

# Fiscal Cliff Tax Changes

January 4, 2013

On January 1, 2013, the U.S. House of Representatives approved a Senate-drafted bill entitled the "American Taxpayer Relief Act of 2012" (the "Act") to avert the so-called "Fiscal Cliff". President Obama has signed the bill into law. The Act makes permanent or extends a number of tax provisions that were set to expire at the end of 2012, preventing an increase in income tax rates for a majority of U.S. taxpayers. The following summarizes some of the key tax provisions in the Act, as well as previously enacted law, which will impact taxpayers starting in 2013.

## Ordinary Income Tax Rates

The Act makes permanent the 10%, 15%, 25%, 28%, 33%, and 35% ordinary income tax rates that applied in 2012. However, taxpayers with income exceeding certain thresholds will now be subject to a top rate of 39.6% on the portion of their ordinary income that exceeds such thresholds. The applicable thresholds are (i) \$400,000 for unmarried individuals, (ii) \$425,000 for individuals filing as head of household, and (iii) \$450,000 for married individuals filing joint returns. These thresholds will be adjusted for inflation for tax years beginning after 2013.

Ordinary income of trusts and estates will be subject to the following graduated tax rates starting in 2013: 15%, 25%, 28%, 33%, and 39.6%. The IRS has not yet released the inflation-adjusted tax tables for 2013. In 2012 the ordinary income of trusts and estates was taxed at the highest marginal income tax rate starting at \$11,650.

## **Capital Gains and Dividends**

The Act increases the maximum tax rate for adjusted net capital gains (including qualified dividend income) from 15% to 20%. The 20% rate will apply to taxpayers whose taxable incomes exceed the applicable thresholds used for the 39.6% ordinary income tax rate, but only to the extent of such excess.

## **Payroll Tax**

The Act does not extend the 2% reduction in payroll taxes for the Old Age, Survivors and Disability Insurance portion of Social Security taxes that applied in 2011 and 2012.

## **Increased Medicare Tax (not part of the Act)**

A new 3.8% Medicare surtax on unearned income, which was added as part of the 2010 Affordable Care Act, also goes into effect in 2013. This Medicare surtax will apply to unmarried individuals with modified adjusted gross incomes exceeding \$200,000 and to married individuals filing joint returns with modified adjusted gross incomes exceeding \$250,000.

Thus, starting in 2013, the top adjusted rates on net long-term capital gains and on other unearned income will be 23.8% and 43.4%, respectively, for a taxpayer with taxable income and modified adjusted gross income exceeding the applicable thresholds.

Starting in 2013, the Medicare tax on earned income increases by 0.9% for unmarried individuals with earned incomes exceeding \$200,000 and to married individuals filing joint returns with earned incomes exceeding \$250,000.

## **Estate, Gift, and Generation-Skipping Transfer Taxes**

The Act prevents steep increases in estate, gift, and generation-skipping transfer taxes that were slated to occur for individuals dying and gifts made after 2012 by permanently keeping the exemption level at \$5,000,000, indexed for inflation from 2010. However, the Act also permanently increases the top estate, gift, and generation-skipping transfer tax rates from 35% to 40%. The Act also continues the portability feature that allows the estate of the first spouse to die to transfer his or her unused exclusion to the surviving spouse. All changes are effective for individuals dying and gifts made after 2012.

## **Itemized Deductions and Personal Exemptions**

The Act reinstates the cap on itemized deductions and the phase-out of personal exemptions for taxpayers with high adjusted gross incomes. The itemized deductions limitation reduces the total amount of a taxpayer's itemized deductions by 3% of the amount by which the taxpayer's adjusted gross income exceeds

the applicable threshold amount described below, but the reduction may not exceed 80% of the otherwise allowable itemized deductions. The total amount of the deduction for personal exemptions that may be claimed by a taxpayer subject to the limitation is reduced by 2% for each \$2,500 (or portion thereof) by which the taxpayer's adjusted gross income exceeds the applicable threshold. These deduction limitations will apply to unmarried individuals with income exceeding \$250,000 and for married individuals filing joint tax returns with income exceeding \$300,000, adjusted for inflation for tax years beginning after 2013.

### **Alternative Minimum Tax**

The Act includes a permanent fix to the alternative minimum tax for individuals, trusts, and estates by increasing the alternative minimum tax exemption amount, which makes it less likely that a middle income taxpayer will be subject to the alternative minimum tax. This fix is effective for 2012 and subsequent years. The Act also provides for an inflation adjustment of the exemption amount starting for tax years beginning after 2012.

### **Business Tax Incentives**

The Act temporarily extends many popular tax provisions for businesses, including the accelerated "bonus" depreciation and Section 179 deduction for investments in new property and equipment, the research and development tax credit, and the new markets tax credit. For subchapter S corporations, the Act also temporarily extends the reduced recognition period (5 years) for application of the built-in gains tax for sales occurring in 2012 and 2013.



For taxpayers other than corporations the Act extends the 100% exclusion for gain on the sale of qualified small business stock held for more than five years to include stock acquired before January 1, 2014.

### **Credits for Individuals**

The Act also temporarily extends many tax credits utilized by individuals, such as the earned income tax credit, the child tax credit, and the \$2,500 credit for qualified tuition payments.

### **Roth Conversions**

The Act allows a participant in any Section 401(k), 403(b) or 457(b) plan to convert any amount in a non-Roth account to a Roth account in the same plan, and the amount converted will be subject to regular income tax. Previously, a participant could convert an amount in a pre-tax account only to the extent that the participant had the current right to withdraw the amount from the plan.

***This summary only provides a brief overview of certain provisions of the Act. To discuss this alert or any tax law matter, please contact your Lathrop Gage attorney or any of the attorneys listed on this alert.***