

THE BERNSTEIN REPORT

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Dear Reader,

At the time this letter was written, no Congressional action has yet been taken regarding the expiration or "sunset" of the so-called "Bush tax cuts." If no action is taken several things will happen for 2011, including the following:

- replacement of the current 35 percent maximum marginal tax rate on ordinary income with two top income brackets taxable at 36 and 39.6 percent (with the 36 percent rate kicking in for married taxpayers filing jointly somewhere between \$200,000 and \$250,000 of taxable income)
- elimination of the current 25 and 33 percent rates; and the return of the 31 percent rate
- elimination of the current lowest tax rate bracket of 10 percent, resulting in a 15 percent lowest rate.

For long-term capital gains, the maximum rate would increase from 15 to 20 percent, and the lower rate applicable to gains that would fall into the 15 percent marginal income-tax bracket would increase from the current rate of zero to 10 percent. Remember, though, that the lower maximum rates on capital gains apply only to long-term gains - gains from the sale of assets held for more than one year. Net short-term capital gains are taxable at ordinary tax rates.

With regard to dividends, the situation is different. For 2010, the rates on long-term capital gains also generally applies to qualified dividends. Without Congressional action, dividends will be taxed in 2011 under ordinary income tax rates (hence, taxable up to 39.6 percent), and will no longer receive any preferential tax treatment on individual tax returns.

The big mysteries at this point are (1) will Congress act to alter the sunset scenario and (2) what will be the resulting tax treatment of Americans moving forward in 2011 and beyond. One interesting and unusual aspect of this situation is that everyone seems to want to do something; i.e., retain certain elements of the current expiring provisions. There are various political pressures attached to each expiring provision. The problem is that there is wide disagreement as to exactly what provisions should be extended.

Cordially,

Richard S. Bernstein

**A Second Opinion Costs You NOTHING,
But Could Save You MILLIONS!**

**WHEN IT COMES TO YOUR HEALTH, YOU GET A SECOND OPINION,
SHOULD YOUR FINANCIAL WEALTH BE ANY DIFFERENT?**

YEAR END TAX PLANNING TIPS FOR 2010

There are many factors to be considered in planning for year-end tax strategies before 2011 arrives. The discussion below covers some of the important issues that affect taxpayers as we face a legislative environment that is still uncertain regarding several key strategies. The closer we get to the end of the year without a resolution of the fate of expiring tax laws, the more intense the scramble of year end planning will become.

Expiring Tax Rates on Ordinary Income, Capital Gains, and Dividends

The cover letter outlines the changes to income-tax rates, long-term capital gain rates and taxation of dividends in 2011, assuming no intervening Congressional action is taken regarding these provisions. This is where more uncertainty comes into play with respect to any planning concerning this situation. If Congress does take action, there are various possibilities. A political compromise could be reached that extends certain portions of the Bush administration's legislation. For example, President Obama would like to retain the 10 percent tax rate on the lowest ordinary income tax bracket, and have a 5 percent tax rather than 10 percent on long-term capital gains for taxpayers whose total taxable income does not exceed the 15 percent tax bracket (\$68,000 for married taxpayers filing jointly in 2010, \$34,000 for single taxpayers). However, many members of Congress also want to extend the lower 2010 rates on both ordinary income and capital gains to upper-income taxpayers (for example, the 35 percent maximum tax rate and the 15 percent overall maximum capital gains rate would continue to apply at upper income levels). The November election will certainly play a part in determining the outcome of these disputes.

Is there a bottom line here? One conclusion that appears obvious is that the maximum rates on ordinary income and capital gains are not likely to go down below 2010 levels in 2011. They can either be expected to stay the same or go up. That means that the planning technique of "accelerating" income – making income taxable in 2010 rather than 2011 (where legitimately available) carries minimal downside risk, particularly for upper-income taxpayers. Such taxpayers will very likely either benefit from that technique or at least break even, assuming all other factors are equal. In any case, both taxpayers and advisors could benefit now probably more than ever from the elusive ability to predict the future.

Itemized Deduction Phaseout Possible for 2011

The so-called "phaseout" rules that in prior tax years reduced the benefits of both personal exemptions and most itemized deductions for upper-income taxpayers are currently scheduled to return to the tax landscape in 2011. These phaseouts have been completely eliminated for the 2010 tax year, making itemized deductions and exemptions fully available without regard to income level. For 2011, upper-income taxpayers (such as marrieds filing jointly with adjusted gross income over approximately a quarter million) will again have their deductions and exemptions reduced unless Congress legislates otherwise.

If Congress acts to repeal the phaseouts of exemptions and itemized deductions for 2011, these items may become more beneficial next year if marginal income tax rates also go up. If rates don't go up and the phaseouts don't apply, then the benefit of these items will be roughly equivalent in 2010 and 2011. However, if the phaseouts do return for upper-income taxpayers, itemized deductions could be more valuable for some taxpayers if they are "bunched" into the 2010

tax year rather than paid in 2011 when the phaseout would apply again. Until we know what the law will be, the planning here is uncertain.

Capital Cost Recovery Provisions under the “Small Business Jobs Act of 2010”

Increased Amount of First-Year Expensing Election for 2010 and 2011. The area of cost recovery deductions, including the depreciation and the first-year expensing deduction, has been enhanced by recently enacted legislation. The “expensing” election allows business taxpayers to claim a higher total cost recovery deduction in the year that eligible depreciable property is placed in service by providing a deduction in addition to the regular depreciation deduction. For 2009, the maximum amount per taxpayer for first-year expensing was \$250,000 of the cost of all eligible property. The Jobs Act has doubled this limit to \$500,000 per taxpayer for tax years beginning in 2010 or 2011.

Also, the “phaseout” threshold applicable to the expensing limit has been dramatically increased from \$800,000 to \$2,000,000 for 2010 and 2011. This phaseout threshold refers to the total amount of the cost of property eligible for the expensing election that is placed in service by a taxpayer during the year. The amount, if any, by which such total cost exceeds the threshold amount will reduce the allowable first-year expensing deduction dollar for dollar for that year. The increases in the expensing amount and the phaseout threshold provide tax opportunities for year-end purchases of qualifying property, as well as an additional benefit for property already placed in service this year with a cost in excess of the prior limit of \$250,000. The bottom line is that there are currently significant tax incentives to make capital investments in small businesses.

Certain Real Property Eligible for First-Year Expensing in 2010 and 2011. Before the Jobs Act, property eligible for first-year expensing was limited to depreciable tangible personal property (including “off the shelf” computer software) purchased for use in a trade or business. For 2010 and 2011, business taxpayers are eligible to claim expensing for certain types of real property, including qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property. Note, however, that the maximum dollar amount eligible for expensing for eligible real property is \$250,000, rather than the increased overall limit of \$500,000. Any amount of expensing claimed for real property will also be applied against the overall \$500,000 limit. Remember that only the portion of the cost of real estate that is attributable to buildings or similar improvements (not land) is eligible for cost recovery deductions.

50 Percent “Bonus” Depreciation Available for 2010. This provision allows taxpayers to claim an additional first-year depreciation deduction equal to 50 percent of the property’s cost. The bonus applies to most depreciable property with a cost recovery period of 20 years or less. This provision was in effect for 2009, but was not previously scheduled to apply in 2010. With respect to depreciable property that also qualifies for the expensing election, the bonus depreciation can be claimed in addition to the expensing election. Note that the bonus depreciation provision was extended only through 2010 for most eligible property. It is not currently scheduled to be generally available for 2011. Therefore, taxpayers who can benefit from it may consider purchasing qualifying property before the end of the year.

\$8,000 Increase in First-Year “Luxury Auto” Cap on Cost Recovery Deductions Extended through 2010. Cost recovery deductions for depreciable passenger automobiles are subject to special limitations on an annual basis. For the year the auto is placed in service, the overall limit per vehicle

(including any depreciation and expensing deductions) was generally \$3,060 for 2010. The Jobs Act provides that the additional amount of \$8,000 that was available for autos placed in service in 2009 will also be available for 2010. This means that the total cost recovery deduction available for an eligible vehicle placed in service in 2010 will be \$11,060 (\$3,060 plus \$8,000). Note that this limit applies to the total of all available cost recovery deductions per vehicle, including depreciation, bonus depreciation, and first-year expensing deductions. Like the extension of bonus depreciation, this increased allowance for passenger autos is not currently scheduled to apply in 2011. Accordingly, the year-end purchase of a car used for business may provide a greater tax benefit in 2010 than in 2011.

Health Insurance Premiums and the Self-Employment Tax

Self-employed taxpayers have been granted a nice tax benefit under the 2010 Jobs Act. However, at least for now, this benefit is scheduled to apply only in 2010. It allows the self-employed to deduct their health insurance premiums for purposes of calculating the amount of self-employment income that is subject to the 15.3% self-employment tax. Many readers may be aware that the self-employed are already permitted to deduct health premiums in determining adjusted gross income for purposes of the federal income tax. However, before now, the health premiums were deducted separately from the self-employment income calculation. This meant that even though the premiums would reduce the amount of self-employment income subject to the federal income tax, they would not reduce the amount of income subject to the self-employment tax for Social Security and Medicare funding. For 2010, both taxes will be reduced by the premiums. Since health premiums are expensive, this benefit is significant. Taxpayers affected by this provision should be sure to pay any monthly premium for January 2011 before the end of the year.

Social Security Wage Base and Benefits

Once again, the amount of earnings subject to the OASDI tax (6.2 percent payable by both employees and employers and 12.4 percent payable by self-employed taxpayers) is scheduled to remain at \$106,800 for 2011 under government inflation calculations. That is OK for workers. However, the flip side is that under the same calculations, Social Security recipients again will not receive an inflation-based increase in their benefit checks in 2011. With bond yields at historic lows, money market funds paying virtually nothing, and retirement benefits staying flat, the economic pressure on individuals who rely on fixed income to pay living expenses continues to mount. Hopefully, such individuals will not feel forced to increase their exposure to investment risk in order to obtain higher yields on their accumulated funds.

This Tax Letter is intended to assist you to conserve your estate and to protect the interests of your family and business associates. Estate planning involves the joint services of a competent Trust Officer, Attorney, Accountant, and Life Underwriter. The experience and advice of each is generally essential.

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