experts believe the most likely scenarios include (in no specific order):

- Congress allowing all of the tax cuts to expire;
- Congress acting to extend all of the tax cuts into 2011;
- Congress passing the tax laws suggested in President Obama's budget, letting cuts expire for families making more than $250,000 a year (and singles making more than $200,000), as well as extending some stimulus measures and imposing new limitations on itemized deductions; and
- Congress passing tax laws recently proposed by congressional Democrats. This proposal is similar to the Obama plan but does not extend stimulus measures and does not impose additional limitations on itemized deductions.

While these may be viewed as the most likely scenarios, the partisanship of the current political environment and the contentiousness of the upcoming mid-term election mean that no option is off the table at this point.

Effects on Taxpayers

In general, the expiration of the tax cuts will result in an overall tax increase of 5-15 percent for most Americans. The affluent will likely be on the higher end of this range*. Other factors affecting the impact of the tax increases include marital status, state of residence, and amount of investment income:

- Married individuals filing jointly would see higher taxes resulting from a change to the standard deduction that will reduce it from 2x that of a single to approximately 1.67x that of a single.
- Individuals in states with low or no state income tax would be subject to higher federal income taxes.

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An Analysis of Potential 2011 Income Tax Changes (continued)

- Those with significant investment income would see a proportionate increase in taxes as capital gains, dividend, and ordinary income tax rates would all be increased.

Nicholas Kasprak of the Tax Foundation has developed an online calculator for estimating federal income taxes under each of the most likely scenarios. Appendix B of this document contains some examples derived from the Tax Foundation's website at http://www.mytaxburden.org.

**Some individuals, such as those who have been subject to the Alternative Minimum Tax (AMT) may not see an increase in taxes. Clients should consult their tax professional for a thorough understanding of the implications of rising taxes in their specific situations.*

Tax Strategies for 2010

In anticipation of tax law changes for 2011 and beyond, many advisors are recommending clients pursue five basic strategies:

- Claim additional ordinary income in 2010 at current tax rates;
- Defer charitable contributions and other potentially deductible payments until 2011;
- Sell investment assets in 2010 and paying taxes at current capital gains rates;
- Consider the purchase of tax-efficient investments, such as municipal bonds – an increased demand for these instruments in the future would drive down yields; and
- Increase allocations of cash to life insurance and deferred annuities, both of which feature tax-deferred build up of cash value.

The Value of Tax-Free Growth

Investments subject to increased taxes, be it capital gains, dividends, or ordinary income taxes, become less attractive as these taxes increase. Over time, the compounding effect of a 4.6 percent increase in taxes on an investment can be significant (35 percent is the highest marginal income tax rate for 2010 and 39.6 percent would be the highest marginal income tax rate in 2011 if the tax cuts are repealed).

	Hypothetical Example Effect of Interest Income Taxes on $100,000 Investment (Assumes 7% Gross Rate of Return)		
Value at Year	Without Taxes	Taxable Investment @ 35% Tax Rate	Taxable Investment @ 39.6% Tax Rate
1	$100,000	$100,000	$100,000
10	$183,846	$149,251	$145,164
20	$361,653	$232,893	$219,636
30	$711,426	$363,410	$332,313
40	$1,399,482	$567,071	$502,796

Conclusion

In 2011 there will likely be considerable changes to the federal income tax. Congress may still act to extend all or a portion of the provisions of EGTRRA, JGTRRA, the Tax Relief and Health Care Act of 2006, and/or ARRA before the conclusion of 2010. However, given the severity of the impending changes—and the uncertainty of the political and economic climate—primary consideration should be given to the potential impact on clients.

For More Information

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Appendix A
Federal Income Taxes

Federal income taxes may change in 2011 for income earners at all levels. In addition to broad changes to income tax rates and the taxation of investment income, many deductions will be reduced or eliminated, and certain tax credits will no longer be available.

Marginal Tax Rates

Perhaps the most significant potential change involves the schedule of marginal federal income tax rates. There are currently six tax brackets: 10 percent, 15 percent, 25 percent, 28 percent, 33 percent, and 35 percent. If the tax cuts are allowed to expire at the end of 2010, these would be replaced with five tax brackets: 15 percent, 28 percent, 31 percent, 36 percent, and 39.6 percent.

2010 Income Tax Brackets, Incremental by Taxable Income		
Tax Bracket	Married Filing Jointly	Single
10% Bracket	$0 – $16,750	$0 – $8,375
15% Bracket	$16,750 – $68,000	$16,750 – $34,000
25% Bracket	$68,000 – $137,300	$34,000 – $82,400
28% Bracket	$137,300 – $209,250	$82,400 – $171,850
33% Bracket	$209,250 – $373,650	$171,850 – $373,650
35% Bracket	More than $373,650	More than $373,650

Projected 2011 Income Tax Brackets if Tax Cuts Expire, Incremental by Taxable Income[1]		
Tax Bracket	Married Filing Jointly	Single
15% Bracket	$0 – $70,040	$0 – $35,020
28% Bracket	$70,040 – $141,419	$35,020 – $84,872
31% Bracket	$141,419 – $215,528	$84,872 – $177,006
36% Bracket	$215,528 – $384,860	$177,006 – $384,860
39.6% Bracket	More than $384,860	More than $384,860

[1] *Extrapolated from 2001 and 2010 Tax Tables; assumes 3% index of income brackets from 2010*

Return of the Marriage Penalty

If the tax cuts are allowed to expire, the standard deduction for married couples filing jointly will be reduced in 2011 from 2x that of a single to approximately 1.67x that of a single.

Capital Gains

Long-term capital gains are currently taxed at 0 percent for taxpayers in the 10 and 15 percent tax brackets and at 15 percent for filers in higher tax brackets. Beginning in 2011, if the tax cuts are allowed to expire, these tax rates will increase to 10 percent and 20 percent, respectively.

Dividends

Dividends are currently taxed at the capital gains rates of 0 percent for taxpayers in the 10 and 15 percent tax brackets and at 15 percent for filers in higher tax brackets. Beginning in 2011, if the tax cuts are allowed to expire, dividend income (other than capital gain distributions from mutual funds) will be taxed at ordinary income tax rates rather than at the lower long-term capital gains rates.

Appendix A cont.
Federal Income Taxes

Other Important Potential Changes to the Federal Income Tax if the Tax Cuts are Allowed to Expire at the End of 2010

In addition to the changes above, the following may occur:

- **Mortgage Insurance Premiums** became an allowable deduction for those with an Adjusted Gross Income (AGI) of $100,000 or less (indexed at 3 percent, simple) under the Tax Relief and Health Care Act of 2006. At the end of 2007, the PMI deduction was extended to premiums paid in 2008 through 2010. Absent any extension, deduction of Mortgage Insurance Premiums will no longer be allowed for 2011 and beyond.

- **The Payroll Tax Credit** of $400 per worker and $800 per couple made available under the American Recovery and Reinvestment Act (ARRA) of 2009 will expire unless it is extended. This credit is calculated at a rate of 6.2 percent of earned income and phases out for taxpayers with adjusted gross income in excess of $75,000 ($150,000 for married couples filing jointly).

- **529 Education Savings Plan** withdrawals for computer or Internet access were deemed Qualified Expenses under ARRA. Absent an extension, this provision only applies for 2009 and 2010.

- **American Opportunity Tax Credits** introduced by ARRA will no longer be available absent an extension. The provision offers tuition credits of up to $2,500 for qualified educational expenses.

- **Earned Income Tax Credit (EITC)** eligibility will now be determined using two additional sources of income: 401(k) deferrals and non-taxable combat pay. The EITC, which is intended to help low to moderate income individuals and families, is reduced as income increases.

- **The Child Credit** increased under EGTRRA will be halved from $1,000 to $500 and will become non-refundable to taxpayers with earned income in excess of $12,550. (A refundable credit is given to the claimant regardless of whether he/she pays federal income taxes. Currently, the Child Credit is refundable for up to 10 percent of earnings more than $10,000.)

- **The Child and Dependent Care Credit**, which offsets some of the costs of paying for child care to work or study, will be pared back from $6,000 to a maximum of $3,000.

Appendix B
Examples Under Possible Income Tax Scenarios

Assumptions			
Client Age	50	45	48
Tax Filing Status	Married, Filing Jointly	Married, Filing Jointly	Single
State of Residence	Oregon	Illinois	Florida
Home Value	$480,000	$400,000	$500,000
2011 Wages, salaries, and self-employment income – Head of Household	$400,000	$350,000	$500,000
2011 Wages, salaries, and self-employment income – Spouse	$50,000	$40,000	$0
Number of Dependents Under 17	One	Three	Zero
Number of Dependents 17 and Over	One, currently in college	Zero	Zero
Capital Gains (Short-Term)	$10,000	$8,000	$18,000
Capital Gains (Long-Term)	$15,000	$12,000	$22,000
Dividend Income	$5,000	$0	$2,000
Social Security Benefits	$0	$0	$0
State and Local Income Taxes (OR Residents pay $4k plus 9% of every dollar over $50,000) (IL Residents pay 3% flat) (FL has no Income Tax)	$30,000	$11,700	$0
Real Estate Taxes (OR Residents pay approximately 1.25%) (IL Residents pay approximately 8% of 1/3 of FMV) (FL Residents pay approximately 1.8% of Taxable Value)	$6,000	$10,400	$9,200
Other Itemized Deductions	$60,000	$30,000	$80,000
Child Care Expenses	$15,000	$25,000	$0

2011 Federal Income Tax Estimates			
Congress allows all of the tax cuts to expire	$116,335	$105,703	$149,942
Congress acts to extend all of the tax cuts into 2011	$109,542	$95,382	$129,614
Congress passes the tax laws in the Obama budget	$118,551	$100,030	$150,956
Congress passes the tax laws proposed by congressional Democrats	$109,542	$95,382	$141,786

Source: www.mytaxburden.org