Did you Fall Off the Fiscal Cliff?

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Everyone wants to know how the changes that Congress finally made will affect their personal finances…

On January 2, 2013, "The American Taxpayer Relief Act of 2012" (the "Act") was signed into law. Among other things, the Act (i) extends the "Bush Tax Cuts" for taxpayers whose adjusted gross income ("AGI") is below a certain threshold, (ii) maintains the $5 million exemption for gift and estate taxes, (iii) permanently patches the Alternative Minimum Tax, (iv) extends certain tax credits, and (v) delays government spending cuts. An explanatory summary of the Act follows:

INCOME TAXES:

Income Tax Rates: The tax rates for most taxpayers will remain the same (e.g. 10%, 15%, 25%, 28%, 33% and 35%). However, the top marginal tax rate for "high income" taxpayers will increase to 39.5% (the rate in effect during the Clinton era). The income threshold for the application of the new 39.5% tax rate applies, beginning in 2013, if AGI exceeds:

- $450,000 – married or surviving spouse; and
- $400,000 - single

These threshold amounts will be adjusted for inflation after 2013.

Social Security: The temporary 2% cut in Social Security payroll tax *was not* extended, so you will notice a slight increase in your payroll deductions, and decrease in your take home pay. In 2013, the employee's portion of Social Security taxes will return to the pre-2011 rate of 6.2% (up from 4.2% in 2011 and 2012).

Medicare – Under the Patient Protection and Affordable Care Act of 2010 ("Obama Care"), beginning in 2013 a 0.9% surtax tax will be assessed on earned income (wages and net earnings from self-employment) in excess of $250,000 (for married taxpayers) and $200,000 (for single taxpayers).

Investment Income: Additionally, under Obama Care, beginning in 2013, a 3.8% surtax will be imposed on net investment income in excess of the threshold amounts if AGI exceeds $250,000 (for married taxpayers) and $200,000 (for single taxpayers). Net Investment income includes income on interest, dividends, annuities, royalties, rents and capital gains.

Capital Gains: After 2012, the capital gain tax rate increases to 20% for married taxpayers with AGI in excess of $450,000 or for single taxpayers with AGI in excess of $400,000 (in addition to the 3.8% Medicare surtax). For taxpayers in the 25% tax bracket, or below, the capital gain tax is still 0% and for the taxpayers above the 25% tax bracket, but below the threshold amounts, the capital gain tax rate is permanently set at 15%.

Education Expenses: The Act extended the American Opportunity tax credit for 5 years (which would have otherwise expired at the end of 2012), enabling taxpayers to claim a credit for tuition related expenses. Additionally, "above the line" deductions for qualified tuition and related expenses will be revived for 2012 and 2013.

Retirement Benefits: A taxpayer over 70½ can still make a tax free contribution from a retirement fund for a charitable purpose and have it applied to the 2012 tax year. Contributions made in January 2013 can apply to the 2012 tax year for both the taxpayer and the charity in receipt of the contribution. Beginning in 2013, plan provisions can allow participants to transfer amounts to a Roth account and be eligible as a qualified rollover contribution.

Certain credits that expired at the end of 2011 will be revived for tax years 2012 and 2013:

- Expenses for elementary and secondary school teachers;
- Exclusion from income for employer provided mass transit and parking benefits;
- Credit for energy efficient appliances;
- Mortgage insurance premiums treated as qualified residence interest;
- Deduction of state and local sales tax;
- Contribution of capital gain property for conservation use; and
- Unemployment benefits.

Discharge of Indebtedness: The special rule which permits taxpayers to exclude up to $2 million of discharge of indebtedness income on a qualified principal residence is extended to the end of 2013.

Alternative Minimum Tax (AMT) Relief: Congress enacted an alternative minimum tax in the 1970's to ensure that wealthy taxpayers paid a certain minimum amount of taxes each year. However, when Congress subsequently amended the tax code, it failed to make corresponding adjustments to the AMT. The result was that each year Congress was forced to pass a 1-year patch to prevent the AMT from affecting middle-class taxpayers. The Act attempts to permanently fix this problem. Beginning with the 2012 tax year, the AMT exemption amounts are permanently increased from $45,000 to $78,750 (for married taxpayers) and from $33,750 to $50,600 (for unmarried taxpayers). Exemption amounts are indexed for inflation beginning in tax year 2013. The Act further allows a taxpayer to offset their entire regular and AMT tax liability by non-refundable personal credits.

Personal Exemption Phaseout (PEP) and deduction (Pease) limitations: Beginning in 2006 Congress began to phase the PEP and Pease limitations, resulting in their complete elimination in 2010. PEP reduces certain exemptions claimed by a taxpayer that are subject to a limitation which will be reduced by 2% for every $2,500 over the threshold amounts. Pease limits the total amount of itemized deductions by 3% of the amount exceeding threshold income levels. Effective for tax years after 2012, these limitations will be resurrected, resulting in the limitations of the amount of itemized deductions and the amount of the dependency exemption for married taxpayers (or surviving spouse) with AGI in excess of $300,000 ($150,000, married filing separately), and for single taxpayers with AGI in excess of $250,000. These amounts will be adjusted for inflation after 2013.

ESTATE TAX:

Estate, Gift and Generation Skipping Tax Exemption: The Act permanently sets the federal exemption for estate and gift tax at $5,000,000, as adjusted for inflation. In 2012 the exemption, as adjusted for inflation, was $5,120,000, and for 2013 it is $5,250,000. It will continue to be adjusted for inflation after 2013. This is exemption is also applicable to the Generation Skipping Transfer Tax (GST Tax). The Act also increased the top rate of estate tax from 35% to 40%.

Portability: A surviving spouse can continue to utilize the unused portion of the federal exemption amount of the deceased spouse. The portability provision is made permanent.

Estate Planning Techniques: The Act maintains, for the time being, the ability to make transfers of closely held assets using discounted values and the ability to use grantor retained annuity trusts.

Sequestration: The Act delays automatic spending cuts for two months, until March 1, 2013. The cost of the delay will be paid equally through later tax revenue increases and future spending cuts.

This article is a brief summary of some of the tax changes that may affect your financial future, for better or for worse. It is not intended, and should not be used, as specific advice or opinions on any particular case or matter. Please use the information in this article for general information purposes, as it was intended, and consult counsel experienced in these matters for advice specific to your particular situation.

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