

What the New Tax Law (Might) Mean for you

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On December 17, 2010, President Obama signed into law the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010, informally known as the 2010 Tax Relief Act (H.R. 4853) or the Obama compromise plan.

If you work, pay taxes, own investments, have a child in college, are over 70-1/2, or anticipate a death in 2011, the new tax law has something for you.

- Here are the main provisions of the new law:
- Continuation of the 2010 individual tax rates for 2011 and 2012
- Continuation of 2010 capital gains and qualified dividends rates for 2011 and 2012
- Extension of the American Opportunity Tax Credit through 2012
- Extension of tax-free distributions from IRAs to charity, for 2010 and 2011
- Employee payroll tax cut from 6.2% to 4.2% for 2011 only
- Estate tax exclusion of \$5 million with top rate of 35%, for 2011 and 2012

Extension of tax rates

Financial planners breathed a sigh of relief after the tax act passed. Finally, there was clarity. Tax and financial planning depends upon the tax rate table because it tells you the rate at which your last dollar of income will be taxed. So if you are contemplating an investment that pays ordinary income, you'll know how much federal income tax you'll owe on that additional income. Conversely, if you are considering a tax-saving strategy, such as contributing to a qualified retirement plan, you'll know how much that strategy will save you in taxes. For example, if you are in the 33% tax bracket and contribute an additional \$10,000 to a qualified retirement plan, it will save you \$3,300 in taxes.

Investors also got some clarity on capital gains tax rates. The 15% rate on capital gains and qualified dividends was extended through 2012. For investors in the 10% or 15% tax bracket, the capital gains tax rate continues to be zero.

Planning opportunity: Meet with your tax and financial advisors early in the year and determine

what your marginal tax rate is likely to be in 2011. Let this number help guide your investment activities during the year. But don't let the tax tail wag the investment dog. Always consider the investment merits first.

Extension of American Opportunity Tax Credit

If you have a child or grandchild in college, you may be able to claim a tax credit for qualified tuition and related expenses. The credit is equal to 100% of the first \$2,000 in expenses, plus 25% of the next \$2,000, for a maximum credit of \$2,500 per student per year. This credit replaced the Hope credit for 2009 and 2010 and had been set to expire after 2010. The 2010 Tax Relief Act extends it for two more years, through 2012. It applies to all four years of college, not just the first two years like the Hope credit.

The full credit is available to taxpayers with modified adjusted gross incomes of up to \$80,000 for single taxpayers, or \$160,000 for married couples filing joint tax returns. A partial credit may be available if income is above these levels. If you are considering some of the other education tax benefits, such as the tuition and fees tax deduction, it will be important to coordinate them because you cannot claim more than one tax benefit for the same expenses.

Planning opportunity: If you will be writing checks for school expenses this year, meet with your advisors to find out how you can maximize tax benefits and take advantage of other educational resources. And if your kids are not yet college age, ask about tax-efficient ways to save for their education.

Tax-free distributions from IRAs to charity

For several years now, IRA holders over 70-1/2 have been able to make a direct contribution from their IRA to charity without it affecting their taxes. The distribution is not taxable, and the contribution is not tax-deductible – an important

benefit for people who do not itemize or otherwise would not be able to fully utilize the deduction. The contribution also satisfies the annual minimum distribution requirement.

This tax break has been very popular among IRA holders and their favorite charities, but it expired at the end of 2009. With the 2010 Tax Relief Act it has been revived for 2010 and 2011. What's more, since it passed so late in the year, Congress gave IRA holders through the month of January 2011 to make their contribution and have it count for 2010. This will give you and your charities time to make the transfer. Also, if you happened to have missed your RMD for 2010, the January grace period allows you to avoid penalties – as long as you direct the money to charity.

Planning opportunity: If you are over 70-1/2, talk to your favorite charities about setting up an ongoing program of direct contributions from your IRA. If you are not yet 70-1/2, ask your financial advisor about how required minimum distributions work; there may be some things you can do now to reduce your tax burden once your IRAs become subject to RMDs.

Reduction of FICA tax

If you work and pay into Social Security, your paycheck will go up in 2011. For one year only, the employee's share of the payroll tax will be reduced by 2% to 4.2%. Self-employed individuals will pay 10.4%. This tax is assessed on earnings up to \$106,800 in 2011 and does not affect the 1.45% Medicare tax, which is assessed on all earnings.

This payroll tax reduction will not affect your future benefits. The government will make up the lost income by transferring an estimated \$120 billion from the general Treasury to the Social Security trust fund. This is the first time in the history of Social Security that a transfer will be made from the general Treasury; up to now Social Security has always been completely self-financed.

Franklin Roosevelt insisted upon this from the very beginning in order to keep Social Security from being perceived as a welfare program. He wanted workers to feel a legal and moral right to collect benefits based on the contributions they had made over their working lives. Now, despite its enormous popularity, some people are worried that Social Security will lose favor if it is perceived as adding to the federal deficit.

Planning opportunity: Consider what you will do with an extra 2% of wages in your pocket. On an income of \$106,800 or more, that amounts to \$2,136. The government hopes you will spend it to stimulate the economy. But directing it into your retirement account might not be a bad idea. And if you're close to Social Security age, talk to your advisor about the right time to claim benefits; there may be some innovative claiming strategies you haven't considered.

Reinstatement of the estate tax

People who died in 2010 didn't have to pay any estate taxes, even if they left billions to their heirs. But there was one feature of the one-year-only estate tax repeal that may not have been too popular with heirs: they also inherited the deceased person's cost basis. So while the estate may have saved on estate taxes, the heirs may now be sitting on large unrealized capital gains that they will someday owe capital gains taxes on.

However, that's not the end of the story. For 2011 and 2012 the estate tax comes back, and with it the step-up in basis. The exemption amount is \$5

million per person, and the top tax rate is 35%. With the 2010 Tax Relief Act, people who died in 2010 were given a choice between the 2010 and 2011 estate tax regimes. Lawyers and accountants will be busy figuring the tax both ways in order to help executors choose.

The new estate tax also comes with what is called portability, which will be advantageous to husbands and wives. If one spouse dies without using up his entire \$5 million exemption, the remaining amount may be added to the surviving spouse's exemption amount. This may eliminate the need for a bypass trust to accomplish the same objective.

Planning opportunity: Now that we have clarity on the estate tax – for a couple of years at least -- estate planning can be done with more confidence. Don't put it off. Make an appointment early in the year to meet with an estate planning attorney and get your affairs in order. You'll be glad you did.

Elaine Floyd, CFP®, is the Director of Retirement and Life Planning, Horsemouth, LLC., where she focuses on helping people understand the practical and technical aspects of retirement income planning. Horsemouth is an independent organization providing unique, unbiased insight into the most critical issues facing financial advisors and their clients. Horsemouth was founded in 1996 and is located in New York City.

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