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New Rules for 2011, Part I – Income Tax Changes

The new year has brought a number of tax law changes at both the federal level and the state level in Illinois. While there was good news from the federal government on income tax rates and other extenders, a significant income tax increase was recently enacted in Illinois. Estate taxes have returned after a one year hiatus in 2010, and a number of changes have been made to federal gift and generation skipping (GST) tax rules. We intend to cover these developments, which includes our insights into the new rules, in a helpful series over the next several weeks. Here is Part 1.

Federal Income and Payroll Tax Rates

December brought some good news about federal income tax rates. With rates slated to increase on January 1, 2011, Congress acted to extend the lower 2010 income tax rates for another two years. As a result, the top marginal individual income tax rate remains at 35%, and capital gains and qualified dividends continue to be taxed at a maximum 15% rate through December 31, 2012 for individuals, estates, and trusts.

In addition, the employee portion of the OASDI component of the federal social security tax has been reduced by 2% during 2011. That means that the withholding rate on employee wages is reduced to 4.2% from 6.2%, and the self-employment tax rate has been reduced to 10.4% from 12.4%. Remember, the maximum income to which the OASDI applies is $106,800. The 2.9% Medicare tax remains unchanged.

***Hint*: In light of the favorable Federal income tax treatment in 2011 and 2012, it may be advisable to consider accelerating income into 2011 and 2012.**

Illinois Income Taxes

For those of us living, working and doing business in Illinois, tax rates just went up. On January 13, 2011, Governor Quinn signed into law legislation increasing Illinois income taxes on individuals, trusts, estates and corporations.

Income Taxes. Before these changes were made, the Illinois income tax rate for individuals, trusts and estates was 3% and the rate for C corporations was 7.3% (including the 2.5% personal property replacement tax). The new Illinois income tax rates are:

	2011-2014	2015-2024	After 2024
Individuals, Trusts and Estates	5%	3.75%	3.25%
C Corporations	9.5%	7.75%	7.3%

No change was made to the additional 1.5% personal property replacement tax on income of S corporations, partnerships and limited liability companies.

***Hint*: The combination of lower individual Federal income tax rates (including capital gains and dividends) and social security tax rates, together with the higher individual Illinois income tax rates, is a mixed bag for Illinois taxpayers. The overall tax impact on individuals in Illinois may not be as severe in 2011-2012 as portrayed in the media. The real test as to the severity of taxes in the future will be answered by the degree of discipline exhibited by both Federal and Illinois governments in actually controlling government spending. History is not favorable on the subject.**

Legislators characterized these tax increases as temporary, as rates go down in four years and then again after ten more years. However, the same thing was said the last time Illinois income tax rates were increased in 1989, but the rates never came down and the increase was made permanent in 1993.

The increases in corporate tax rates make Illinois corporate tax rates the third highest in the United States (after Pennsylvania at 9.99% and Minnesota at 9.8%). Prior to the increase, Illinois ranked 21st. Neighboring states currently have lower corporate tax rates – the top rate is 8.5% in Indiana, 7.9% in Wisconsin, 6.25% in Missouri, 6% in Kentucky and 4.95% in Michigan.

***Hint*: In light of the corporate tax increase in Illinois, a corporation doing business in Illinois and other states should pay close attention to the correct apportionment of its income to the various states in which the corporation does business.**

Corporate Net Operating Losses in Illinois. In addition to the change in rates, C corporations (not S corporations, LLCs, partnerships, individuals, estates, and trusts) in Illinois will be unable to utilize net operating loss (NOL) carryforwards that arose after December 31, 2003, for corporate tax years 2011-2014, but the legislation extends the NOL carryforward period for four additional years (to 16 years). While the presumed intent of the General Assembly was to suspend NOLs for four years, technically, the legislation applies to suspend NOLs arguably for only three tax years, not four.

Hint*: This change is particularly harsh because C corporations that may have lost money in recent years and generated NOL's will not be able to use those NOL's to reduce their Illinois income taxes if business improves over the next four years. Furthermore, the NOL rules for Illinois now differ from the Federal rules, so businesses will have to track this important tax attribute separately for their Illinois and Federal income tax returns, complicating tax planning. If an Illinois C corporation has an NOL carried to 2010 and the corporation was considering electing installment treatment of gain realized in 2010, or was considering consummating a 1031 tax free exchange, the corporation might consider, instead, recognizing the income in 2010 and using up more of the remaining NOL in 2010.

Estimated Tax Payments to Illinois in 2011. The new law also increased for one year the estimated tax payments that must be paid to Illinois to avoid interest and penalties. For estimated tax payments made between February 1, 2011 and February 1, 2012 (i.e., those for 2011 income taxes), the safe harbor amount is now the lesser of 90% of the actual amount of 2011 tax or 150% of the amount of taxes paid for 2010 (so long as tax was paid for 2010). While the increase in the safe harbor amount for 2011 taxes may have been driven by the increase in rates from 2010, the legislation curiously does not provide for a reduction in the safe harbor amount in 2016 (to take account of the reduced rates in 2015) or in 2025(to take account of the reduced rates in 2024).

***Hint*: Start careful planning to pay Illinois estimated taxes now to avoid penalties, because Illinois estimated tax payments made in 2011 are likely to be significantly higher than last year.**

This increase in the estimated tax safe harbor is only effective for 2011, and the safe harbor amount reverts to 100% of prior year taxes for payments made after February 1, 2012 (i.e., those for 2012 income taxes).

The information described herein is of a general nature, based on information currently available, and should not be relied upon to make planning, purchase, sale, or exchange decisions without seeking personal professional advice.

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