POST-FISCAL CLIFF TAX UPDATE

The tax side of the "Fiscal Cliff" has been narrowly averted by Congress and the President. On January 1, 2013, the Senate and House approved the American Taxpayer Relief Act of 2012, which was subsequently signed by President Obama on January 2, 2013. This article addresses some important tax measures included in the bill.

Here are the act's main tax features:

1) **Individual Income Tax Rates** – The favorable Bush-era tax rates were retained and made permanent (10%, 15%, 25%, 28%, 33%, and 35%). A new top tax rate of 39.6% was introduced for taxpayer's with taxable income over $400,000 for single filers, $425,000 for head-of-household filers, and $450,000 for married taxpayers filing jointly (or $225,000 for each married spouse filing separately). Although these rates were made permanent, nothing would stop Congress from reconsidering the entire tax rate structure as part of a comprehensive tax reform plan or as part of the debt ceiling and sequestrations negotiations that will take place in two months.
2) **Phase-out of Itemized Deductions and Personal Exemptions** – For higher income taxpayers, personal exemptions and itemized deductions will be start to be phased out at income levels of $250,000 for single taxpayers, $275,000 for heads-of-household, and $300,000 for married taxpayers filing jointly.
3) **Capital Gains and Dividends** – The favorable 0% and 15% tax rates for capital gains and qualified dividends were permanently retained, while a 20% rate was introduced for taxpayers above the top income tax bracket. Taxpayers in the 10% and 15% income tax brackets will pay 0% tax on capital gains and qualified dividends, while taxpayers in the middle and top brackets will pay 15%.
4) **Alternative Minimum Tax** – One of the most important victories for the American middle-class was the permanent extension of the AMT "patch", which refers to the exemption amount for calculating AMT. Without the "patch", AMT would have affected roughly 20 million more Americans in filing their 2012 tax returns, with an estimated additional $3,700 in taxes. The exemption amount was set to decrease from $74,450 for married couples filing jointly to a measly $45,000. However, the American Taxpayer Relief Act of 2012 permanently extended the higher exemption amount, which will be adjusted annually for inflation. The 2012 AMT exemption will be $78,750 for married filing jointly taxpayers, and $50,600 for single filers.
5) **Estate and Gift Tax** – The top tax rate for estate and gift taxes has increased from 35% to 40%, effective January 1, 2013. The exclusion amount per taxpayer was retained at $5 million (indexed annually for inflation). The 2012 exclusion amount is $5.12 million. It is also important to note that the "portability" election, which was set to expire in 2012, was made permanent. This election allows a surviving spouse to elect to use the deceased spouse's unused exclusion amount.
6) **Other Individual Income Tax Extensions** – Various expiring tax provisions were extended or made permanent under the American Taxpayer Relief Act of 2012. Some important extensions include:
    a. Marriage penalty relief (increased size of the 15% bracket and increased standard deduction for married taxpayers filing jointly);
    b. State and local sales tax deduction;
    c. Increased child tax credit of $1,000;
    d. Expanded adoption credit and adoption-assistance program;
    e. American Opportunity Tax Credit for qualified tuition and related expenses;
    f. Above-the-line deduction for qualified tuition and related expenses;
    g. Teacher's classroom expense deduction;
    h. Deduction of mortgage insurance premiums; and
    i. Tax-free distributions from IRA's to charity.
7) **Business Tax Extenders** – Many business tax provisions and credits were temporarily extended. Notably, the following provisions should be mentioned:

   a. Section 179 Expensing – The higher expensing limit for Section 179 was extended in the amount of $500,000 (with a $2 million investment limit). This provision allows businesses to deduct up to $500,000 of fixed assets (machinery, equipment, etc.) in the year purchased.
   b. 50% Bonus Depreciation – Bonus depreciation was extended through 2013. This provision allows businesses to write-off 50% of qualified <u>new</u> fixed asset purchases in the year acquired, in addition to regular first-year depreciation.
   c. 15-year Life for Qualified Leasehold Improvements, Qualified Restaurant Buildings and Improvements, and Qualified Retail Improvements – Extended through 2013.
   d. Tax Credit for Increasing Research and Development Activities – This tax credit, which was set to expire at the end of 2011, was extended through 2013.
   e. Work Opportunity Tax Credit – This tax credit, which is available to employers who hire from certain target groups, was extended through 2013.
   f. Temporary Exclusion of 100% Gain on Certain Small Business Stock – Extended through 2013.
8) **Energy Tax Extenders** – Several energy tax incentives were extended through 2013, which include: credit for energy-efficient existing homes, credit for energy-efficient new homes and appliances, incentives for biodiesel and renewable diesel fuels, and excise tax credits for alternative fuels (i.e. propane used in forklifts).
9) **2% Payroll Tax Holiday** – The 2% payroll tax holiday that employees have enjoyed for the past two years has <u>not</u> been extended. However, this provision was originally meant to be temporary. **The IRS has recently released guidance (including new withholding tables) on how to account for changes in 2013 withholding for various types of employment taxes. Please see IRS Notice 1036 for a more detailed discussion on this topic.** http://www.irs.gov/pub/irs-pdf/n1036.pdf

In addition to the various provisions enacted, extended, or made permanent as part of the American Taxpayer Relief Act discussed above, it is pertinent to discuss several provisions enacted as part of the Affordable Care Act that take effect on January 1, 2013.

1) **0.9% Additional Medicare Tax** – The employee's share of Medicare tax has been increased by 0.9% for higher-income taxpayers that earn wages in excess of the threshold amount for their filing status ($250,000 combined wages with spouse for married filing jointly taxpayers, $125,000 for married spouses filing separately, and $200,000 for single and head-of-household taxpayers). This tax also applies to self-employment income in excess of the threshold amount. In addition, employers will be required to withhold this additional tax from wages once a taxpayer's wages reach $200,000. It is important to note that married couples subject to this tax should consult with their tax adviser on whether to file separately to minimize the amount of tax paid.
2) **3.8% Medicare Contribution Tax on Investment Income** – A new tax will be assessed starting January 1, 2013 that is equal to 3.8% of the <u>lesser</u> of an individual's net investment income or the individual's modified adjusted gross income in excess of a threshold amount. The threshold amounts are $250,000 for married couples filing jointly ($125,000 for married filing separately), and $200,000 for single and head-of-household taxpayers. Net investment income includes interest, dividends, capital gains, annuities, royalties, and other unearned income, such as income from a trade or business that is considered a <u>passive activity</u>.
3) **Qualified Medical Expenses** – The threshold for deduction medical expenses as an itemized deduction has increased from 7.5% to 10% of adjusted gross income. This increased limitation is in effect for all taxpayers, except in the years 2013 – 2016, if either the taxpayer or the taxpayer's spouse has turned 65 before the end of the tax year. In this case, the 7.5% threshold would apply.