

Income Tax Provisions of the 2010 Tax Relief Act

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In a January 2011 article we addressed the changes to the gift and estate tax provisions contained in the Tax Relief Act. Everything may change at the end of 2012 so it's more important than ever to really take a look at these provisions.

Income and Capital Gains Tax Rates. The current federal income tax rates will be retained for two years (2011 and 2012), with a top rate of 35% on ordinary income and 15% on qualified dividends and long-term capital gains.

Social Security Tax Break. In 2011, employees and self-employed workers will receive a reduction of two percentage points in Social Security payroll tax, bringing the rate down from 6.2% to 4.2% for employees and from 12.4% to 10.4% for the self-employed on a maximum earned income of \$106,800.

The Medicare tax rate remains the same: 1.45% for employees and 2.9% for the self-employed on all earned income. The income-tax deduction for the self-employed will be increased to 59.6% of the Social Security tax, and 50% of the Medicare tax.

Alternative Minimum Tax. A two-year Alternative Minimum Tax (AMT) "patch" for 2010 and 2011 will keep the AMT exemption near current levels and allow personal credits to offset AMT. Without the patch, an estimated 21 million additional taxpayers would have owed AMT for 2010.

Tax Credits. Key tax credits that benefitted working families and that were enacted or expanded in the American Recovery and Reinvestment Act of 2009 were retained by the Tax Relief Act. Specifically, the new law extends, for two years, the \$1,000 child tax credit and maintains its expanded refundability. The refundable credit equals 15% of earned income in excess of \$3,000.

The Tax Relief Act also extended rules expanding the earned-income credit for larger families and married couples and extended for two years the higher education tax credit (the "American Opportunity" credit) and its partial refundability.

Depreciation. Businesses can write off 100% of their equipment and machinery purchases, effective for property placed in service from September 9, 2010, through December 31, 2011. For property placed in service in 2012, the new law provides for 50% additional first-year depreciation.

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Tax Deductions. Many of the “traditional” tax extenders are extended for two years, retroactively to 2010 and through the end of 2011. Among many other provisions, the Tax Relief Act extends (a) the election to take an itemized deduction for state and local general sales taxes in lieu of the itemized deduction for state and local income taxes; (b) the \$250 above-the-line deduction for certain expenses of elementary and secondary school teachers; and (c) the above-the-line deduction for higher education expenses.

The Tax Relief Act also retroactively reinstates, for 2010 and 2011, the exclusion from gross income of up to \$100,000 of qualified charitable distributions directly from a regular IRA or Roth IRA, provided the taxpayer is at least 70½ years old. A qualified distribution made in January 2011 can be treated as made in 2010 for purposes of the \$100,000 limitation and the required minimum distribution (RMD) for 2010.

A FEW TIPS

Give to Charity. You don’t have to meet a threshold to deduct your charitable donations. As long as you give to an IRS-qualified organization within the tax year, you usually can claim it as an itemized deduction for the full amount that you give.

Adjust Your Withholding Rate. Make sure you are having only the amount you need withheld from your paycheck. If you over-withhold federal taxes, you’ll get a big refund, but you’ve given up your hard-earned dollars for the other 364 days of the year. On the other hand, do not under-withhold, or you’ll end up owing the IRS at filing time.

Evaluate Educational Accounts for Kids. College costs increase every year, but tax-advantaged savings accounts can help. The key is determining which plan best suits your needs. For example, every state offers a 529 plan, and, although plan contributions are not tax-deductible, the earnings are not taxed. In addition, when you take out funds to pay for eligible expenses, the distributions are also tax-free.

Start a Business. Whether you operate your own business as your main source of income or as a sideline venture, tax laws offer several ways to save. As described above, the tax deduction for equipment and other business-related tools and machinery has been increased. Other popular business tax breaks, such as writing off new business startup costs, and many home office expense deductions also still apply.

Adapted from the Daily Plan-It newsletter.

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