

# Will You See Higher Tax Rates in 2011?

The year was 2001. The top marginal federal income tax bracket was 39.6%, and the tax rate that applied to most long-term capital gains was 20%. Then the Economic Growth and Tax Relief Reconciliation Act of 2001 arrived, followed two years later by the Jobs and Growth Tax Relief Reconciliation Act of 2003. By mid-2003, the top marginal tax rate was 35%, and the 20% capital gains rate had dropped to 15%. But this tax relief was designed to be temporary--the provisions that established lower rates were crafted to self-expire after a period of time. And now, in 2010, we're only months away from seeing those provisions expire.

## Federal income tax brackets

Right now, there are six marginal income tax brackets: 10%, 15%, 25%, 28%, 33%, and 35%. For 2010, these brackets apply to married couples filing joint federal income tax returns in the following manner:

| <b>2010 Marginal Income Tax Brackets<br/>Married Filing Jointly</b> |                          |
|---------------------------------------------------------------------|--------------------------|
| <b>Taxable Income</b>                                               | <b>Marginal Tax Rate</b> |
| Not over \$16,750                                                   | 10%                      |
| Over \$16,750 to \$68,000                                           | 15%                      |
| Over \$68,000 to \$137,300                                          | 25%                      |
| Over \$137,300 to \$209,250                                         | 28%                      |
| Over \$209,250 to \$373,650                                         | 33%                      |
| Over \$373,650                                                      | 35%                      |

As it stands now, these marginal tax brackets will expire at the end of 2010. There would be no 10% bracket for 2011, and the remaining bracket rates would return to their original 2001 levels: 15%, 28%, 31%, 36%, and 39.6%.

## Long-term capital gain tax rates

For 2010, if you sell shares of stock that you've held for more than a year, any gain is long-term capital gain, generally taxed at a maximum rate of 15%. If you're in the 10% or the 15% marginal income tax bracket, however, you'll pay no federal tax on the long-term gain (a 0% tax rate applies). That means if you're a married couple filing a joint federal income tax return, and your taxable income is \$68,000 or less, you'd pay no federal tax on the gain.

However, these rates are also scheduled to expire at the end of 2010. Absent new legislation, in 2011, a 20% rate will generally apply to long-term capital gains. Individuals in the 15% tax bracket (remember, there won't be a 10% bracket in 2011) will pay the tax at a rate of 10%. Special rules (and slightly lower rates) will apply for qualifying property held for five years or more.

Finally, while qualifying dividends are taxed in 2010 using the same capital gain tax rates described above (i.e., 15% and 0%), in 2011 they'll be taxed as ordinary income.

Will Congress take action?

In the proposed 2011 budget submitted to Congress in February, President Obama asked for a permanent extension of the current 10%, 15%, and 25% marginal income tax brackets, and an expansion of the current 28% tax bracket. The current 33% and 35% brackets would be allowed to expire, resulting in the top two marginal rates for 2011 returning to 36%

and 39.6%. The expanded 28% bracket would be calculated in a way that would allow individuals earning less than \$200,000 (less the standard deduction amount and one exemption) and married couples filing jointly earning less than \$250,000 (less the standard deduction and two personal exemptions) to escape taxation at the top rates.

The President also proposed making the current tax rates that apply to long-term capital gain (i.e., the 0% and 15% rates) permanent, but adding a new 20% rate for those in the newly reestablished 36% and 39.6% brackets.

Will Congress act, or will it simply let current rates expire? There's plenty of time before 2011, so stay tuned ...

## **Ask the Experts: My child got a scholarship for college. Is it taxable?**

In certain situations, yes. If a scholarship is used to pay for college tuition, fees, books, or required equipment, it's not taxable. But if the scholarship is used to cover room and board, travel costs, or optional equipment, or if it's awarded as payment for teaching, research, or some other required service, then it is taxable.

With most scholarships, the recipient can decide how to apply the money. Your first instinct may be to have your child apply it to tuition, fees, or books (making it tax free). But be aware that this may impact your ability to claim the Lifetime Learning or the American Opportunity (formerly the Hope) tax credits. That's because these credits are based on the amount of tuition and fees you pay, and any tuition and fees paid with a tax-free scholarship can't be counted when calculating your credit.

This rule has the most impact on your ability to claim the Lifetime Learning credit, worth up to \$2,000. Why? This credit is calculated as 20% of the first \$10,000 of tuition and fees, so a hefty scholarship applied to these expenses may leave you with less than \$10,000 in eligible tuition and fees to count toward the credit. The American Opportunity credit, worth up to \$2,500, is calculated differently--100% of the first \$2,000 of tuition and fees, plus 25% of the next \$2,000 of such expenses. (You can only take one of these credits in a given year for the same student.)

If the scholarship has no restrictions on how it can be applied (and assuming you meet the income limits to take the credits--each credit has different income limits), consider running some numbers to determine your best option: (1) apply the scholarship to tuition and enjoy its tax-free status, but reduce the amount of eligible tuition that can be used to calculate the tax credits, or (2) apply the scholarship to room and board and pay income tax on the scholarship, but allow all tuition to be counted when calculating the credits. When running the numbers, keep in mind that generally a tax credit is more valuable than a tax deduction because it reduces your taxes dollar for dollar.

For more information, see IRS Publication 970, Tax Benefits for Education.