Tax Update

2011: A Happy New Year for Taxpayers

The two-year extension of 2010 tax rates for all income levels brought welcome clarity to the new year. The following summary focuses on the income tax provisions that are most likely to affect Bessemer clients and their families.

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 includes several important provisions:

Income Tax. The new legislation provides a two-year extension of 2009 income tax rates for all taxpayers, regardless of income level. As such, the top marginal rate on ordinary income will remain 35%; long-term capital gains and qualified dividends will retain a top rate of 15%.

Had the Bush-era tax cuts expired as scheduled at the end of 2010, the top marginal tax rate on ordinary income would have increased from 35% to 39.6%, and the top rate on long-term capital gains would have jumped from 15% to 20% (an increase of more than 33%). Equity investors are happy to see that dividends will continue to be taxed at 15%, instead of the previously scheduled 39.6% (an increase of 164%).

Stealth Tax. Itemized deductions, such as mortgage interest, property taxes, state income taxes, and charitable contributions, have long been a lynchpin of our income tax system and a means to limit taxable income. Yet over the past two decades these deductions have been limited or "phased out" for higher-income taxpayers, thereby creating a "stealth tax" — higher tax liability without an actual increase in tax rates. This provision, which can disallow up to 80% of otherwise allowable itemized deductions, was fully repealed for 2010 but set to return in 2011. Fortunately, the new legislation extends the repeal of this provision through 2012. For many higher-income taxpayers, this can greatly increase the value of itemized deductions such as charitable contributions.

Alternative Minimum Tax (AMT). Although the legislation included a "patch" to save millions of middle-income taxpayers from an unexpected AMT liability, unfortunately many Bessemer clients will still be subject to this additional tax. However, tax projections and planning can help to minimize its bite.

Qualified Charitable Distributions (QCDs). From 2006 through 2009, taxpayers aged 70½ or older could contribute up to $100,000 annually to qualified charities directly from their IRA and apply this toward their required minimum distribution amount. The new legislation extends this beneficial treatment to distributions made in 2010 and 2011. Since this provision is retroactive to January 1, 2010, QCDs made earlier in the year will qualify.

Because the extension of QCD treatment for 2010 was not finalized until December 17, a special rule was added to allow taxpayers more time to take advantage of this beneficial provision. For one month only, eligible taxpayers will be able to treat QCDs made in January 2011 as if they were made in 2010. Under this special rule, taxpayers may obtain QCD treatment up to $200,000 in 2011 if they contribute $100,000 in January of this year.

On the Horizon

And lest we forget, there will be a new tax in 2013. This so-called "Medicare tax" was included as a funding provision for the major healthcare legislation passed last year. For higher-income taxpayers, this adds an extra 3.8% tax to passive income such as interest, dividends, and capital gains. If no intervening tax legislation is passed, the tax rates will not only revert to their levels before the Bush tax cuts, but will also increase an additional 3.8% because of the Medicare tax (Exhibit 1).

The potential percentage increases are indeed daunting, as shown in the last column of Exhibit 1, with the tax rate on dividends now scheduled to nearly triple in 2013.

While the fog of uncertainty over income taxes has been lifted for now, it is sure to return to the national forefront as we move closer to 2012 elections. Deficit reduction and tax reform are likely to be prominent issues for the new Congress and the president. As always, we will keep you informed during the tax tempest that is sure to rage in Washington for the next two years. In the short term, we are thankful for greater certainty on the tax front.

For more information, please contact your Client Account Manager or one of Bessemer's Senior Tax Consultants.

Exhibit 1: Top Tax Rates

	2011	2012	2013	Percentage Increase Over 2012 Rate
Passive Income, Interest, Short-Term Capital Gain	35%	35%	43.4%	24%
Long-Term Capital Gain	15%	15%	23.8%	59%
Qualified Dividends	15%	15%	43.4%	189%