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2010 TAX RELIEF ACT - BUSH CUTS IN GENERAL

By Victor Sy, CPA

The heart of the recently enacted Tax Relief Act (Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010) is a two-year extension of the Bush tax cuts.

Bush tax-cut legislation

The Bush tax cuts refer primarily to tax changes in two major pieces of legislation:

- The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and
- The Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA).

The 2001 legislation (EGTRRA) was a 10-year $1.35 billion tax cut package which was the largest tax cut since 1981. Key elements of EGTRRA included:

- Lowering individual income tax rates from 15%, 28%, 31%, 36%, 39.6% to 10%, 15%, 25%, 28%, 33%, 35%.
- Doubling the child tax credit from $500 to $1,000.
- Gradual reduction in estate taxes, culminating in one-year repeal in 2010 (but reinstatement in 2011).

But the crucial element of the 2001 tax cuts, at least for current purposes, is that they were temporary, set to expire at the end of 2010 unless Congress acted to extend them.

The 2003 legislation (JGTRRA) accelerated certain tax changes passed in EGTRRA, but the centerpiece of the law was a cut in the top capital gains rate from 20% to 15% and a cut in the top individual rate on dividends from 35% to 15%. Under the 2003 legislation, the capital gains and dividends cuts were set to expire after 2008, but they were later extended for two additional years (until 2010).

So when people talk about the “Bush tax cuts,” they are referring, for the most part, to the provisions in the 2001 and 2003 Acts that lowered individual income tax rates and cut the top rates on capital gains and dividends.

New law extends lower tax rates for all taxpayers for two years:

Over the past several years, a lot of political energy has been expended on the issue of whether the favorable individual income tax rates, which were set to expire at the end of 2010, should be extended for everyone, or for everyone except the “rich.”

The new law settles the issue by extending the lower rates for all taxpayers. Under the new law, the rates that have been in effect in recent years -10%, 15%, 25%, 28%, 33%, and 35% - will remain in place. However, the extension is only for two years through 2012.

New law extends lower capital gains rates for two years:

Capital gains refers to the profits realized on sales of non-inventory assets. For individuals, capital gains are generally taxed at a preferential rate in comparison to ordinary income. The amount of tax depends on both the investor's tax bracket and how long the investment was held before being sold. Short-term capital gains on investments held for a year or less are taxed at the investor's ordinary income tax rate. Long-term capital gains, which apply to assets held for more than one year, are taxed at a lower rate than short-term gains.

Since 2008, the tax rate on long-term capital gains has been 0% for individuals in the 10% and 15% income tax brackets, and 15% for everyone else. However, those rates were scheduled to expire at the end of 2010, as explained above, with the result that in 2011 the long-term capital gains tax rate would have risen to 20% (10% for taxpayers in the 15% tax bracket) if Congress had not acted. The new legislation forestalls these increases by extending the 0% and 15% long-term capital gains tax rates for two years (through 2012).

New law extends lower rates for qualified dividends for two years:
Since 2003, “qualified dividends” have been taxed at the same low tax rates that apply to long-term capital gains. For dividend income falling in the higher tax brackets, the rate is 15%. In the first two brackets (where ordinary income is taxed at 10% and 15% rates), the dividend rate is 0%.

To count as “qualified,” dividend-paying common stocks must be held for at least 61 continuous days before the ex-dividend date - the last purchase day for collecting the dividend. For preferred stock, the required holding period is 91 days before the ex-dividend date.

The low rates for qualified dividends, like the other Bush tax cuts, were scheduled to expire at the end of 2010. If Congress had not acted, beginning in 2011 taxes on dividends would have returned to the rates that were in effect before 2001, and all dividend income received in 2011 would have been taxed as ordinary income. Since the top income tax rate was scheduled to return to 39.6%, individuals could have paid as much as a 39.6% tax on dividends.

The new legislation prevents that from happening by continuing the tax regime in effect for qualified dividends (treatment as long-term capital gains, subject to a 0% tax rate for individuals in the 10% and 15% tax brackets and a 15% tax rate for all other taxpayers) for two years through 2012.

I hope this information is helpful. If you would like more details about the extension of the Bush tax cuts as well as audits, appeals, income, deductions, corporations, LLCs and other tax matters, please visit our website at www.victorsycpa.com and go to 300 TAX TIPS A-Z.