# 2011: Year of the Tax Man

The current personal income tax rates will expire beginning January 1, 2011. If Congress does not act to extend the current tax rates, the tax burden will increase for *all* income levels, not just the wealthy.

**The Disappearing Income Tax Cuts:** The 2001 and 2003 Bush income tax cuts lowered tax rates throughout the income range and reduced capital gains taxes. But if the provisions are not made permanent, these reduced rates will expire soon. The tax bracket for the lowest income-earners will rise from 10 percent to 15 percent; the highest earners will face an increase from 35 percent to 39.6 percent. Data from the Joint Committee on Taxation shows that at least 55 percent of the revenue raised by increasing the top two rates would come from small business income. That amounts to an estimated $8.69 billion increase in small business taxes in 2011 alone. (See "Soaking the Rich and Drenching Small Business.")

In addition to federal taxes, states impose income, property and other taxes that raise the total tax burden on small business. As a result of these state levies, if the Bush tax cuts expire:

- A small business in Texas would pay a maximum marginal tax rate of 42.5 percent (the lowest in the nation).
- A small business in Oregon would pay a maximum marginal tax rate of 53.5 percent (the highest in the nation).

Raising marginal tax rates in 2011 will not result in more tax revenues for the government. As rates increase, people become incentivized to game the system. Thus, tax revenue as a percentage of GDP tends to remain historically unchanged. (See, "The Limit of Tax Revenues.")

**The Attack on Capital Gains and Dividends.** Under current law, capital gains on assets held more than a year are taxed at a flat 15 percent rate for most taxpayers. The capital gains of taxpayers in the 10 percent and 15 percent federal income tax brackets are not taxed at all. Capital gains on assets held less than a year are taxed at an individual's ordinary income tax rate. In 2011, however:

- Long-term capital gains tax rates will increase from 15 percent this year to 20 percent.
- Dividends will be taxed at marginal income tax rates of up to 39.6 percent.

Thus, for high-income earners the after-tax rate of return on a capital gain (for example, the sale of a stock held for at lease one year) would fall by more than 10 percent, or nearly one percentage point. (See "New Taxes on the Wealthy are Bad News for Everyone").

**New Medicare Taxes on the "Wealthy."** If the 2011 tax increases are not enough to digest, beginning in 2013, the new health care reform law will impose an additional 0.9 percent Medicare tax on wage income for individuals earning more than $200,000 a year and couples earning more than $250,000. This will be added to the existing 2.9 percent Medicare tax split

between employees and employers. In addition, the new law imposes a 3.8 percent Medicare tax on unearned income, such as rent, royalties, dividends and capital gains for the same high-income earners. (See "New Taxes on the Wealthy are Bad News for Everyone").

**The Reappearing Estate Tax.** The Bush tax cuts gradually lowered the top tax rate from 55 percent to 45 percent for 2007 to 2009. The amount of an estate exempted from the tax rose from $650,000 to $2 million in 2007 and 2008, and to $3.5 million in 2009. These rates are scheduled to sunset in 2011, when the estate tax will return and rates will revert to those in effect prior to 2001 - up to 55 percent. Only the first $1 million of an estate will be exempt.

*A Second Layer of Estate Taxation: The Generation-Skipping Tax***.** In addition to the estate tax, there is an added tax - called the generation-skipping tax (GST) - if a bequest goes to a grandchild or other relative more than one generation removed from the decedent. The GST rate is equivalent to imposing a 45 percent tax on the estate (as if it had gone to a child), and then imposing another 45 percent rate on the remaining 55 percent of the estate (as if it had gone from the child to the grandchild).

In 2007, the top rate for the combined GST/transfer tax reached nearly 70 percent. Prior to 2001, the top rate with the GST was just under 80 percent. The GST will return to its pre-2001 levels along with the estate tax in 2011. (See "The High Marginal Cost of the Estate Tax," "The Politics of Estate Tax Reform" and "Estate Tax Myths.")

**Penalizing Marriage Again.** Prior to the Bush tax cuts, an estimated 25 million couples paid a penalty for being married in 1999, amounting to about $1,141 per couple. However, the Bush tax cuts of 2001 made the income bracket for married couples twice that of single filers for incomes up to the 25 percent tax bracket. That virtually eliminated the marriage penalty for low- to moderate- income workers, and mitigated it for higher-income earners. The marriage penalty will return if the Bush tax cuts are allowed to expire:

- In 2007, a married couple filing jointly with taxable income of $25,000 and $75,000 actually paid about $685 less than if they were single.
- If the couple filed separate returns, they paid about $322 more in taxes than if they were single.
- If the Bush tax cuts expire, a married couple filing jointly in 2011 will pay about $619 more than the two singles; if the couple files separately, the penalty will be $1,280!

In this sense, the marriage penalty is more of a penalty on working than on marriage itself. If the marriage penalty returns and couples face higher tax rates, second-earner spouses will have less incentive to work. Finally, the standard deduction of $11,400 for joint filers will revert to less than twice the deduction for single filers (currently $5,700).

**Taxing the Kiddos.** The tax credit for taxpayers with children will fall 50 percent, from $1,000 to $500. (See "Will Congress Penalize Marriage Again?")

***Low- and middle-income families will be hit hardest by these changes in 2011.***