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MP&S Tax Alert: What the American Taxpayer Relief Act Means for Your Individual Taxes

Despite Some Legislative Relief, Many Individuals Will See Higher Taxes in 2013

The American Taxpayer Relief Act of 2012 (ATRA) does, as its name implies, provides substantial tax relief to many taxpayers. However, while higher-income taxpayers will enjoy some benefits, they'll also see some tax increases. Here's a closer look at ATRA's most important changes for individuals, along with the tax planning implications.

Ordinary Income Tax Rates

ATRA makes the 2012 tax rates permanent for most individual taxpayers for 2013 and later years. (For tax years 2003 through 2012, the top marginal tax rate was 35%). However, beginning in 2013, taxpayers with taxable income that exceeds $400,000 (single individuals), $425,000 (heads of households) or $450,000 (married couples filing jointly) will be subject to a higher top marginal tax rate of 39.6% on taxable income in excess of the applicable threshold. These thresholds will be indexed for inflation in future years.

Because the tax rates are permanent, for 2013 you can employ the traditional timing strategies of accelerating deductible expenses into the current year and deferring income to the next year, where possible, to defer tax (assuming you don't expect to be in a higher tax bracket in 2014). If you're facing the 39.6% rate, however, you may want to see if there are additional strategies you can employ to help minimize the impact of the higher rate.

Long-Term Capital Gains Rates

ATRA makes the maximum capital gains tax rate of 15% rate permanent, except that it brings back a 20% capital gains rate for higher-income taxpayers. As with the top 39.6% ordinary income tax rate, the 20% capital gains tax rate also applies when taxable income exceeds $400,000 (single individuals), $425,000 (heads of households) or $450,000 (married filing jointly) — indexed for inflation in future years.

ATRA also makes permanent the 0% capital gains tax rate for taxpayers in the bottom two tax brackets. If you have children or other loved ones in these brackets, consider transferring appreciated assets to them. They can sell the assets and pay no tax on the capital gain. You may find this strategy particularly powerful if you pay tax at the 20% rate if you sold the assets. However, before gifting any assets, if the recipients are under age 24, make sure they won't be subject to the "kiddie tax." Additionally, regardless of their age, consideration should also be given to any gift tax consequences.

Qualified Dividend Tax Rates

ATRA also makes permanent the long-term capital gains treatment of qualified dividends. Consequently, most taxpayers will continue to enjoy a 15% rate (0% for those in the bottom two brackets). However, taxpayers with taxable incomes exceeding the applicable income thresholds will face a rate increase to 20% on qualified dividends. Nevertheless, without ATRA, they would have paid a much higher rate, because dividends would have gone back to being taxed at ordinary income rates in 2013, with a top rate of 39.6%.

If you hold dividend-producing investments and will face the 20% rate, consider whether you should make adjustments to your portfolio in light of their potentially higher tax cost. Keep in mind, however, that qualified dividends will remain more attractive from a tax perspective than other income investments. For example, interest from CDs, money market accounts and taxable bonds will continue to be taxed at ordinary-income rates.

Itemized Deduction Reduction and Personal Exemption Phase Out

For 2010 through 2012, the income-based reduction on itemized deductions and phaseout of personal exemptions were eliminated. ATRA allows both limits to return in 2013 and sets thresholds for them of $250,000 (singles), $275,000 (heads of households) and $300,000 (married filing jointly).

This actually provides some tax savings over what would have occurred without ATRA, because the thresholds would have been significantly lower. For future years, the thresholds will be indexed for inflation.

AMT

Before ATRA, unlike the regular tax system, the alternative minimum tax (AMT) system was not regularly adjusted for inflation. Instead, Congress legislated adjustments in the form of a “patch” — an increase in the AMT exemption. Given that the last patch had expired Dec. 31, 2011, millions more taxpayers could have been subject to the AMT on their 2012 tax returns.

ATRA makes the patch permanent by increasing the exemptions for 2012 and indexing them for inflation for future years. ATRA also makes permanent the ability to offset your AMT liability with certain nonrefundable personal credits.

You may be able to time income and deductions to avoid the AMT or reduce its impact. Now that AMT relief is permanent, AMT planning will be a little easier.

Deduction for State and Local Sales Taxes

For the last several years, taxpayers have been allowed to take an itemized deduction for state and local *sales* taxes in lieu of state and local *income* taxes. ATRA extends this break for 2012 and 2013.

The break can be valuable to those residing in states with no or low income tax rates or who purchase major items, such as a car or boat. If you’re contemplating a major purchase, you may want to make it in 2013 to ensure the sales tax deduction is available.

Breaks Related to Children and Education

Many child and education-related breaks that had expired (generally on Dec. 31, 2012) have been made permanent by ATRA, while others have been temporarily extended:

- The $1,000 child credit and other enhancements of the credit have been made permanent.
- The higher adoption credit and income exclusion for employer-provided adoption assistance have been made permanent.
- The higher dependent care credit has been made permanent.
- The American Opportunity education credit has been extended through 2017.
- The above-the-line tuition and fees deduction (expired Dec. 31, 20*11*) has been extended through 2013.
- The enhancements to the student loan interest deduction have been made permanent.

- The income exclusion for employer-provided education assistance has been made permanent.
- The $2,000 Coverdell Education Savings Account (ESA) annual contribution limit, the ability to use tax-free ESA distributions for elementary and secondary school expenses, and other ESA enhancements have been made permanent.

Please note, however, that the benefit of many of these breaks is phased out if a taxpayer's income exceeds certain limits.

Don't Forget About Medicare Tax Hikes

Under the 2010 health care act, an additional 0.9% Medicare tax on earned income and a new 3.8% Medicare tax on net investment income go into effect in 2013 when income exceeds certain levels. Taxpayers hit with higher income tax rates under ATRA will likely also face the expanded Medicare taxes. Including the expanded Medicare taxes, these taxpayers could see a 5.5 percentage point tax increase on a portion of their earned income, and an 8.8 percentage point tax increase on some or all of their long-term capital gains and qualified dividend income (8.4 percentage points on short-term gains, nonqualified dividends and taxable interest).

Additionally, some taxpayers who escape an income tax hike will nevertheless still face a Medicare tax increase. This is because the thresholds for the expanded Medicare taxes are much lower than those for the 39.6% ordinary-income tax rate and the 20% long-term capital gains rate.

The additional 0.9% Medicare tax applies to FICA wages and self-employment income exceeding $200,000 (singles and heads of households) or $250,000 (married couples filing jointly). The new 3.8% Medicare tax applies to net investment income to the extent that modified adjusted gross income exceeds those same thresholds. ATRA did nothing to change these thresholds.

These expanded Medicare taxes going into effect in 2013 were the subject of two separate Tax Alerts that we recently issued. Please contact us if you would like additional copies of these Alerts.

Tax Planning Remains Complicated

The changes under ATRA affect many areas of planning, and, in addition, there are the Medicare tax increases to consider. Complicating matters further is the fact that higher rates and various limits on tax breaks go into effect at different income levels, depending on the type of tax or break. We would be pleased to help you determine how you will be affected and what strategies you can implement to reduce, or at least defer, taxes.

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FOR MORE INFORMATION

If you have questions about anything you read in this Alert or in the MP&S tax guide, please contact an MP&S tax advisor or Steven Eliach, JD, LLM, the Principal-in-Charge of the MP&S Tax Practice, by phone at 212.503.6388 or by email at seliach@markspaneth.com.

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