TAX INCREASES FOR INDIVIDUALS START JANUARY 1, 2011

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A hot topic in and outside of Washington D.C. is the upcoming changes to the federal income tax rates for individual taxpayers, scheduled to take effect on January 1, 2011. The Bush tax cuts for the wealthy will "sunset" after their statutory 10-year period and either the Obama Administration will enact its FY 2011 budget, or the tax rates in effect prior to the Bush tax cuts will return. Either way, without a legislative fix, one thing is certain: many U.S. taxpayers, whether resident in the United States or Canada (or elsewhere), will face higher tax bills for income earned after January 1, 2011.

In addition, the U.S. estate tax continues to be in flux, making estate planning especially difficult. Like the federal income tax rates, if January 1, 2011 arrives without legislative action on the U.S. estate tax, many U.S. citizens and domiciliaries will face significantly higher U.S. estate taxes.

Income Taxes

With respect to income taxes, there's quite a bit of confusion about what, exactly, will happen on January 1, 2011, since there are at least three different scenarios in play. First, if the U.S. Congress does nothing in the waning months of 2010, income tax rates will simply revert to what they were prior to the Bush tax cuts of 2001 and 2003 ("the pre-Bush rates"). Second, President Obama's proposed 2011 budget could be enacted ("the Obama rates"). And finally, it's possible that legislation will be passed either temporarily extending or making permanent the Bush tax cuts of the last several years ("the status quo"). Although these various scenarios have implications for many dozens of federal income tax provisions, our focus is on those that are most commonly encountered by U.S. individual taxpayers—the ordinary income tax brackets, the capital gains tax rate, and the tax rate on dividend income.

Assume John and Jane Smith, married U.S. citizens who file a joint tax return, earn $500,000 of ordinary wage income each year, as well as $100,000 of dividends from a U.S. corporation and $100,000 of capital gains from the disposition of stock held for more than one year. Assuming no deductions, exemptions, and the like, and estimating the 2011 tax bracket thresholds, the Smiths' federal income tax bill in 2011 will vary depending on which regime is in effect, as described below.

Status Quo

If the status quo applies in 2011, when the top income tax rate applicable to individuals is 35 percent, the Smiths could pay approximately $145,310 of federal income taxes on their wages. However, the dividend income, assuming it is a qualified dividend, is taxed at only 15 percent, resulting in a tax of $15,000, as are the long-term capital gains, which also results in a tax of $15,000. For 2011, then, the Smiths' federal income tax bill would be approximately $175,310.

Pre-Bush Rates

If the current rates are allowed to expire and no tax legislation is passed enacting different rates, in 2011, the pre-Bush rates will be in force, and there will be two federal income tax brackets in excess of the current top rate of 35 percent. They are 36 percent for married and filing jointly with taxable income between approximately $237,300 and $382,650, and 39.6 percent for married and filing jointly with taxable income over approximately $382,650. The Smiths would therefore pay approximately $161,730 of federal income taxes on their wages. Moreover, dividend income would also be treated as ordinary income and taxed at the marginal rate, which in the Smiths' case would be 39.6 percent, resulting in a tax of $39,600. The pre-Bush rate on long-term capital gains would be 20 percent, which results in a tax of $20,000. For 2011, the Smiths' federal income tax bill would be approximately $221,330.

Obama Rates

If Obama's proposed FY 2011 budget is enacted, the Smiths' scenario isn't all that different from the pre-Bush rates scenario, given their earnings level, except that (i) the Smiths would pay approximately $153,200 of federal income tax on their wages (rather than the pre-Bush $161,730), and (ii) their dividend and capital gain income will be taxed at the same rate, 20 percent, resulting in a total federal income tax bill in 2011 of approximately $193,200.

The most significant differences between the Obama rates and the pre-Bush rates are that the Obama rates for capital gains will stay at 15 percent for taxpayers with AGI up to approximately $250,000 (married filing jointly) and $200,000 (single), but increase to 20 percent for all taxpayers above that threshold. Moreover, under the Obama rates, the tax rates for dividends would be tied to the capital gains tax rate (15 percent to 20 percent) rather than taxed as ordinary income (up to 39.6 percent) as in the pre-Bush rate scenario.

Although it is unclear what Congress will do in the coming months, especially given the upcoming midterm elections, there is a significant chance that taxpayers in the upper income tax brackets (generally $250,000 if married filing jointly and $200,000 if single) will pay higher taxes starting January 1, 2011. This presents current planning opportunities. For example, although income deferral is usually the goal of tax planning, given the upcoming tax rate changes on long-term capital gains and ordinary income for taxpayers in higher tax brackets, there may be scenarios where accelerating income into 2010 may produce a better tax result.

Estate Taxes

If Congress fails to act on the U.S. estate tax by the end of this year, January 1, 2011 will also bring about a significantly different—and harsher—U.S. estate tax system for both U.S. citizens and domiciliaries and non-U.S. individuals owning U.S.-situs assets, such as stock in U.S. companies and real estate located in the United States.

In 2001, President Bush implemented estate tax law amendments that gradually increased the estate tax exemption and reduced the top estate tax rate over the last decade, so that in 2009, the estate tax exemption was at an all-time high of $3.5 million and the top rate was 45 percent. The Bush changes culminated in the U.S. estate tax's repeal for 2010, which is estimated to cost the U.S. Treasury billions of dollars in lost revenue in 2010 unless an estate tax is enacted retroactively for 2010, a prospect that becomes more unlikely with each passing day.

The estate tax system in effect before the Bush changes is scheduled to return on January 1, 2011, so after 2010, the top estate tax rate will be 55 percent, and the exemption will be only $1 million for U.S. citizens and domiciliaries. The return of the pre-Bush estate tax system would also affect nonresidents of the United States who own U.S.-situs property because such individuals are generally only entitled to a significantly lower exemption amount.

Reverting to pre-2001 law will significantly increase the estate tax's reach and effect. As exemptions increased and rates decreased over the last decade, the estate tax touched fewer U.S. citizens. Many more Americans—including those who consider themselves middle class—will become subject to federal estate tax exposure, although the 55 percent rate does not kick in until a decedent has at least $3 million of assets. For example, consider Sue and Steve Taylor, who are both U.S. citizens. They own a home worth $500,000, have $250,000 in retirement assets, and each owns an insurance policy on the other's life with a $1 million death benefit. Their total estate is $2.75 million, but their total combined exemptions under pre-2001 law are only $2 million. Therefore, their estate would pay estate tax of approximately $250,000 in 2011 if pre-2001 law returns (and without proper planning for use of the exemptions, the actual estate tax could be much higher). While estate tax could still be avoided altogether in the Taylors' situation by planning, such as through the use of life insurance trusts, this is a far different scenario than they would have been in under the 2009 estate tax rules, which provided a $3.5 million exemption for each person, and thus would have eliminated estate tax for the Taylors.

If the estate tax reverts to pre-2001 rules, a U.S. citizen or domiciliary with assets in excess of $1 million should carefully consider estate planning options to reduce exposure to U.S. estate tax. These include ensuring that assets owned by spouses are held in a way that maximizes available exemptions, ensuring that life insurance is held in trust, gifting, and other planning techniques like family limited partnerships and GRATS, once considered necessary only for wealthier people.

A continual flow of bills introduced in the U.S. Congress to alter the scheduled estate tax reversion—either increasing the exemption, reducing the top rate, or both—have failed to gain traction. Republicans and Democrats are sharply divided over appropriate exemption amounts and rates: Democrats seem willing to restore the 2009 rules ($3.5 million exemption and 45 percent top rate) and Republicans want higher exemptions and lower rates ($5 million exemption or more and 35 percent top rate). Failure to agree is a loss for both parties, but the lingering recession, large budget deficit, and government debt burden make it difficult to justify any exemption increase or rate reduction that is not offset by other revenue raisers. A recent Congressional analysis tagged the revenue loss of continuing the 2009 estate tax system for 10 years at an enormous $253 billion. Moreover, the highly contentious upcoming midterm elections also make 2010 action on the estate tax seemingly unlikely, at least until late November.

Looking Ahead

Now, approximately two-thirds of the way through 2010, it remains to be seen which income tax and estate tax regime will be in effect beginning January 1, 2011. However, it is reasonably clear that, at least for higher income taxpayers, the U.S. capital gains and dividend tax rates will likely increase, and the highest marginal tax rate on ordinary income will be 39.6 percent. There is still time to consider the impact of the upcoming U.S. federal income tax rate changes that will go into effect on January 1, 2011, as well as planning strategies to address them. And any current business structuring for individuals should take these upcoming rate changes into consideration as well. The potential changes to the U.S. estate tax may mean estate planning will become important for a much greater number of taxpayers.

Stay tuned for what should be an interesting fall in the U.S. Congress.

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