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As a result of the recently passed American Taxpayer Relief Act of 2012 (the “2012 Taxpayer Relief Act”), coupled with the 2010 Health Care Reform Act (the “2010 Health Care Act”), significant changes in the tax laws will take effect in 2013. Additionally, some laws that expired at the end of 2011 have been extended retroactively for 2012. The summary below highlights some of the more important changes that are likely to impact taxpayers, including modifications to the estate and gift tax laws, as well as a few tax planning strategies to consider in the new year.

Tax Highlights of the 2012 Taxpayer Relief Act and the 2010 Health Care Act

- For single taxpayers with taxable income greater than $400,000 ($450,000 for married filing jointly taxpayers and $225,000 if married filing separately), the top marginal income tax rate increases from 35% to 39.6%. For taxpayers with taxable income below these thresholds, the income tax rates remain the same as the rates in effect for 2012.
- The top tax rate on long-term capital gains and qualified dividends increases from 15% to 20% for single taxpayers with taxable income in excess of $400,000 ($450,000 for married filing jointly taxpayers and $225,000 if married filing separately). The additional 5% tax is only levied on taxable income in excess of the threshold amounts; for long-term capital gain and qualified dividend income below these thresholds, the capital gains tax rates remain the same as the rates in effect for 2012.
- In addition to the increases in the top marginal income tax rate and tax on long-term capital gains and dividends, taxpayers will also be subject to a payroll tax increase of 0.9% on wages and self employment income for single taxpayers with adjusted gross income (“AGI”) in excess of $200,000 ($250,000 for married filing jointly taxpayers and $125,000 for married filing separately taxpayers). The payroll tax increase, which is effective January 1, 2013, was enacted as part of the 2010 Health Care Act.
- The 2010 Health Care Act also includes a surtax of 3.8% on net investment income (i.e., interest, dividends, rents, royalties, capital gains and gross income from passive business activities) for single taxpayers with AGI in excess of $200,000 ($250,000 for married filing jointly taxpayers and $125,000 for married filing separately taxpayers). Please note that the payroll tax and net investment income surtax enacted as part of the 2010 Health Care Act are based on AGI, whereas the top marginal income tax rate increase and the additional 5% capital gains tax of the 2012 Taxpayer Relief Act are based on taxable income.
- The marriage penalty relief and child tax-credit provisions are permanently extended for taxpayers below the $400,000/$450,000/$225,000 thresholds.
- The Alternative Minimum Tax (“AMT”) "patch" for 2012 is adjusted to $78,750 for joint filers ($39,375 for married filing separately) and $50,600 for single filers. The 2012 Taxpayer Relief Act makes the AMT patch permanent and also provides for future indexing.

- The Personal Exemption Phase-out ("PEP"), which was temporarily repealed for tax years 2010 through 2012, has been permanently repealed for individual taxpayers with AGI of less than $250,000 and for married filing jointly taxpayers with AGI of less than $300,000 ($150,000 for married filing separately taxpayers). For taxpayers above those threshold amounts, the PEP is reinstated. The PEP reduces the total amount a taxpayer may claim in personal exemptions by 2% for each $2,500 ($1,250 if married filing separately), or fraction thereof, by which the taxpayer's AGI exceeds the threshold amounts.
- Individual taxpayers with AGI of less than $250,000 and married filing jointly taxpayers with AGI of less than $300,000 ($150,000 for married filing separately taxpayers) also benefit from the permanent repeal of the itemized deduction limitation (known as the Pease limitation). The Pease limitation was temporarily repealed for tax years 2010 through 2012. For taxpayers with AGI above the threshold amounts, the limitation on itemized deductions is restored. Under the Pease limitation, the total amount of itemized allowable deductions is reduced by 3% for each dollar of AGI in excess of the threshold amounts.
- The 2010 Health Care Act also limits the amount of medical deductions a taxpayer may claim. Beginning in 2013, medical expenses paid in a calendar year must exceed 10% of AGI before the expenses are deductible, with one exception. Taxpayers over age 65 are still eligible to deduct medical expenses that exceed 7.5% of AGI.
- Several popular tax benefits are permanently extended, including expanded Coverdell Account contribution limits, expanded exclusion for employer-provided educational assistance, expanded student loan interest deduction, and exclusion from income of amounts received under certain limited scholarship programs. In addition, the American Opportunity Tax Credit for the cost of tuition and related expenses is extended for five years.
- The provision allowing for the deduction of state and local general sales taxes is extended for two years.
- Taxpayers who receive mortgage debt relief (whether the mortgage is canceled or forgiven) may exclude up to $2 million from income in 2013 (a one year extension).
- The above-the-line deduction for qualified tuition and related expenses is extended for one year.
- Taxpayers may convert their existing 401(k) account to a Roth account if their employer offers designated Roth accounts under the plan, regardless of whether the individual is allowed to take distributions from the plan. A conversion to a Roth IRA is a taxable event, which will require taxpayers to have cash on hand to pay the income taxes due on the conversion.
- The Social Security payroll tax holiday for individuals, which was in effect for the past two years, was not extended. Accordingly, the individual contribution for Social Security payroll tax will increase from 4.2% of salary/wages to 6.2% (its previous level) effective January 1, 2013. Moreover, the 6.2% payroll tax will apply to all income levels.

Estate and Gift Tax Highlights of the 2012 Taxpayer Relief Act

- The estate and gift tax exemption amount has been unified at $5,000,000 per individual and $10,000,000 per couple. Under the 2012 Taxpayer Relief Act, the exemption will continue to be indexed annually for inflation; the 2013 exemption amount is $5,250,000.
- The estate, gift, and generation-skipping transfer tax rate increases from 35% to 40%.
- Portability, which allows a surviving spouse to use a deceased spouse's unused exemption, was made permanent for decedents dying after December 31, 2012.
- If the 2012 Taxpayer Relief Act had not been enacted, the estate and gift tax exemptions would have fallen to $1,000,000, portability would have disappeared, and the top estate, gift, and generation-skipping transfer tax rate would have risen to 55%.
- The annual gift exclusion increases from $13,000 to $14,000 for gifts made in 2013.
- A taxpayer may gift up to $143,000 annually to a non-citizen spouse without generating a gift tax. This annual exclusion amount was raised from $139,000 (the 2012 level).
- Contrary to industry expectations, Grantor Retained Annuity Trusts (GRATs), Intentionally Defective Grantor Trusts (IDGTs), and Spousal Lifetime Access Trusts (SLATs) were not affected by the 2012 Taxpayer Relief Act. Thus, these planning vehicles continue to be viable options for those looking to minimize their exposure to the federal estate and gift tax.
- Taxpayers who funded 2012 trusts with cash may now want to consider substituting assets that may be discounted and/or appreciate in value into the recently established trusts.

Summary

As indicated in this Update, many changes were made to the tax laws under the 2012 Taxpayer Relief Act and the 2010 Health Care Act. When one factors in the continuing uncertainty surrounding the impending federal debt limit negotiations with the new tax laws, proper income and estate tax planning is essential. Some taxpayers will need to adjust their withholding or estimated tax payments to account for the new income tax laws. Other changes to the tax laws will be accounted for automatically by way of withholding changes made by the taxpayer's employer (such as the new 39.6% bracket as well as the additional 0.9% payroll tax). With regard to estate planning, taxpayers should continue to consider dynasty planning because the current estate, gift and generation skipping transfer tax exemption amounts allow the ability to pass significant wealth to future generations. For any questions with regard to your alternatives, or any questions relating to the content of this article, please feel free to contact us at any time.