

TAX RELIEF ACT:

# Extensions Spell Relief for Investors



The tug-of-war between deficit reduction and tax relief has been settled – for now. Setting aside the need to balance the Federal budget, Congress acted instead on behalf of the taxpayer.

In December, Congress passed, and the President signed, the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (the “Tax Relief Act.” The complex name is a reflection of the breadth of the bill. In addition to extending the Bush-era tax cuts, the bill:

- Cuts social security taxes for employees for one year
- Extends unemployment insurance for the unemployed for 13 months
- “Patches” the Alternative Minimum tax (AMT)
- Allows families to pass on more of their estates to their heirs free of tax

The cloud inside this silver lining is that the majority of the cuts expire in two years and it’s uncertain in most cases what will happen in 2013. The fluidity and complexity of the U.S. tax code serves as a sharp reminder for investors. With tax day rapidly approaching, they should consult with their financial professionals and CPAs as soon as practical to ensure that they keep more of what they earn.

From a big-picture point of view, the bill for most Americans and provides some much-needed clarity around the tax code that’s been missing for the last couple of years. The Bush tax cuts were set to expire at the end of 2010, which would have increased taxes for nearly all taxpayers, especially at the higher income levels. Let’s look at some of the major provisions:

## Income tax rates

The most notable aspect of the Tax Relief Act is the two-year extension of the 2003 tax cuts. The income tax brackets remain in place for 2011 and 2012 at the following rates: 10, 15, 25, 28, 33 and 35%. Without a congressional compromise, the top bracket would have reverted to the pre-Bush rate of 39.6%. The question for Washington observers and taxpayers is what happens when the extension expires after 2012, and whether Congress will be more willing to raise taxes in a healthier economic climate. This could impact not only tax rates but capital gains and dividend taxes as well.

We know one thing for sure about 2013 – Medicare taxes will go up. The Medicare tax rate on households with earned income greater than \$250,000 will jump from 1.45% to 2.35%. The same increase will occur for singles with earned income over \$200,000.

Also, there is a new Medicare surtax of 3.8% on net investment income applying to the same groups mentioned above. Net investment income can include interest, dividends and capital gains and can be offset by investment-related expenses.

## Big break for workers

One of the more historic and unprecedented elements of the bill is the one-year reduction in Social Security taxes. The employee's portion of the tax has been reduced from 6.2% to 4.2% for 2011 only.

For someone who earns \$106,800 – the maximum amount subject to Social Security – they'll save \$2,136. There were no changes to the Medicare portion of Social Security, which is currently 1.45 % for both employer and employee.

Employers, however, were not so fortunate. Their share of the tax remains at 6.2%, although the rate for self-employed taxpayers drops from 12.4 to 10.4%.

*What should workers do with that one-year tax savings? Why not put it into an IRA?*

## Patching the AMT

No less significant is the "patch" to the Alternative Minimum Tax or AMT. It's dubbed a "patch" because it's only a temporary band-aid – two years – on a long-term problem. The patch will increase the exemption amounts for 2010 to \$47,450 (\$72,450 married filing jointly) and to \$48,450 (\$74,450 married filing jointly) in 2011.

## Here are the 2011 Federal income tax brackets:

2011 Tax Brackets	Income – Single	Income – Married Filing Jointly
10% Bracket	\$0 – \$8,500	\$0 – \$17,000
15% Bracket	\$8,500 – \$34,500	\$17,000 – \$69,000
25% Bracket	\$34,500 – \$83,600	\$69,000 – \$139,500
28% Bracket	\$83,600 – \$174,400	\$139,500 – \$212,300
33% Bracket	\$174,400 – \$379,150	\$212,300 – \$379,150
35% Bracket	\$379,150+	\$379,150+

Source: IRS.gov

The AMT was originally put in place to ensure people at high income levels pay taxes, but because it wasn't indexed for inflation, it has pushed more and more middle income taxpayers into the AMT-taxable status. Under these changes, millions of investors will be spared from the AMT, although we'll have to wait and see whether Congress can fix it permanently.

### Extending many deductions

Homeowners, taxpayers with college-age children, and small-business owners all stand to benefit from a potpourri of tax relief extensions. Under the Tax Relief Act, taxpayers can:

- Make tax-free distributions of up to \$100,000 from IRAs to charities
- Take above-the-line deductions for qualified tuition and related higher education expenses, including Coverdell savings accounts and the American Opportunity Credit
- Deduct state and local sales taxes
- Receive a 30% credit for energy-efficient home improvements
- Continue to deduct mortgage insurance premiums (PMI)
- Exclude qualified small-business capital gains

### Keeping those capital gains

Congress also kept in place the favorable rates for capital gains and dividends. Both will continue to be taxed at 15% through 2012, and at 0% for taxpayers in the 10% and 15% brackets. Rates would have reverted to 20% or higher had the cuts been allowed to expire.

### Preserving your estate for heirs

No less significant was the compromise on estate, gift and generation-skipping transfer taxes. Under the new bill, a 35% rate with a \$5 million exclusion for individuals and \$10 million for couples will remain in place for two years. It is estimated that these provisions will cut the number of estates subject to tax by one-third. If no compromise had been reached, the pre-Bush rate of 55% with a \$1 million exclusion would have been reinstated.

It's also worth noting that Congress has made the estate tax exclusion "portable" between spouses, meaning that if one spouse dies, any unused exclusion may be used by the surviving spouse.

Interestingly, gift taxes were revised to match estate taxes. For 2011-2012, the gift and estate tax exclusion are "reunited" at \$5 million, with a gift tax rate of 35%.

*Here's a planning idea for investors. Consider taking advantage of gifting over 2011 and 2012 to reduce the size of your estate. Also consider using Grantor Retained Annuity Trusts (GRATS).*

### Max out your retirement plan contributions

While contributions to retirement plans were not affected by the Tax Relief Act, we would be remiss if we did not address them in a discussion about tax management. Limitations on retirement plan contributions are indexed annually and today are sufficiently high to make a marked difference in the tax bill of many taxpayers. The chart below details the limits and catch-up provisions for various types of qualified savings plans. Talk to your financial professional or accountant about whether you're eligible to defer additional income.

Taxpayers should also confer with their financial professional on the potential benefits of converting IRA or retirement plan assets to a Roth IRA. While they're not for everybody, the benefits of a Roth are numerous:

- Tax-free compounding
- No Required Minimum Distributions at age 70½
- Tax-free withdrawals for beneficiaries

### Retirement Plan Limitations for 2010 & 2011

Limitation	2010 / 2011
Maximum annual contribution to qualified plan	\$49,000
401(k), 403(b), 457 maximum elective deferral limit	\$16,500
SIMPLE plan elective deferral limit	\$11,500
Traditional IRA / Roth IRA contribution limit	\$5,000
Catch-up contribution limit – (401(k), 403(b), 457) (over age 50)	\$5,500
Catch-up contribution limit – SIMPLE (over age 50)	\$2,500
Catch-up contribution limit – traditional / Roth IRA (over age 50)	\$1,000

Also, with Federal tax rates remaining consistent through 2012, investors can do partial Roth conversions each year and pick up the conversion income on their 2011 and 2012 tax returns.

For investors trying to build long-term wealth, taxes can be a major drag on earnings. They work like a riptide, pulling against investors, slowing progress towards their goals. But your financial professional has many tools at his or her disposal to minimize the negative impact of taxes on your wealth. Whether it's placing you in tax-exempt investments, or orchestrating tax-management strategies like loss harvesting and tax-aware trading, your financial professional can help you to keep more of your hard-earned investment gains and move you closer to achieving your life's goals.



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**To hear more about the Tax Relief Act and important tax-management strategies, we encourage you to contact us today.**