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What Will Happen If the Bush Tax Cuts Are Allowed to Expire?

Background

As you know, the so-called Bush tax cuts (from legislation enacted in 2001 and 2003) are scheduled to expire at the end of this year. But, you may not understand the full extent of what is in store for you if Congress simply sits back and allows the expirations to occur without making any changes. Here's the little-known truth. Appendix 1 contains a summary of 2010 versus 2011 rates and amounts if the Bush cuts expire as scheduled.

Higher Income Tax Rates for All

Some may believe that only individuals in the top two federal income tax brackets will face higher rates when the Bush cuts go bye-bye. Not true! Unless Congress takes action and President Obama goes along, rates will automatically go up for everyone who pays taxes---not just "the rich." Specifically, the existing 10% bracket will go away, and the lowest "new" bracket will be 15%. The existing 25% bracket will be replaced by the "new" 28% bracket; the existing 28% bracket will be replaced by the "new" 31 % bracket; the existing 33% bracket will be replaced by the "new" 36% bracket; and the existing 35% bracket will be replaced by the "new" 39.6% bracket. [See IRC Sec. 1 (i).] Appendix 1 shows income levels in each of these brackets for 2010 and 2011 assuming that there are no inflation adjustments between 2010 and 2011.

Outlook: The Administration has pledged to keep the three lowest brackets (the 10%, 15%, and 25% brackets) in place. The 28% bracket would be expanded to accommodate unmarried taxpayers with income (whatever that is determined to mean) below \$200,000 and joint filers with income below \$250,000. Only taxpayers with income above those levels would be affected by the new 36% and 39.6% rates. As we said, however, Congress must make changes, and the president must go along for these things to happen. Right now, that's looking more problematic than a few months ago, and it now appears that Congress won't even bring up the subject until sometime after returning from its summer recess in August. To sum up, the only thing we know for sure is that tax rates will go up for everyone if Congress sits on its hands.

Marriage Penalty Will Get Worse

Right now, the 10% and 15% rate brackets for married joint-filing couples are 200% as wide as the 10% and 15% brackets for singles. Similarly, the standard deduction for joint-filing couples is 200% of the amount for singles. Right now, the 10% and 15% rate brackets for those who use married filing separate status are the same as the 10% and 15% brackets for singles. Similarly, the standard deduction for those who use married filing separate status is the same as the standard deduction for singles. The Bush tax cuts put this relatively favorable framework for married individuals in place to reduce the so called marriage penalty, which can cause a married couple to pay more federal income tax than if they were single. Note that the marriage penalty still exists for many married couples, but it's not as harsh as before the Bush tax cuts. [See IRC Secs. 1(f) and 63(c).] However, unless Congress makes changes and the president goes along, the marriage penalty will automatically get worse when the Bush tax cuts expire.

Starting next year, the new lowest bracket of 15% for Married Filing Joint (MFJ) couples will be only 167% as wide as the 15% bracket for singles---for Married Filing Separate (MFS) couples, it'll be 83.5% as wide as the 15% bracket for singles. Similarly, the new standard deduction for joint-filers will be only 167% of the standard deduction for singles. For MFS



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status, it'll be only 83.5% of the amount for singles. See Appendix 1 for 2010 versus 2011 amounts assuming no inflation adjustments for 2011.

Outlook: Presumably, the Administration's pledge to keep things the same for lower and middle-income taxpayers includes extending the Bush tax cut elements that reduce the impact of the marriage penalty. However, extending those elements would require Congress to make changes and the president to go along. Will it happen? We don't know, and neither does anyone else.

Itemized Deduction Phase-out Rule Will Return with a Vengeance

Before the Bush tax cuts, a nasty phase-out rule could eliminate up to 80% of affected itemized deductions for bigger-income individuals. The phase-out rule covered the big-ticket deductions for mortgage interest, state and local taxes, and charitable donations. Deductions for medical expenses, investment interest expense, casualty and theft losses, and gambling losses were not affected. Thanks to the Bush tax cuts, the phase-out rule was gradually eased and finally eliminated this year. Next year, however, it will automatically return with a vengeance, unless Congress takes action and the president goes along.

If nothing changes, clients will lose \$1 of affected deductions for every \$3 of AGI in excess of the applicable AGI threshold (subject to the 80% disallowance limitation), starting next year. As shown in Appendix 1, the threshold for 2011 is estimated to be \$171,100 (or \$85,550 for those who use MFS status). (See IRC Sec. 68.)

Outlook: The Administration has said it wants the phase-out rule back, but at higher AGI thresholds of \$250,000 for married joint-filing couples and \$200,000 for other taxpayers. However, raising the AGI thresholds would require Congress to take action and the president to go along. Don't bet the house on it.

Personal Exemption Phase-out Rule Will Return with a Vengeance

Before the Bush tax cuts, another nasty phase-out rule could eliminate some or all of a higher-income individual's personal exemption deductions. Thanks to the Bush tax cuts, this phase-out rule was gradually eased and finally eliminated this year. Starting next year, it will automatically return with a vengeance, unless Congress takes action and the president goes along. [See IRC Sec. 151(d)(3).]

If nothing changes, clients need to be ready for yet another bite out of their wallets if their 2011 AGI exceeds the applicable threshold. As shown in Appendix 1, the phase-out thresholds for 2011 are estimated to be \$256,700 for MFJ; \$171,100 for singles; \$213,900 for heads of households; and \$128,350 for MFS.

Outlook: The Administration has said it wants the phase-out rule back, but at different AGI thresholds: \$250,000 for married joint-filing couples, \$200,000 for unmarried individuals, and \$125,000 for those who use married filing separate status. Since this is pretty close to what will happen without any making changes, it would not be surprising if Congress chooses to do nothing.

Higher Capital Gains and Dividends Taxes for All

Right now, the maximum federal rate on garden-variety long-term capital gains and qualified dividends is 15%. (As you know, a 25% maximum rate applies to unrecaptured Section 1250 gains, and a 28% maximum rate applies to long-term gains from collectibles.) Starting next year, the maximum rate on garden-variety long-term capital gains will increase to 20% (or 18% on gains from assets held for over five years). Starting next year, dividends will once again be taxed at ordinary income rates. So, the maximum rate on dividends will balloon to a whopping 39.6%.

Right now, a 0% federal rate applies to garden-variety long-term capital gains and qualified dividends collected by folks in lowest two rate brackets of 10% and 15%. Starting next year, folks in the "new" lowest bracket of 15% will have to pay 10% on long-term gains (or 8% on gains from assets held for over five years) and 15% on dividends (since dividends will be taxed



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at ordinary income rates). Again-these things will happen automatically, unless Congress takes action and the president goes along. [See IRC Sec. 1 (h).]

Outlook: The Administration has repeatedly said the current 0% and 15% rates on long-term capital gains and qualified dividends will be left in place except for married couples with income above \$250,000 and unmarried individuals with income above \$200,000. For this to happen, however, Congress must take action and the president must go along. A few months ago that looked likely, but now it looks more problematic. In particular, we think the odds are rising that dividends will once again be taxed at ordinary rates (of up to 39.6%), starting next year. We hope we are wrong.

Some Bush Tax Cuts Are Likely to Be Continued

Some elements of the Bush tax cuts have gained bipartisan support and become "extenders." They will probably be continued, despite the scheduled demise of the Bush tax cuts. Examples include inflation-indexed AMT exemption amounts, the ability to use nonrefundable personal tax credits to offset individual AMT liabilities, the above-the-line deduction for qualified higher education tuition and fees, and the increased Section 179 deduction. We also think the current versions of the child tax credit, earned income credit, dependent care credit, and adoption credit are also likely to be continued, despite the scheduled demise of other elements of the Bush tax cuts. (The Bush tax cut legislation liberalized these credits, and later legislation liberalized them even more).

Conclusions

Despite what some people think, the Bush tax cuts don't just help "the rich." They help just about anyone who pays federal income taxes, including folks who only file returns to collect free money from the government thanks to refundable tax credits. The scheduled demise of the Bush tax cuts next year will hurt lots of people, unless Congress makes changes and the president jumps on board. We did not even get to the fate of the Bush estate tax cuts. That's a whole separate story, and it's even more up in the air than the fate of the Bush income tax cuts. Stay tuned for developments, but don't hold your breath. Our Washington politicians don't seem to be in a big hurry to resolve the many tax uncertainties that we have summarized here. Even worse, it appears the odds are increasing that we may not see resolution until after the November election. Good grief!

References: IRC Secs. 1, 63, 151, and 179.

This Tax Action Memo was written by Tax Action Panel member William R. Bischoff, CPA of Colorado Springs, Colorado.

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Appendix 1-2010 Versus 2011 Rates and Amounts If Bush Tax Cuts Expire as Scheduled

	2010	2011
Standard Deductions		
Joint or Qualifying Widow(er) (MFJ)	\$ 11,400	9,520 ¹
Single	5,700	5,700 ¹
Head of Household (HOH)	8,400	8,400 ¹
Married Filing Separately (MFS)	5,700	4,760 ¹
Long-term Capital Gains (LTCGs) Tax Rate	0% / 15% ²	10% / 20% ³
Dividend Tax Rate	0% / 15% ²	015% to 39.6% ⁴
Ordinary Income Tax Rates:		
Beginning of 15% Bracket		
MFJ	\$ 16,750 ⁵	\$ 0
Single	8,375 ⁵	0
HOH	11,950 ⁵	0
MFS	8,375 ⁵	0
Beginning of 25% ⁶ / 28% ⁷ Bracket		
MFJ	\$ 68,000	\$ 58,200 ⁸
Single	34,000	34,850 ⁸
HOH	45,550	46,650 ⁸
MFS 34,000 29,100 ⁸		
Beginning of 28% ⁶ / 31% ⁷ Bracket		
MFJ	\$ 137,300	\$ 140,600 ⁸
Single	82,400	84,350 ⁸
HOH	117,650	120,500 ⁸
MFS 68,650 70,300 ⁸		
Beginning of 33% ⁶ / 36% ⁷ Bracket		
MFJ	\$ 209,250	\$ 214,250 ⁸
Single	171,850	176,000 ⁸
HOH	190,550	195,150 ⁸
MFS	104,625	107,125 ⁸
Beginning of 35% ⁶ / 39.6% ⁷ Bracket		
MFJ, Single, HOH	\$ 373,650	\$ 382,650 ⁸
MFS	186,825	191,325 ⁸
Gift and Estate Tax		
Applicable Exclusion Amount (Estate Tax)	\$ N/A ⁹	\$ 1,000,000
Gift Tax Exemption	1,000,000	1,000,000
Gift Tax Annual Exclusion	13,000	13,000 ¹
Beginning of Personal Exemption Phase-out		
MFJ	\$ N/A ⁹	\$ 256,700 ⁸
Single	N/A ⁹	171,100 ⁸
HOH	N/A ⁹	213,900 ⁸
MFS	N/A ⁹	128,350 ⁸
Beginning of Itemized Deduction Phase-out		
MFJ, Single, HOH	\$ N/A ⁹	\$ 171,100 ⁸
MFS	N/A ⁹	85,550 ⁸
Child Tax Credit	\$ 1,000	\$ 500
Section 179 Deduction	\$ 250,000	\$ 25,000
Qualifying Property Limit	800,000	200,000
SUV Deduction Limit	25,000	25,000

¹ Estimate based on 2010 amounts with no inflation adjustment.

² The 0% rate applies to the extent the taxpayer hasn't fully utilized the 10% and 15% ordinary income tax brackets.

³ The 10% rate applies to the extent the taxpayer hasn't fully used the 15% ordinary income tax bracket. Also, the 10% / 20% rates are reduced to 8% / 18% on gains from assets held for over five years. ⁰

⁴ Dividends will be taxed as ordinary income. Therefore, the tax rate can be as high as 39.6%, depending on the taxpayer's marginal tax bracket

⁵ Income below these amounts is taxed at 10%. The 10% rate will not apply in 2011.

⁶ Rate for 2010.

⁷ Rate for 2011.

⁸ Estimate provided by the Joint Committee on Taxation report to the Senate Finance Committee.

⁹ For 2010, the estate tax, phase-out of personal exemptions, and phase-out of itemized deductions do not apply.



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