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CLIENT NEWSLETTER

WINTER 2012-2013

January 1, 2013: Fiscal Cliff Averted (Sort of)

Late on January 1, 2013 Congress passed the *American Tax Relief Act* which averted the *tax aspects* of the so-called "Fiscal Cliff". No agreement was reached with respect to future government spending and deficit reduction. Also no agreement was reached on exceeding the legal debt ceiling of the U.S. Government, which occurred over the weekend. Such an agreement must be reached by approximately mid-February to prevent the United States from defaulting on its obligations. Stay tuned.

The American Tax Relief Act removes *all* of the expiration dates contained in the laws comprising the so-called "Bush-Era Tax Cuts" (see note at the end of this Newsletter for definition of this term), as well as some expiration dates contained in later tax laws, thereby making almost all of the Bush-Era Tax Cuts "permanent"; that is, as permanent as tax laws ever are. Here is a summary:

Tax Rates on Individuals:

For those with *taxable income* (that is, income after all deductions and exemptions) below $400,000 (single), $425,000 (head-of-household), and $450,000 (married filing jointly), all tax rates remain the same. For those above these threshold amounts, the top tax rate of 35% is increased to 39.6% beginning in 2013. That means that a couple with taxable income of $500,000 will pay an extra 4.6% on the taxable income over $450,000 or $2,300 (4.6% x $50,000). A couple making $5,000,000 will pay an extra $209,300 (4.6% x $4,550,000).

Increased Social Security Tax:

The temporary 2% decrease in Social Security taxes that was in effect for 2011 and 2012 has expired. Therefore, effective 1/1/13 employees and self-employed persons will see their Social Security taxes increase by $20 per $1000 earned. The maximum amount of taxable Social Security income in 2013 is $113,700, making the maximum Social Security tax 6.2% x $113,700 = $7,049.40 each on the employee and employer.

Higher Medicare Tax; Less Medical Deductions:

As previously enacted under the Affordable Health Care Act, starting in 2013 married couples with taxable income over $250,000 ($200,000 for singles), will pay a Medicare Tax of 3.8% on their investment income on amounts exceeding $250,000. People earning salaries above $200,000 will have an additional 0.9% Medicare tax withheld from their paychecks. This will be creditable against the 3.8% tax on investments. Therefore those making over the Medicare threshholds will be subject to the increased Medicare Tax, and those making over the income tax thresholds (see above) will be subject to both higher income taxes and higher Medicare taxes.

Effective in 2013, medical expenses will be deductible only to the extent they exceed **10%** of adjusted gross income ("AGI"), up from 7.5%. For those 65 and older, this change is postponed until 2017.

Phase-Out of Personal Exemptions and Itemized Deductions

Effective 2013: For adjusted gross incomes ("AGI") exceeding $300,000 (married/joint), $275,000 (head-of-household), and $250,000 (single), itemized deductions and personal exemptions will be phased out by disallowing itemized deductions by 3% of the amount that AGI exceeds the above thresholds (up to a maximum of 80% of itemized deductions). Personal exemptions are reduced by 2% of AGI in excess of the threshold amounts (in $2500 increments). For example, if a joint return has AGI of $500,000, then $6,000 [3% x ($500,000 - $300,000)] of itemized deductions would be disallowed; $4,000 of personal exemptions would also be disallowed. (Similar rules were in effect through the mid-2000's.)

Estate & Gift Taxes:

The lifetime exemption is set permanently at $5,000,000 (adjusted annually for inflation), as it has been since 2011. Tax rates will now be 40% (up from 35%) on estates exceeding $5,000,000. The "portability" provision in effect since 2011, which allowed the unused portion of the exemption of the first spouse to die to be transferred to the surviving spouse, is retained. This means that a married couple has a $10,000,000 exemption. The change in the exemption was a very important provision for **middle class families**, particularly those living in places where home values are high. Had this not been enacted, the exemption would have reverted to $1,000,000 with no "portability", thereby subjecting many middle class families to the Estate Tax. All changes are effective for decedents dying on or after 1/1/13.

Capital Gains and Dividends:

Rates on capital gains and dividend income are retained for many taxpayers: 0% maximum for those whose tax bracket is below 25% (married filing jointly with taxable income below about $69,000, single below about $35,000), and 15% for those in the 25% and higher brackets but below 39.6%, and a new 20% rate (effective 2013) that applies individuals who are subject to the 39.6% rate on regular income (see "Tax Rates on Individuals" above).

Credits Extended:

American Opportunity Tax Credit for education costs, refundable child tax credit of $1000 per child, and the increased Earned Income Tax Credit for low income workers. The child tax credit is of particular importance to **middle class families**, as the credit was scheduled to drop to $500 per child, and be limited to tax liability (non-refundable unless there was enough tax to cover the credit).

Alternative Minimum Tax (AMT) Fix Made Permanent:

Each year Congress would enact a last minute "AMT Fix" to prevent **middle class families** from being subjected to this onerous tax. This was necessary because the exemption from the AMT was a fixed amount (set in the 1990s) and not adjusted for inflation. Finally we have a permanent fix. The new AMT exemptions for 2012 are $78,750 (married/joint), $50,600 (single or head-of-household), and $39,375 (married/separate). These amounts will be adjusted for inflation starting in 2013, so they don't have to be adjusted annually by Congress.

Roth IRA Transfers from Qualified Plans:

Qualified pension, profit sharing, 401(k) and other plans will be allowed to permit a participant to transfer funds to a Roth IRA even if the participant is not otherwise eligible to receive a distribution from the Plan. The amount distributed will be taxable to the participant. Effective January 1, 2013 and thereafter.

Other Extenders for Individuals for 2012 and 2013:

- Teachers' expenses up to $250.
- Non-taxability of cancellation of debt on principal residence.
- Deductibility of Mortgage Insurance Premiums ("PMI").
- Option to deduct state & local sales taxes if greater than state & local income taxes.
- Deduction up to $4000 for qualified school tuition.
- Tax-free Distributions from IRAs to Charities, with special rules for those who took Required Minimum Distributions in December 2012. Also, transfers from IRAs to charities made by January 31, 2013 can be treated as being made in 2012.

Business Tax Extenders 2012 and 2013:

- Research Credit and Rare Disease Testing Credit.
- Employer Wage credit for Employees who are active members of the Uniformed Services.
- Work Opportunity Credit.
- 15 year depreciation for qualified Leasehold Improvements, Restaurant Buildings, and Retail Improvements, for things placed in service by 12/31/13.
- Section 179 (direct deduction of business assets) of $500,000 per year.
- 100% exclusion of gain on certain small business stock.
- Many other items extended for specific businesses and/or industries.

Non-Tax Provision:

As with the annual “AMT Fix”, each year Congress would enact a last minute “Doc Fix” to prevent Medicare payments to doctors from being cut by 26.5%, which would have the effect of forcing many doctors to stop participating in Medicare. But the new Doc Fix is for only one year, 2013, so this will be debated yet again.

Our next Newsletter will focus on the Affordable Health Care Act and/or Tax Law changes (if there are any). News Flashes and Newsletters are posted on our website www.famtax.com.

Please feel free to call or write if you have any questions.

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 and 

“Bush-Era Tax Cuts”:

The “Bush-era” tax cuts is the collective term for the tax measures enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA). In addition to the individual, capital gains, dividends and estate tax rates that remain the focus of the attention, EGTRRA made over 30 other major changes to the Tax Code, which were set to expire at the end of 2010. The 2010 Tax Relief Act extended all these measures through 2012. EGTRRA also made many changes to retirement and pension rules in the Tax Code. These changes were made permanent by the Pension Protection Act of 2006 (PPA