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Investment, Tax, and Financial Planning

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January 15, 2013

Re: American Taxpayer Relief Act

After weeks, indeed months of proposals and counter-proposals, seemingly endless negotiations and down-to-the-wire drama, Congress has passed legislation to avert the tax side of the so-called "fiscal cliff." The American Taxpayer Relief Act permanently extends the Bush-era tax cuts for lower and moderate income taxpayers, permanently “patches” the alternative minimum tax (AMT), provides for a permanent 40-percent federal estate tax rate, renews many individual, business and energy tax extenders, and more. In one immediately noticeable effect, the American Taxpayer Relief Act does not extend the 2012 employee-side payroll tax holiday.

The American Taxpayer Relief Act is intended to bring some certainty to the Tax Code. At the same time, it sets the stage for comprehensive tax reform, possibly in 2013. Moreover, the new law creates important planning opportunities for taxpayers, which we can discuss in detail.

Individuals

Unlike the two-year extension of the Bush-era tax cuts enacted in 2010, the debate in 2012 took place in a very different political and economic climate. If Congress did nothing, tax rates were scheduled to increase for all taxpayers at all income levels after 2012. President Obama made it clear that he would veto any bill that extended the Bush-era tax cuts for higher-income individuals. The President’s veto threat gained weight after his re-election. Both the White House and the GOP realized that going over the fiscal cliff would jeopardize the economic recovery, and the American Taxpayer Relief Act is, for the moment, their best compromise.

Tax rates. The American Taxpayer Relief Act extends permanently the Bush-era income tax rates for all taxpayers except for taxpayers with taxable income above certain thresholds: $400,000 for single individuals, $450,000 for married couples filing joint returns, and $425,000 for heads of households. For 2013 and beyond, the federal income tax rates are 10, 15, 25, 28, 33, 35, and 39.6 percent. In comparison, the top rate before 2013 was 35 percent. The IRS is expected to issue revised income tax withholding tables to reflect the 2013 rates as quickly as possible and provide guidance to employers and self-employed individuals.

Additionally, the new law revives the Pease limitation on itemized deductions and personal exemption phase out (PEP) after 2012 for higher-income individuals, but at revised thresholds. The new thresholds for being subject to both the Pease limitation and PEP after 2012 are $300,000 for married couples and surviving spouses, $275,000 for heads of households, $250,000 for unmarried taxpayers; and $150,000 for married couples filing separate returns.

Capital gains. The taxpayer-friendly Bush-era capital gains and dividend tax rates are modified by the American Taxpayer Relief Act. Generally, the new law increases the top rate for qualified capital gains and dividends to 20 percent (the Bush-era top rate was 15 percent). The 20-percent rate will apply to the extent that a taxpayer's income exceeds the $400,000/$425,000/$450,000 thresholds discussed above. The 15-percent Bush-era tax rate will continue to apply to all other taxpayers (in some cases, zero percent for qualified taxpayers within the 15-percent-or-lower income tax bracket).

Payroll tax cut. The employee-side payroll tax holiday is not extended. Before 2013, the employee-share of OASDI taxes was reduced by two percentage points from 6.2 percent to 4.2 percent up to the Social Security wage base (with a similar tax break for self-employed individuals). For 2013, the two-percent reduction is no longer available and the employee-share of OASDI taxes reverts to 6.2 percent. The employer-share of OASDI taxes remains at 6.2 percent. In 2012, the payroll tax holiday could have saved a taxpayer up to $2,202 (taxpayers earning at or above the Social Security wage base for 2012). As a result of the expiration of the payroll tax holiday, everyone who receives a paycheck or self-employment income will see an increase in taxes in 2013.

AMT. In recent years, Congress routinely "patched" the AMT to prevent its encroachment on middle-income taxpayers. The American Taxpayer Relief Act patches permanently the AMT by giving taxpayers higher exemption amounts and other targeted relief. This relief is available beginning in 2012 and going forward. The permanent patch is expected to provide some certainty to planning for the AMT. No single factor automatically triggers AMT liability, but some common factors are itemized deductions for state and local income taxes; itemized deductions for miscellaneous expenditures, itemized deductions on home equity loan interest (not including interest on a loan to build, buy, or improve a residence); and changes in income from installment sales. Our office can help you gauge if you may be liable for the AMT in 2013 or future years.

Child tax credit and related incentives. The popular $1,000 child tax credit was scheduled to revert to $500 per qualifying child after 2012. Additional enhancements to the child tax credit also were scheduled to expire after 2012. The American Taxpayer Relief Act makes permanent the $1,000 child tax credit. Most of the Bush-era enhancements are also made permanent or extended. Along with the child tax credit, the new law makes permanent the enhanced adoption credit/and income exclusion; the enhanced child and dependent care credit, and the Bush-era credit for employer-provided child care facilities and services.

Education incentives. A number of popular education tax incentives are extended or made permanent by the American Taxpayer Relief Act. The American Opportunity Tax Credit (an enhanced version of the Hope education credit) is extended through 2017. Enhancements to Coverdell education savings accounts, such as the $2,000 maximum contribution, are made permanent. The student loan interest deduction is made more attractive by the permanent suspension of its 60-month rule (which had been scheduled to return after 2012). The new law also extends permanently the exclusion from income and employment taxes of employer-provided education assistance up to $5,250 and the exclusion from income for certain military scholarship programs. Additionally, the above-the-line higher education tuition deduction is extended through 2013, as is the teachers' classroom expense deduction.

Charitable giving. Congress has long used the tax laws to encourage charitable giving. The American Taxpayer Relief Act extends a popular charitable giving incentive through 2013: tax-free IRA distributions to charity by individuals age 70 ½ and older up to maximum of $100,000 for qualified taxpayer per year. A special transition rule allows individuals to re-characterize distributions made in January 2013 as made on December 31, 2012. The new law also extends for businesses the enhanced deduction for charitable contributions of food inventory.

Estate tax. Few issues have complicated family wealth planning in recent years as has the federal estate tax. Recent laws have changed the maximum estate tax rate multiple times. Most recently, the 2010 Tax Relief Act set the maximum estate tax rate at 35 percent with an inflation-adjusted exclusion of $5 million for estates of decedents dying before 2013. Effective January 1, 2013, the maximum federal estate tax will rise to 40 percent, but will continue to apply an inflation-adjusted exclusion of $5 million (projected to be $5.25 million in 2013). The new law also makes permanent portability between spouses, which effectively raises their combined exemption amount to $10 million), as well as some Bush-era technical enhancements to the estate and generation-skipping transfer taxes.

Businesses

The business tax incentives in the new law, while not receiving as much press as the individual tax provisions, are valuable. Two very popular incentives, bonus depreciation and small business expensing, are extended, as are many business "tax extenders."

Bonus depreciation/small business expensing. The new law renews 50-percent bonus depreciation through 2013 (2014 in the case of certain longer period production property and transportation property). Code Sec. 179 small business expensing is also extended through 2013 with a generous $500,000 expensing allowance and a $2 million investment limit. Without the new law, the expensing allowance was scheduled to plummet to $25,000 with a $200,000 investment limit.

Small business stock. To encourage investment in small businesses, the tax laws in recent years have allowed non-corporate taxpayers to exclude a percentage of the gain realized from the sale or exchange of small business stock held for more than five years. The American Taxpayer Relief Act extends the 100-percent exclusion from the sale or exchange of small business stock through 2013.

Tax extenders. A host of business tax incentives are extended through 2013. They include the research tax credit, Work Opportunity Tax Credit (WOTC), Indian employment credit, New Markets Tax Credit, tax incentives for empowerment zones, and more.

Energy

For individuals and businesses, the new law extends some energy tax incentives. The Code Sec. 25C credit, which rewards homeowners who make energy efficient improvements, with a tax credit is extended through 2013. Businesses benefit from the extension of the Code Sec. 45 production tax credit for wind energy, credits for biofuels, credits for energy-efficient appliances, and many more.

Looking ahead

The negotiations and passage of the new law are likely a dress rehearsal for comprehensive tax reform during President Obama's second term. Both the President and the GOP have called for making the Tax Code more simple and fair for individuals and businesses. The many proposals for tax reform include consolidation of the current individual income tax brackets, repeal of the AMT, moving the United States from a worldwide to a territorial system of taxation, and a reduction in the corporate tax rate. Congress and the Obama Administration also must tackle sequestration, which the American Taxpayer Relief Act delayed for two months. All this and more is expected to keep federal tax policy in the news in 2013. Our office will keep you posted on developments.

If you have any questions about the American Taxpayer Relief Act, please contact my office at (941)907-0374. We can schedule an appointment to discuss how the changes in the new law may be able to maximize your tax savings.

"...the new law creates important planning opportunities for taxpayers..."

Sincerely,

Aaron Niec, CPA CFP ®

P.S. With tax season quickly approaching, please call me to schedule a meeting so that I can gather the appropriate materials to correctly and timely prepare and file your 2012 income taxes.