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January 13, 2013

Dear Clients and Friends:

On New Year's Day 2013, Congress passed a far-reaching new law intended to avert the so-called fiscal cliff. The American Taxpayer Relief Act, signed into law by President Obama on January 2, 2013, impacts every taxpayer. Not only does the new law make permanent reduced income tax rates for most taxpayers, it extends either permanently or temporarily a host of other tax incentives. At the same time, the new law creates valuable tax planning opportunities. Not all provisions, however, are good for all taxpayers. Those individuals with income above $400,000 ($450,000 for families) are now subject to a new top income tax rate of 39.6 percent and a new capital gains maximum rate of 20 percent. And, all taxpayers will be taxed two percent more in 2013 than in 2012 on wages and self-employment income up to the Social Security employment tax wage base ($113,700). I can help you plan a tax strategy that reflects the important changes in the American Taxpayer Relief Act.

Tax Rates

Unless Congress acted, taxpayers in all incomes groups were looking at a tax hike in 2013 because of the expiration of the Bush-era tax cuts and the 2012 payroll tax holiday. The long-time bracket structure of 10, 15, 25, 28, 33, and 35 percent was scheduled to revert to 15, 28, 31, 36 and 39.6 percent after 2012. On top of that, the payroll tax holiday reduced the employee-share of Social Security taxes (with a comparable benefit for self-employed individuals) for two years: 2011 and 2012.

The American Taxpayer Relief Act preserves and permanently extends the Bush-era income tax cuts except for single individuals with taxable income above $400,000; married couples filing joint returns with taxable income above $450,000; and heads of household with taxable income above $425,000. Income above these thresholds will be taxed at a 39.6 percent rate, effective January 1, 2013. The $400,000/$450,000/$425,000 thresholds will be adjusted for inflation after 2013.

The new law, however, does not extend the payroll tax holiday. Effective January 1, 2013, the employee-share of Social Security increased from 4.2 percent to 6.2 percent (its rate before enactment of the payroll tax holiday). The net result is that all individuals who receive wages (and self-employed individuals) will see less take-home pay in 2013.

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Capital Gains

Effective January 1, 2013, the maximum tax rate on qualified capital gains and dividends rises from 15 to 20 percent for taxpayers whose incomes exceed the thresholds set for the 39.6 percent rate (the $400,000/$450,000/$425,000 thresholds discussed above). The maximum tax rate for all other taxpayers remains at 15 percent; and moreover, a zero-percent rate will continue to apply to qualified capital gains and dividends to the extent income falls below the top of the 15-percent tax bracket.

Alternative Minimum Tax

The alternative minimum tax (AMT) was put in place more than 40 years ago to ensure that very wealthy individuals did not escape taxation. Due to many factors, including the fact that the AMT was not indexed for inflation, the AMT has encroached on middle-income taxpayers. In recent years, Congress routinely “patched” the AMT by increasing the exemption amounts and making other relief available. These patches were just that: temporary measures. The American Taxpayer Relief Act permanently patches the AMT by increasing the exemption amounts and indexing them for inflation.

For 2012, the exemption amounts are increased to $78,750 for married couples filing jointly and surviving spouses, $50,600 for single taxpayers and heads of households, and $39,375 for married individuals filing separately.

The AMT exemption amounts are phased out at certain income levels. Because the phase-out calculation is affected by the amount of the exemption, an increase in the exemption also increases the maximum amount of alternative minimum taxable income (AMTI) a person can have before the exemption is phased out. Although the exemption amounts have increased, the threshold levels for calculating the phase-out remain unchanged in 2012. However, beginning in 2013 the threshold levels will also be inflation-adjusted.

For 2012, the AMT exemption amounts are completely phased out when AMTI reaches $465,000 for married couples filing jointly and surviving spouses, $314,900 for single taxpayers and heads of households, and $232,500 for married individuals filing separately.

Additionally, the nonrefundable personal tax credits offset rule is made permanent after 2011by the 2012 Taxpayer Relief Act. Therefore, these credits can be offset against regular tax and AMT liability, after reduction for any foreign tax credit.

Retirement Savings

The American Taxpayer Relief Act makes a valuable change to the treatment of retirement savings and opens up an important planning opportunity. Generally, participants with 401(k) plans and similar plans have been allowed to roll over funds to designated Roth accounts in the same plan subject to certain qualifying events or age restrictions. The American Taxpayer Relief Act lifts most restrictions, and now allows participants in 401(k) plans with in-plan Roth conversion features to make transfers to a Roth account at any time. Congress made this change because conversion is a taxable event and will raise revenue.

Estate Tax

Federal transfer taxes (estate, gift and generation-skipping transfer (GST) taxes) seem to have been in a constant state of flux in recent years. The American Taxpayer Relief Act aims to provide some certainty. Effective January 1, 2013, the maximum estate, gift and GST tax rate is generally 40 percent, which reflects an increase from 35 percent for 2012. The exclusion amount for estate and gift taxes is unchanged for 2013 and subsequent years at $5 million (adjusted for inflation). The GST exemption amount for 2013 and beyond is also $5 million (adjusted for inflation). The new law also makes permanent portability and some enhancements made in previous tax laws.

Tax Credits and Deductions

Like the Bush-era income tax cuts, many popular tax credits and deductions were scheduled to expire after 2012 (in some cases, they expired after 2011). The American Taxpayer Relief Act makes some of these incentives permanent and extends others. One of the most widely used tax credits, the $1,000 child tax credit, is made permanent. If Congress had not acted, the $1,000 child tax credit would have decreased to $500 per qualifying child for 2013 and beyond. The $1,000 amount is not, however, indexed for inflation.

Other popular tax credits and deductions for individuals made permanent or extended by the new law include:

- Enhanced adoption credit/exclusion (permanent)
- Enhanced child and dependent care credit (permanent)
- Enhanced student loan interest deduction (permanent)
- American Opportunity Tax Credit (through 2017)
- Higher education tuition deduction (through 2013)
- IRA distributions to charitable organizations (through 2013)
- Transit benefits parity (through 2013)
- Cancellation of indebtedness on principal residence (through 2013)
- Code Sec. 25C residential energy efficient property credit (through 2013)
- Teachers' classroom expense deduction (through 2013)

The American Taxpayer Relief Act also revives the Pease limitation (which reduces itemized deductions for some taxpayers) and personal exemption phase out (PEP) for higher-income taxpayers after 2012, but not at their former levels. Generally, individuals with incomes over $250,000 and married couples with incomes over $300,000 will be affected.

Planning Opportunities

The American Taxpayer Relief Act opens tax planning opportunities because it impacts so many tax rules, everything from income rates to retirement planning. Congress intended to make permanent many of the changes, which creates a climate for tax planning unlike the recent past where uncertainty was the rule and not the exception. I will have more information on these changes in the weeks and months ahead.

Sincerely yours,

Eric

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