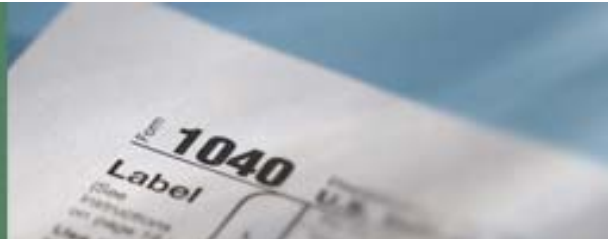


TAX TRANSITIONS 2012 – 2013



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Averting The Cliff: The American Taxpayer Relief Act of 2012 (ATRA)

On January 1, 2013, the 112th Congress passed the American Taxpayer Relief Act of 2012 (“the Act”). In rare New Year’s sessions, both the House and the Senate voted in favor of ATRA in order to avert the so-called fiscal cliff by approving much anticipated federal tax provisions, including provisions for the 2012 taxable year. Additionally, Congress delayed sequestration by postponing mandatory spending cuts for two months from January 1. On January 2, 2013, President Obama signed ATRA into law.

ATRA addresses the revenue side of the continuing fiscal cliff negotiations in several ways. The Act permanently extends the lower Bush-era income tax rates for all but the highest-income taxpayers. Tax rates for long-term capital gains and qualified dividends are permanently paired. Also, the Act establishes permanent relief for the alternative minimum tax (AMT) for 2012, as well as subsequent taxable years, and permanently unifies the estate, gift, and generation-skipping transfer taxes. Portability of a spouse’s unused exclusion amount at death is maintained.

Additionally, many business tax extenders, such as small business expensing under Internal Revenue Code (Code) section 179 and bonus depreciation expensing, are extended through the end of 2013. The Act also extends the enhanced education credit for five years.

When assessing the new tax landscape, as established by ATRA, it is important to note the different threshold levels for the various tax provisions. These newly established levels are not necessarily the same for each tax. However, the Act takes important steps to permanently index certain threshold levels for inflation.

Although ATRA resolves many of the uncertainties regarding filings for the 2012 taxable year and makes permanent numerous provisions that were merely extended by the 2010 Tax Relief Act (and therefore otherwise scheduled to sunset at the end of 2012), this legislation only marks the first step in continuing discussions regarding tax reform, entitlements, government spending, the national deficit and long-term debt.

Ordinary Income Tax Rates

Had Congress not enacted the American Taxpayer Relief Act of 2012, individual tax rates for all taxpayers would have increased in 2013. However, except for the highest-income taxpayers, ATRA makes permanent the lower Bush-era income tax rates for 2013 and beyond. Individual ordinary income tax rates are 10%, 15%, 25%, 28%, 33%, 35%, and 39.6% for 2013.



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The highest income taxpayers—individual taxpayers with taxable income in 2013 above \$400,000, \$450,000 for married filing jointly, and \$425,000 for heads of households—will be taxed at a 39.6% rate. The Act also applies these thresholds to the new, higher 20% rate for long-term capital gains and qualified dividends. The new law directs that the tax brackets be adjusted for inflation.

Now, for 2013, the 35% tax bracket includes a relatively narrow range of taxpayers:

	<u>2013 Taxable Income</u>
Single Filers	\$398,351 - \$400,000
Heads of Households	\$398,351 - \$425,000
Married Filing Jointly and Surviving Spouses	\$398,351 - \$450,000
Married Filing Separately	\$199,176 - \$225,000

For 2013, the 39.6% tax bracket applies to:

	<u>2013 Taxable Income</u>
Single Filers	Over \$400,000
Heads of Households	Over \$425,000
Married Filing Jointly and Surviving Spouses	Over \$450,000
Married Filing Separately	Over \$225,000

Long-term Capital Gains and Qualified Dividends

The Act raises only the top rate for long-term capital gains and qualified dividends. Under prior law, capital gains and qualified dividends were taxed at 0% and 15%. Under ATRA, the tax rates for long-term capital gains and qualified dividends are 0%, 15%, and a top rate of 20%. The 20% tax rate applies to the extent that capital gains and taxable income exceed the thresholds set by ATRA for the 39.6% tax bracket, as outlined above.

<u>Ordinary Income Tax Rates</u>	<u>Long-term Capital Gain and Qualified Dividend Tax Rates</u>
10%, 15%	0%
25%, 28%, 33%, 35%	15%
39.6%	20%

Non-qualified dividends continue to be taxed at ordinary income tax rates.

Phaseout of the Personal Exemption and Itemized Deductions

In 2013, each taxpayer is entitled to a personal exemption of \$3,900. When determining taxable income, the personal exemption is subtracted from a taxpayer's adjusted gross income (AGI). AGI is further reduced by either a standard deduction or itemized deductions.



ATRA provides for a personal exemption phaseout (“PEP”) as well as a phaseout of itemized deductions (the so-called Pease limitation) for high-income taxpayers. Whereas the personal exemption may be fully phased out, itemized deductions may only be phased out up to 80%. There is a single threshold for the limitations on both itemized deductions and personal exemptions, although it does not correspond with other thresholds relevant to high-income taxpayers, such as the 39.6% tax bracket or the Medicare contribution tax.

Applicable 2013 thresholds for AGI, at which the PEP and Pease limitation phaseout take effect:

	<u>2013 Threshold (AGI)</u>
Single Filers	\$250,000
Heads of Households	\$275,000
Married Filing Jointly and Surviving Spouses	\$300,000
Married Filing Separately	\$150,000

Above these thresholds, the phaseout is computed differently for PEP and itemized deductions—2% increments for personal exemptions and 3% increments for itemized deductions.

	<u>Calculation</u>	<u>Extent to Which May Be Phased Out</u>
Personal Exemption	2% of exemption phased out for every \$2,500 of AGI above the threshold (\$1,250 for married filing separately)	May be fully phased out (for married filing jointly, phaseout complete at \$422,500 AGI)
Itemized Deductions	3% of excess of AGI above the threshold (\$.03 reduction for each dollar above the AGI threshold)	May only be phased out up to 80% of itemized deductions

Categories of itemized deductions subject to the phaseout include State and local income taxes, real property and certain personal property taxes, home mortgage interest, charitable contributions, and certain miscellaneous expenses (in excess of 2% of AGI). A few items, such as medical expenses, investment interest, and casualty, theft or wagering losses, are excluded from the phaseout.

IRAs and Charitable Distributions

ATRA extends the provisions allowing tax-free distributions from individual retirement accounts (IRAs) for qualified charitable purposes by individuals 70½ years of age or older. Qualified charitable distributions may not exceed \$100,000 per taxpayer in a taxable year. A “qualified” charity is one described in Code section 170(b)(1)(A), which generally includes public charities. Although this provision had expired at the end of 2011, the extension is for two calendar years—for 2012 (subject to transitional rules) and 2013.

ATRA provides special transitional rules for 2012. First, taxpayers may elect to treat qualified charitable distributions made during January 2013 as made on December 31, 2012. Second, taxpayers may elect to treat distributions from an IRA to an individual made in December 2012 as a 2012 qualified charitable distribution to the extent that it is transferred in cash to a public



charity before February 1, 2013.

The Alternative Minimum Tax

ATRA increases the specific amounts of alternative minimum taxable income (AMTI) exempt from the alternative minimum tax (AMT). The Acts also permanently indexes AMT threshold levels for inflation.

	<u>2012 AMT Exemption</u>	<u>2013 AMT Exemption</u>
Single Filers	\$50,600	\$51,900
Married Filing Jointly and Surviving Spouses	\$78,750	\$80,800
Married Filing Separately	\$39,375	\$40,400

Gift, Estate, and Generation-Skipping Transfer Taxes

Under the Act, the applicable exclusion and exemption amounts for gift, estate, and generation-skipping transfer (GST) tax purposes remain unified at \$5 million, adjusted for inflation. Portability continues to be available for estate tax purposes. The Act imposes a 40% highest marginal transfer tax rate. To be noted, had Congress not addressed the marginal transfer tax rates, the highest marginal rate would have become 55%, with a 5% surtax on estates larger than \$10 million.

	<u>Exclusion/Exemption</u>	<u>2013 Exclusion/Exemption Adjusted for Inflation</u>	<u>Highest Marginal Tax Rate</u>
Gift	\$5,000,000 adjusted for inflation	\$5,250,000	40%
Estate	\$5,000,000 adjusted for inflation (with portability)	\$5,250,000 (with portability)	40%
GST	\$5,000,000 adjusted for inflation	\$5,250,000	40%

Various other estate tax provisions are impacted by ATRA. In particular, the 5% surtax on estates larger than \$10 million is repealed, the state death tax deduction is extended, and certain provisions affecting qualified conservation easements and the installment payment of estate taxes for closely held businesses are extended.

Prior to the enactment of ATRA, several GST tax provisions were scheduled to expire after 2012. ATRA makes permanent certain provisions that were scheduled to sunset, most importantly:

- the ability to take advantage of unused GST exemption in certain circumstances relating to “deemed allocations” and “retroactive allocations”;
- the provisions allowing for “qualified severances” of trusts;
- certain clarifying language with respect to valuation of property for GST purposes; and
- certain relief provisions related to late GST elections and allocations.



Payroll and Medicare Taxes

The new law does not impact either the expiration of the payroll tax “holiday” or the new Medicare contribution taxes, enacted in 2010 pursuant to the Patient Protection and Affordable Care Act.

	<u>Social Security Payroll Tax</u>	<u>Social Security Payroll Tax</u>
	<u>2012</u>	<u>2013</u>
Employees	4.2%	6.2%
Self-employed	10.4%	12.4%

On January 1, 2013, certain new Medicare taxes came into effect as scheduled: the additional 0.9% Medicare tax on wages for high-income wage earners, the additional 0.9% Medicare tax on high-income self-employed individuals, and the new 3.8% unearned income Medicare contribution tax on the “net investment income” of high-income taxpayers.

The 0.9% employee tax is on wages and self-employment income in excess of \$250,000 for married couples filing jointly, and \$200,000 for singles.

The 3.8% Medicare contribution tax is imposed on the net investment income of high-income individuals, estates and trusts. For individuals, the 3.8% net investment income tax applies to the lesser of (1) the individual’s net investment income for a taxable year, or (2) the excess (if any) of the individual’s modified AGI over \$250,000 for married filing jointly, and \$200,000 for singles. For estates and trusts in 2013, the threshold above which the additional 3.8% tax applies is \$11,950.

Looking Ahead to the 113th Congress

The Congressional Budget Office (CBO) estimates that, compared to the pre-Bush era laws otherwise scheduled to take effect in 2013, ATRA will result in a decrease of revenue of approximately \$280 billion in 2013, as well as a projected total decrease of approximately \$3.6 trillion beginning in 2013 through 2022. As a result of changes in revenue and direct spending associated with the Act, the CBO projects that the deficit will increase in 2013 by approximately \$330 billion, and beginning in 2013 through 2022, by approximately \$4 trillion. These CBO estimates presuppose that Congress does not make additional changes to the ATRA provisions during these timeframes.

As noted, the American Taxpayer Relief Act of 2012 is merely the initial legislative step in a broader conversation involving taxes, tax reform, and government spending. In particular, ATRA only delayed sequestration (mandatory spending cuts) for two months from January 1, 2013. So, although the 112th Congress rang in the New Year while averting the fiscal cliff, these issues remain in the forefront during the early days of the 113th Congress.



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