# Highlights of the American Taxpayer Relief Act of 2012

**Client Advisories**

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On January 1, 2013, the U.S. Congress took a significant step toward addressing one aspect of the fiscal cliff, the expiration of Bush era tax cuts, by passing The American Taxpayer Relief Act of 2012 (H.R. 8). In doing so, Congress finally came to terms with a problem largely of its own making. Back in 2001, when the Bush tax cuts were first enacted, Congress was mandated to make any tax decrease revenue-neutral. To minimize the impact, Congress limited the cuts to 10 years, thereby reducing the need to find revenue to finance them. With all that time to deal with the expiration of the rules, Congress acted like the college student waiting until the last night to complete his senior paper. What is important is that Congress got the project completed by the deadline and gets a passing grade on the assignment.

So what impact will this 137-page bill and other tax legislation have on your taxes in 2013 and the coming years? Following are the highlights for individuals:

First, between H.R. 8 and the Medicare tax legislation that also became effective January 1, 2013, nearly every individual taxpayer will face a tax increase going forward. The brunt of the income tax increase will be borne by those who have adjusted gross income in excess of $200,000 (if single) or $250,000 (if filing a joint return). A still greater impact of the new law will be placed on those making more than $400,000 in income.

**Impact on Lower Income Taxpayers**

Two different tax laws went into effect on January 1, 2013, and a third expired. Expiring was the temporary payroll tax reduction enacted in 2010 to provide wage earners with tax relief during the bad economic times following the 2008 recession. As a result of negotiations between the President and Congress, the 2% payroll tax reduction was allowed to expire as of December 31, 2012. So, all wage earners, even those in the lowest pay scale, will see their paychecks shrink starting in early 2013. Overall, these payroll adjustments will be small, and key benefits such as the earned income tax credit, child tax credit and credit for child and dependent care will continue. Congress also agreed to extend for 52 weeks the time one can collect unemployment benefits. For taxpayers whose ordinary income is generally taxed at a rate of 10% or 15%, H.R. 8 provides that capital gains and dividends will be permanently subject to a 0% tax rate. These rates were due to increase to a maximum of 10%, with dividends subject to ordinary rates, had Congress not acted.

**Tax Impact on Middle Income Individuals**

One of the new tax laws that became effective on January 1, 2013, was the Medicare tax enacted under the Patient Protection and Affordable Care Act of 2010. This imposes an additional 0.9% Medicare tax on the wages of employees earning $200,000 or more, if single, or $250,000 if married and filing jointly.

In addition to the Medicare tax imposed on wage earners, it also applies to net investment income earned by single taxpayers with more than $200,000 of adjusted gross income and married taxpayers filing jointly if adjusted gross income is $250,000 or more. The rate is 3.8% on net investment income, which includes interest, dividends, annuities, royalties, rents, passive activity income and net gains from the disposition of property other than property held in an active trade or business. It also includes hedge fund income, but not income from an active trade or business, distributions from qualified pension plans, non-qualified deferred compensation, or municipal bond interest. Individuals whose total income falls below $200,000 single or $250,000 joint will not be subject to this tax. However, those with wages greater than $200,000 single or $250,000 joint who have investment income could be subject to both the 0.9% on wages in excess of the threshold and the 3.8% tax on investment net income.

**Personal Exemption and Itemized Deduction Phase Outs**

Another impact of H.R. 8 that will affect both middle and upper tax bracket taxpayers is the phase out of the personal exemption and itemized deductions for taxpayers whose adjusted gross income exceeds $300,000 for joint filers and surviving spouses, $275,000 for heads of households, $250,000 for single filers and $150,000 for married taxpayers filing separately. These rules had been in effect during the 1990s but were thereafter dropped from the Internal Revenue Code during the Bush administration. Like a vampire, these have come back to life to reduce the benefit of the exemptions and itemized deductions for middle- and high-income taxpayers.

Exemptions subject to the limitation are reduced by 2% for each $2,500 by which the taxpayer’s adjusted gross income exceeds the threshold amount. Itemized deductions are reduced by 3% of the amount by which the taxpayer’s adjusted gross income exceeds the threshold amount, with the reduction not to exceed 80% of the otherwise adjusted allowable itemized deductions. Essentially, this means that a high-income individual could lose the tax benefit of personal exemptions and up to 80% of allowable itemized deductions.

## Impact of H.R. 8 on High-Income Individual

For tax years beginning on or after January 1, 2013, tax bracket rates will remain the same as in 2012 with the exception of a new 39.6% rate that will apply to taxable income in excess of an “applicable threshold.” The applicable threshold is $450,000 for joint filers and surviving spouses, $425,000 for heads of households, $400,000 for single filers and $225,000 for married taxpayers filing separately.

Taxpayers in this category of income also face a higher tax rate on qualified dividends and long-term capital gains. Instead of a preferential rate of 15% as in past years, the rate on such income will be 20%. However, as such persons could also be subject to the Medicare tax on investment income, the total tax rate on long-term capital gains and dividends could actually be 23.8%, 8.8 percentage points higher than in 2012. In short, persons in the new high income bracket will be subject to a 39.6% rate on their taxable income over the threshold amount, a 0.9% Medicare tax on salary exceeding the Medicare tax floor, and 23.8% on the preferential income from qualified dividends and long-term capital gains. They will also see the tax benefit of their personal exemptions reduced and the value of any itemized deductions significantly limited.

## Alternative Minimum Tax Changes

H.R. 8 finally addresses a problem Congress has delayed acting on for decades. The alternative minimum tax (“AMT”) is a separate tax that applies to taxpayers who have been effective in using tax deductions and other tax benefits to substantially reduce their income taxes. The AMT is a way to ensure that one cannot reduce his tax rate through certain “tax preferences” below a rate of 26% or 28%. However, unlike individual tax rates, which have been indexed for inflation, the AMT rate has not been indexed. Congress had to repeatedly pass an annual bill to correct this problem so that middle class taxpayers did not slip into paying the AMT. Congress has now agreed to adjust the AMT rate for inflation on an annual basis in the same manner as regular income tax rates. Congress also passed a fix for 2012 to minimize the impact of the tax retroactively for the 2012 year. The 2012 AMT Exemption Amounts will increase to $78,750 for married persons filing jointly and $50,600 for unmarried individuals.

## Overall Impact of Tax Changes

The Congressional Budget Office published the following table, which summarizes the impact of the expiration of the payroll tax, the enactment of the Medicare tax, and the new H.R. 8 Law on various individual taxpayers.

How taxes would change this year from 2012 under H.R. 8, on top of the effects of the expiring payroll tax cut and new taxes from the health care law:

Advisory Tax Chart

The impact of the law on any individual will depend on the amount of income, the type of income earned, and the extent to which the taxpayer uses personal exemptions and takes itemized deductions. Overall, the Act increases taxes on those with higher incomes, keeps rates low on lower to middle class taxpayers and keeps in place many of the tax benefits and credits that were due to expire on December 31, 2012, making some of them permanent or otherwise extending them to 2018. These benefits and credits include: the earned income tax credit, tuition credits, marriage penalty relief, and deductions for state and local general sales taxes, among others. Middle- to high-income taxpayers who greatly benefit from itemized deductions will pay more tax. Those who realize most of their income from municipal bond interest are not likely to see much in the way of change.

**Estate and Gift Tax Changes**

For those concerned about changes in the federal estate, gift and generation skipping taxes, Congress left those rules largely unchanged from 2012 except for raising the maximum federal gift and estate tax rate to 40% (up from 35%). What is truly significant on this issue is that Congress made the $5 million gift and estate tax exemption amount permanent, provided for the exemption amount to be indexed for inflation, and made permanent the portability provisions that allow a husband and wife to share their combined $10 million exemption. As a result of indexing rates to inflation, the total estate and gift tax exemption amount for 2013 will be $5,250,000. The total annual gift tax per donee annual exclusion in 2013 will be $14,000 (up from $13,000).

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While Congress drove everyone crazy with its last minute negotiations and vote, it did accomplish a great deal in making the tax rates for income and estate taxes essentially permanent. While no law is ever permanent, Congress did not set any automatic expiration dates for the tax rates, as was the case before. We can expect these rates to remain in effect for the foreseeable future, thereby enabling taxpayers to do more effective tax planning.

If you have questions or would like to discuss this advisory or a related matter, please contact any member of Archer’s Tax Law Group.

For a previous Archer advisory on a new Roth account conversion opportunity in the fiscal cliff legislation, click here.

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