Details of New Tax Law Changes Signed into Law by President Obama

Stable rates on investment income

One of the biggest concerns among investors has been what would happen to tax rates on long term capital gains and dividends if the Bush tax cuts were allowed to expire on December 31. Some had contemplated selling appreciated assets before the end of the year just to take advantage of current low capital gains rates. Without congressional action, tax rates on the profits of assets sold after more than a year would have increased to 20%, and dividends would have reverted to being taxed at ordinary income rates as high as 39.6% starting in 2011. But now that it's clear that tax rates will remain the same through 2012, it's back to year end tax planning as usual: defer income, such as bonuses, into next year when possible and accelerate deductions into the current year to minimize your taxable income.

Tax rates on long term capital gains and qualified dividends will remain at a maximum 15% through 2012, and those in the two lowest income tax brackets – 10% and 15% - will continue to enjoy a 0% capital gains rate. So if you decide to rebalance your portfolio before the end of the year, follow your usual course action: If sales and capital gains distributions to date have produced a net gain, consider selling assets that will produce a loss to offset the profits... and the tax bill that goes along with them. If you wind up with net long term gains, you'll pay just 15% on your profits. If your income losers outweigh your winners, you can use up to $3,000 of losses to offset ordinary income, such as wages, and carry over any excess losses to future years.

Bigger Paychecks for most

One of the major elements of the tax package is a one year reduction in the payroll tax that funds Social Security. FICA taxes will drop from 6.2% to 4.2% for most workers. Since the tax applies to up to $106,800 in 2011, the tax cut is worth as much as $2,136 for a worker or $4,272 for a working couple. (The self-employed will pay 10.4% on income up to the cap, down from 12.4% in 2010) The 1.45% portion of payroll taxes that funds Medicare will continue to apply to all earnings with no cap.

But not everyone will benefit from the payroll tax holiday. Workers who do not participate in the Social Security system, such as some public school teachers and many civil servants, will see no reduction in their payroll taxes. And some federal employees will get hit with a double whammy: no break on payroll taxes and a wage freeze next year.

Some lower income workers may also feel as if Santa left them a lump of coal in their stocking. Although they will benefit from the lower payroll tax, the tax break will not be as generous as the Making Work Pay credit that reduced their taxes by up to $400 for individuals and up to $800 for married couples in 2010.

For example, a married couple making $36,000 will see their payroll taxes reduced by $720 in 2011. Compared to the $800 Making Work Pay tax credit they enjoyed in 2010, their taxes would increase by $80 next year. But for an individual earning $36,000 that same $720 reduction in payroll taxes in 2011 will represent a $320 tax cut compared to the $400 tax credit he or she enjoyed in 2010.

In general, higher income taxpayers will benefit across the board from the payroll tax reduction. For example, a married couple earning $75,000 per year will pay $1,500 less in payroll taxes in 2011, nearly twice the size of the $800 tax credit they benefited from in 2010. And a couple earning $150,000 who were not eligible for the Making Work Pay credit this year, will see their Social Security payroll taxes decline by the maximum $2,136 in 2011.

No cap on exemptions, deductions

Upper income taxpayers will also benefit from no limit on their itemized deductions and the personal exemptions that they claim for themselves, their spouse and dependents. In the past, those tax benefits were reduced above certain income levels. Caps on both deductions and personal exemptions were eliminated for 2010, and the legislative package extends those valuable tax breaks through 2012.

Middle class dodge the AMT

The compromise tax package boosts the exemption levels for the alternative minimum tax, protecting more that 20 million middle income taxpayers from being snagged by the parallel tax system that disallows most tax deductions and exemptions. The AMT, designed 40 years ago to ensure that the loophole savvy wealthy paid at least some taxes, has never been indexed for inflation. So over the decades, the AMT has morphed from a class tax into a mass tax, prompting Congress to approve temporary patches each year to lift the AMT exemption level and spare millions of middle class taxpayers from becoming unintended victims of the stealth tax. The package increases the AMT exemption levels for 2010 and 2011.

More breaks for education costs

The popular American Opportunity tax credit, worth up to $2,500 to offset the high cost of college, was scheduled to expire at the end of 2010. Now it has been extended through 2012. The full credit, which reduces your tax bill dollar for dollar, is available to individuals with incomes of up to $80,000 and married couples with joint income of up to $160,000. The credit phases out above those income levels, disappearing at $90,000 for individuals and $180,000 for married couples. The tax package also extends more generous contribution levels and qualified tax free distributions for Coverdell Education Savings Accounts, which can be used to fund elementary and secondary school expenses in addition to college costs. Maximum contribution levels had been slated to drop from $2,000 to $500 per year beginning in 2011, and tax free distribution would have been limited to college expenses. The package extends existing funding and distribution rules through 2012.

Two year reprieves

A host of other popular tax breaks that had expired at the end of 2009 have been reinstated for 2010 and 2011. You'll appreciate them when you file your taxes next spring. They include:

-A choice between deducting state sales taxes or state income taxes
-A tax deduction of up to $4,000 for college tuition costs available to some taxpayers whose incomes are too high to qualify for the American Opportunity credit.
-A deduction of up to $250 that teachers can claim for out of pocket expenses for classroom supplies, even if they don't itemize their deductions
-And the ability of taxpayers who are age 70 ½ or older to donate up to $100,000 of their IRA's directly to a charity and exclude the amount of their donation from their taxable income.

More generous estate tax

The most controversial element of the tax package is a reinstatement of the federal estate tax, which had temporarily disappeared in 2010, with a higher exemption level and a lower rate than in the past. Beginning in 2011, estates valued at $5 million or less ($10 million or less for married couples) will escape the federal estate tax completely, and estates above those thresholds would be taxed at a 35% rate. House Democrats, who had been excluded from negotiations on the package, rallied against the deal, which they claimed is a giveaway to the rich. But in the end, they failed in efforts to ratchet down the exemption to the $3.5 million level that had been in effect in 2009 before the estate tax expired and to increase the tax rate to 45%.