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SPECIAL TAX ISSUE

SPECIAL ISSUE 2013

NEW ACT CHANGES MANY INDIVIDUAL TAX PROVISIONS

In recent years, many individual tax provisions had expiration dates that were extended until December 31, 2012. In numerous cases, the 2012 Act has permanently resolved these provisions. Some of the more significant changes include:

❍ INDIVIDUAL INCOME TAX RATES — The current marginal income tax rates of 10%, 15%, 25%, 28%, 33%, and 35% are now permanent. The rates will not revert to the old rates of 15%, 28%, 31%, 36%, and 39.6%. However, a 39.6% tax rate will apply to taxpayers over certain taxable income limits — over $450,000 for married taxpayers filing jointly, over $400,000 for single taxpayers, and over $425,000 for heads of household. All tax bracket ranges will be adjusted for inflation going forward.

The 2012 Act also extends marriage penalty relief. The 15% tax bracket for joint filers and qualified surviving spouses will remain at 200% of the amount for single filers, rather than reverting to 167%.

❍ SOCIAL SECURITY TAXES — The 2012 Act does not extend the payroll tax reductions of 2011 and 2012 that had reduced the old age, survivors, and disability insurance (OASDI) tax on employees from 6.2% to 4.2% of wages up to the Social Security wage base. Starting in 2013, employees will again pay 6.2% OASDI tax on wages up to the Social Security limit of $113,700, while self-employed individuals will pay 12.4% rather than the reduced rate of 10.4%. This provision effectively raises taxes for all wage earners.

❍ CAPITAL GAINS AND DIVIDENDS — The 2012 Act raises the maximum tax rate for capital gains and dividends from 15% to 20%. The 20% rate applies only when a taxpayer's income exceeds the income limits set for the 39.6% tax rate ($400,000 for single filers, $450,000 for joint filers, and $425,000 for heads of household). All other taxpayers will be subject to a maximum tax rate of 15%. The 0% rate will still apply to capital gains and dividends for taxpayers in the 10% or 15% tax bracket.

Although not part of the 2012 Act, starting in 2013, higher-income taxpayers are also subject to an additional 3.8% tax on net investment income when certain income limits are exceeded — $200,000 for single filers and $250,000 for joint filers.

❍ ITEMIZED DEDUCTION LIMITATION — The limitation on itemized deductions has been revived by the 2012 Act. Itemized deductions are now reduced by 3% of the

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2013 MARGINAL TAX RATES BY TAX FILING STATUS

	Married Filing Jointly and Surviving Spouse	Single	Married Filing Separately	Head of Household
10%	$0–17,850	$0–8,925	$0–8,925	$0–12,750
15%	17,850–72,500	8,925–36,250	8,925–36,250	12,750–48,600
25%	72,500–146,400	36,250–87,850	36,250–73,200	48,600–125,450
28%	146,400–223,050	87,850–183,250	73,200–111,525	125,450–203,150
33%	223,050–398,350	183,250–398,350	111,525–199,175	203,150–398,350
35%	398,350–450,000	398,350–400,000	199,175–225,000	398,350–425,000
39.6%	over 450,000	over 400,000	over 225,000	over 425,000

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New Act Changes

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amount by which the taxpayer's adjusted gross income (AGI) exceeds the threshold amount, with the reduction not to exceed 80% of itemized deductions. Those AGI limits are $300,000 for joint filers, $250,000 for single filers, $275,000 for heads of household, and $150,000 for married taxpayers filing separately, which will be adjusted for inflation in future years.

❍ **Personal exemption phaseout** — The 2012 Act also revives the personal exemption phaseout rules. Under the phaseout, the total amount of exemptions that can be claimed by a taxpayer is reduced by 2% for each $2,500 of AGI over the threshold amounts. Those AGI limits are $300,000 for joint filers, $250,000 for single filers, $275,000 for heads of household, and $150,000 for married taxpayers filing separately, which will be adjusted for inflation in future years.

❍ **Standard deduction** — The standard deduction for married couples, used if deductions are not itemized, will continue to be twice the amount for single taxpayers, rather than reverting to 167% of the single rate.

❍ **State and local sales tax deduction** — The ability to claim state and local sales taxes rather than state and local income taxes as an itemized deduction has been extended through 2013.

❍ **Child tax credit** — Instead of reverting to $500 per qualifying child (dependents under age 17), the 2012 Act permanently extends the $1,000 child tax credit for each qualifying child and numerous enhancements to the refundable component of the credit. The amount will not be adjusted for inflation in future years.

❍ **Earned income tax credit** — The 2012 Act extends through 2017 enhancements to the earned income credit, including a simplified definition of earnings income, reform of the relationship test, and modification of the tie-breaking rule.

❍ **Adoption credit** — The dollar limitation for the adoption credit and the income-exclusion for employer-paid or reimbursed adoption expenses has been made permanent and will continue to be adjusted for inflation for both nonspecial-needs and special-needs adoptions. The 2013 limit is $12,970. This credit is phased out for taxpayers with modified AGI over $194,580 in 2013.

❍ **Dependent care credit** — The 2012 Act makes the enhancements to the child and dependent care credit permanent. The maximum dependent care credit remains at $1,050 (35% of up to $3,000 of eligible expenses) for one qualifying individual and $2,100 (35% of up to $6,000 of eligible expenses) for two or more qualifying individuals. The credit percentage can go as low as 20% for individuals with AGI over $43,000. The dependent care credit can be claimed by a taxpayer who incurs expenses for a child under age 13 or for an incapacitated dependent or spouse so that the taxpayer can work or look for work.

❍ **Alternative minimum tax (AMT) relief** — The 2012 Act contains an AMT patch for 2012 and subsequent years, designed to prevent the AMT from encroaching on middle-income taxpayers through higher exemption amounts and other relief. The 2012 exemption amounts are $78,750 for joint filers ($80,800 in 2013), $50,600 for single filers ($51,900 in 2013), and $39,375 for married taxpayers filing separately ($40,400 in 2013). These amounts will be adjusted for inflation in future years. Without the patch, the exemption amounts in 2012 would have been $45,000 for married filers, $33,750 for single filers, and $22,500 for married taxpayers filing separately. It is estimated that this patch will prevent over 60 million taxpayers from being subject to the AMT for 2012.

❍ **Individual retirement account (IRA) distributions to charity** — This provision has been extended for two years, through December 31, 2013. It allows taxpayers age 70½ and older to make tax-free distributions, up to $100,000 each year, from traditional and Roth IRAs for charitable purposes. Two special transition rules apply for 2012. The first allows taxpayers to recharacterize distributions taken in January 2013 as taken on December 31, 2012. The second allows distributions made to the taxpayer in December 2012 to be treated as charitable distributions, as long as the amount is transferred to the charity before February 1, 2013.

❍ **Cancellation of indebtedness** — Typically, if a debt is forgiven so that the individual does not have to repay it, the amount of the debt forgiveness is income to the individual. The 2012 Act extends through 2013 a tax provision that excludes cancellation of mortgage debt of up to $2 million on a principal residence from income.

❍ **Mortgage insurance premiums** — The 2012 Act extends through December 31, 2013 (the provision originally expired in 2011) a provision that treats mortgage insurance premiums as deductible interest if they are related to a qualified residence. ❍❍❍

More Certainty for Estate Planning

Although tax laws in general have been under great uncertainty over the past several years, estate tax laws have experienced the most fluctuation. The federal estate tax had been gradually reduced over a number of years and then was abolished for 2010 only. In 2011, the estate tax was set to return based on 2001 tax laws, which included a 55% maximum tax rate and $1 million estate tax exclusion. However, in 2010, the law was changed to set a maximum estate tax rate of 35% and an exclusion amount of $5 million, which was set to expire on December 31, 2012. All of these changes made it difficult for many individuals to prepare estate-planning documents. Finally, with the 2012 Tax Act, many estate tax provisions have been made permanent:

❍ **Estate tax** — For estates of individuals dying after December 31, 2012, the maximum estate tax rate is 40% (up from 35%) with an exclusion amount of $5 million adjusted for inflation. The 2012 exclusion amount was $5,120,000, while the 2013 amount is $5,250,000. The exclusion amount will be adjusted annually for inflation.

❍ **Gift taxes** — No changes were made to the annual gift tax exclusion. For 2013, the annual exclusion amount is $14,000 (up from $13,000 in 2012), with married couples able to split their gift to make a combined gift of $28,000. The gift tax remains unified with the estate tax, with a maximum gift tax rate of 40% and a maximum applicable lifetime exclusion amount of $5 million adjusted for inflation ($5,120,000 in 2012 and $5,250,000 in 2013).

❍ **Generation-skipping transfer (GST) tax** — The maximum GST tax rate is also 40% with a lifetime exclusion amount of $5,000,000 adjusted for inflation ($5,120,000 in 2012 and $5,250,000 in 2013). A number of provisions that were set to expire in 2012 have been extended.

❍ **Portability of unused exemption** — The provision that allows a surviving spouse to use the unused portion of the estate tax exclusion of a predeceased spouse has been made permanent. This additional exclusion amount can be used for taxable transfers during life or at death. For instance, if one spouse dies in 2013 and uses $3 million of his $5.25 million exclusion, his surviving spouse's exclusion would equal $7.5 million (her $5.25 million exclusion plus her spouse's unused $2.25 million exclusion). Thus, with careful planning, couples are able to avoid estates taxes on up to $10.5 million of property in 2013, without the need for trusts or other sophisticated estate-planning vehicles.

If the surviving spouse is predeceased by more than one spouse, the additional exclusion amount carried over to the surviving spouse is limited to the lesser of $5 million (adjusted for inflation) or the unused exclusion of the last deceased spouse. ❍❍❍

Extension of Business Tax Provisions

The 2012 Act extends several business tax provisions, designed to encourage businesses to spend more money, through December 31, 2013:

❍ **Code section 179 expensing** — For 2012 and 2013, businesses can expense, rather than depreciate, up to $500,000 of new or used tangible personal property. That limit is reduced dollar-for-dollar by the amount of property placed in service in excess of the limit of $2,000,000. Without this extension, the section 179 limit would have been reduced to $125,000 (subject to an inflation adjustment) with a $500,000 (subject to inflation adjustment) investment limit.

❍ **50% bonus depreciation** — The 2012 Act extends 50% bonus depreciation through December 31, 2013. Some transportation and long-term production property is eligible for 50% bonus depreciation through 2014.

❍ **Research tax credit** — The 2012 Act extends the research tax credit, which had expired after 2011, through December 31, 2013. The tax provision rewards taxpayers who engage in qualified research activities with a tax credit.

❍ **Work opportunity tax credit (WOTC)** — The WOTC has been extended through 2013, which rewards employers who hire individuals from targeted groups. Employers who hire individuals in a targeted group, typically those who are hard to employ, are eligible for a credit equal to 40% of first-year wages up to $6,000. The WOTC for qualified veterans can be higher, depending on factors such as whether the veteran has a service-connected disability and the period of unemployment. ❍❍❍

Education Incentive Extensions

The 2012 Act extends some education incentives temporarily, while others have been made permanent:

- **American Opportunity Tax Credit (AOTC)** — The AOTC, a temporary replacement of the HOPE education tax credit, has been extended through December 31, 2017. The AOTC equals 100% of the first $2,000 of tuition, fees, and textbooks and 25% of the next $2,000 paid for a taxpayer, spouse, or dependent, for a maximum credit of $2,500 per year per student. The credit applies to all four years of college and is 40% refundable. The credit is phased out for single filers with modified AGI between $80,000 and $90,000 and for joint filers with modified AGI between $160,000 and $180,000. The AOTC provides greater benefits than the HOPE education tax credit. The HOPE education tax credit has a maximum credit of $1,800, applies to only the first two years of undergraduate education, only includes tuition and fees (not textbooks), is nonrefundable, and is phased out at lower income levels.
- **Higher education tuition deduction** — This provision had expired on December 31, 2011, but it has been extended for two years, through December 31, 2013. The maximum deduction is $4,000 for single filers with modified AGI below $65,000 and joint filers with modified AGI below $130,000. Single filers with modified AGI not exceeding $80,000 and joint filers with modified AGI not exceeding $160,000 are entitled to a maximum deduction of $2,000. The higher education deduction cannot be claimed in the same year that the AOTC or Lifetime Learning Credit is claimed.
- **Coverdell Education Savings Accounts (ESAs)** — The 2012 Act makes permanent enhancements to Coverdell ESAs. These enhancements include a maximum annual contribution of $2,000 (this was scheduled to decrease to $500) for beneficiaries under age 18 and special-needs beneficiaries of any age. The account is exempt from income taxes, while earnings distributions are tax free if used for qualified education expenses. Qualified education expenses include elementary and secondary school expenses in addition to post-secondary school expenses. The contribution limit is phased out for single filers with modified AGI between $95,000 and $110,000 and for joint filers with modified AGI between $190,000 and $220,000.
- **Student loan interest deduction** — Taxpayers can deduct a maximum of $2,500 annually for interest paid on qualified higher education loans. The deduction was supposed to revert to a maximum deduction of 60 months of interest payments, but the 2012 Tax Act permanently suspends that limitation. For 2012, the deduction is phased out for single filers with modified AGI between $60,000 and $75,000 and for joint filers between $125,000 and $155,000. The phaseout ranges will be adjusted for inflation annually.
- **Employer-provided education assistance** — Employees can exclude up to $5,250 annually in employer-provided education assistance from income and employment taxes, while employers can deduct up to $5,250 annually for qualified education expenses paid on behalf of an employee. The 2012 Act makes these provisions permanent.
- **Scholarships** — The 2012 Act makes permanent the exclusion from income for income tax purposes of scholarships from the National Health Services Corps Scholarship Program and the Armed Forces Scholarship program. ❍❍❍

Please Call

The American Taxpayer Relief Act of 2012 (2012 Act) was signed into law by the president on January 2, 2013. The 2012 Act averted the tax side of the "fiscal cliff," but delayed the mandatory across-the-board spending cuts for two months. The 2012 Act prevented many of the tax increases that were scheduled to go into effect on January 1, 2013, as well as retained many favorable tax breaks that were scheduled to expire on December 31, 2012. However, it increases income taxes for some high-income individuals and eliminates the payroll tax reduction for all individuals. The articles in this newsletter cover major provisions in the 2012 Act in the areas of individual taxes, estate taxes, education provisions, and business taxes. There are many more provisions in the 2012 Act that may apply to individual situations. Please call if you would like to review your situation to determine how specific provisions may impact you. ❍❍❍