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Taxes—American Taxpayer Relief Act

Just in the nick of time, with a drama reminiscent of old silent westerns in which the heroine is snatched from the wheels of an oncoming train by the hero, Congress averted the dreaded fiscal cliff. Well, sort of—left to be resolved are issues concerning the debt ceiling and spending on entitlements. However, we now have clarity on income, payroll, and transfer taxes for the foreseeable future.

The new law, referred to as the American Taxpayer Relief Act, contains both good and bad news for affluent and high-net worth (HNW) taxpayers.

Here are the highlights.

Income Tax Rates—This was one of the most controversial issues in the negotiations leading up to the new law's enactment. When the dust settled, income tax rates for 2013 will remain the same as last year for most individuals. However, affluent and HNW taxpayers will see their top rate increases from 35 percent to 39.6 percent. This change affects singles with taxable income above $400,000, marrieds filing jointly with taxable income above $450,000, heads of households with taxable income above $425,000, and married individuals who file separate returns with taxable income above $225,000.

The following table contains the new rates and brackets with *projected* inflation adjustments. As of this date, the IRS has not announced the official inflation-adjusted numbers.

FEDERAL INDIVIDUAL INCOME TAX RATES FOR 2013

Tax Rate	Single Individuals	Married / Joint	Married / Separate	Head of Household
10% on taxable income to:	$8,925	$17,850	$8,925	$12,750
15% on next taxable income to:	36,250	72,500	36,250	48,600
25% on next taxable income to:	87,850	146,400	73,200	125,450
28% on next taxable income to:	183,250	233,050	111,525	203,150
33% on next taxable income to:	398,350	398,350	199,175	398,350
35% on next taxable income to:	400,000	450,000	225,000	425,000
39.6% on next taxable income above:	400,000	450,000	225,000	425,000

Rates on Long-Term Gains and Dividends—While the tax rates on long-term capital gains and dividends will also remain the same as last year for most individuals, the maximum rate for affluent and HNW clients increases from an historic low of 15 percent to 20. This change affects singles with taxable income above $400,000, married joint-filing couples with taxable income above $450,000, heads of households with taxable income above $425,000, and married individuals who file separate returns with taxable income above $225,000.

Note also, that beginning in 2013 taxpayers with modified adjusted gross incomes (MAGIs) above a designated threshold ($200,000 for single filers, $250,000 for married couples filing jointly) will pay a surtax of 3.8 percent on *net investment income*. Net investment income is gross income from annuities, interest, rents, royalties, dividends, and net gain from the sale of property, reduced by deductions attributable to the production of such income. This provision is part of what has become known as Obamacare and is unrelated to the American Taxpayer Relief Act.

Personal and Dependent Exemption Deduction Phase-Out—The phase-out of personal and dependent exemptions has not been seen since 2009. However, under the new law, the phase-out returns for affluent and HNW clients. Phase-out starts at the following adjusted gross income (AGI) thresholds:

- $250,000 for single filers;
- $300,000 for marrieds filing jointly;
- $275,000 for heads of households; and
- $150,000 for married individuals who file separate returns.

Itemized Deduction Phase-Out—Similarly, the new law revives the limitation on total itemized deductions for taxpayers whose (AGI) exceeds the applicable amount. The applicable amount is $300,000 for marrieds filing jointly, $275,000 for heads of household, $250,000 for individuals, and $150,000 for married individuals filing separately.

These applicable amounts for both phase-outs are indexed for inflation for tax years beginning after 2013.

Alternative Minimum Tax—With negotiations leading up to the new law's passage appearing to ignore the alternative minimum tax (AMT), many tax professionals were worried that a "glitch" in the law could cause the AMT to affect even more taxpayers.

The AMT is a parallel tax system. Individuals pay the higher of the AMT or their regular income tax. Originally enacted in 1969, the stated purpose of the AMT was to prevent higher-income tax payers from minimizing or eliminating their income taxes through taking advantage of certain deductions and credits including:

- State and local income taxes and property taxes;

- Child-tax credits;
- Home-equity loan interest; and
- Miscellaneous itemized deductions such as employee business expenses that are not reimbursed by employers.

Although the highest tax rate under the AMT, 28 percent, is lower than the highest regular income tax rate, 35 percent, AMT victims pay more taxes because their taxes are based on a higher taxable base.

Here was the concern, prior to the new legislation. In 2011 the AMT applied to Alternative Minimum Taxable Income (AMTI) over $48,450 for individuals and $74,450 for couples. The exemption was reduced and phased-out entirely for high-income taxpayers. Although the exemption was not indexed for inflation, Congress routinely enacted legislation to increase the exemption. Unfortunately, the last "patch" expired on December 31, 2011. Thus, for tax year 2012, the alternative minimum tax exemption amounts reverted to the previous amounts of $45,000 for married couples filing jointly and $33,750 for single filers.

Fortunately, the new law sets the *2012* exemption level at $50,600 for single filers and $78,750 for joint filers and adjusts these amounts for inflation going forward. In 2013, inflation adjustments are *projected* to result in an exemption level of $51,900 for single filers and $80,800 for joint filers.

Payroll Taxes—Despite the fact that income tax rates stay the same for most taxpayers, wage-earners can expect a decrease in their paychecks beginning in January of 2013. That's because the 2011 decrease in payroll taxes from 6.2 percent to 4.2 percent was allowed to expire on December 31, 2012.

By some estimates, monthly paychecks for those earning $113,700 or more annually will decrease by upwards to $200.

Estate and Gift Taxes—Prior to the new law, many were concerned that both tax rates and exemption amounts would revert to 2001 levels (55 percent maximum rate, $1 million exemption amount).

Fortunately, the new tax law is more generous than many feared it would be.

First, the new law makes permanent the $5 million gift, estate, and GST tax exemption amount, subject to annual inflation increases. In 2012 the inflation-adjusted exemption amount was $5.12 million. The *projected* inflation-adjusted amount in 2013 is approximately $5.25 million per person. For married couples in 2013, the aggregate exemption will be twice this amount (i.e., approximately $10.5 million).

The new law also caps the top rate at 40 percent tax for decedents dying and transfers occurring in 2013.

In addition, the new law also makes permanent "portability" of an unused deceased spouse's estate tax exemption amount to a surviving spouse. For example, if the first spouse passes away in 2013 with $5 million of assets, that deceased spouse could leave his or her entire estate to the surviving spouse tax free under the marital deduction, thus preserving the use of his or unused exemption by the survivor. Even if the surviving spouse's estate was also valued $10 million (including the inheritance from the deceased spouse), he or she could pass the entire estate to non-spousal beneficiaries without tax by combining the deceased spouse's "unused estate tax exemption amount" and his or her own exemption amount. The "inherited" exemption may be applied against both lifetime gifts and bequests.

Bottom Line

Most affluent and HNW clients would have preferred to see income, capital gains, and transfer tax rates remain at the 2012 historic lows. However, things could have turned out much worse if the Bush Era tax cuts had simply expired as many feared.

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