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JANUARY 2nd, 2013

TAX ALERT!

Re: 2012 American Taxpayer Relief Act (ATRA)

Dear Friends,

After much debate, endless negotiations and down-to-the-wire drama, Congress finally passed the American Taxpayer Relief Act (ATRA) of 2012. ATRA averts the tax side of the “fiscal cliff”, provides numerous extenders and avoids the automatic sunset provisions that were scheduled to take effect after 2012 under the “Bush-era” tax cuts in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA).

The impact on individuals is significant. Without the American Taxpayer Relief Act, individual tax rates on all income groups would have increased, taxpayer-friendly treatment of capital gains and dividends would have been greatly diminished, the federal estate tax would have reverted to a maximum 55 percent with $1M lifetime exclusion, and many other popular but temporary incentives would no longer be available.

INDIVIDUAL INCOME TAX RATES

The American Taxpayer Relief Act makes permanent for 2013 and beyond the lower Bush-era income tax rates for all individuals, except those taxpayers with taxable income above $400,000 ($450,000 for married taxpayers, $425,000 for heads of households & $225,000 for married filing separately).

Income above these levels will be taxed at a 39.6 percent rate. Therefore, the 10, 15, 25, 28 and 33 percent marginal rates remain the same after 2012, as does the 35 percent rate for income between the top of the 33 percent rate (projected to be at $398,350 for most taxpayers) and the $400,000 (single) / $450,000 (married filing jointly) thresholds referenced above at which point the 39.6 percent bracket now begins. *Taxpayers in the 39.6 percent marginal income tax bracket nevertheless <u>also benefit from extension of all Bush-era rates below that level.</u>*

Marriage Penalty Relief (*sort of)*

The American Taxpayer Relief Act extends all existing marriage penalty relief provisions. Before EGTRRA, married couples experienced the so-called marriage penalty in several areas. EGTRRA gradually increased the basic standard deduction for a married couple filing a joint return to twice the basic standard deduction for an unmarried individual filing a single return. Without marriage penalty relief, the standard deduction for married couples would be 167 percent of the deduction for single individuals rather than 200 percent. For joint filers in 2013, that would have meant a drop of $1,950, from $12,200 to $10,150.

EGTRRA also gradually increased the size of the 15 percent income tax bracket for a married couple filing a joint return to twice the size of the corresponding rate bracket for an unmarried individual filing a single return. Without that relief, the top of the 15 percent rate bracket in 2013 for married taxpayers filing jointly would be set at a projected $60,550 rather than $72,500.

Nonetheless, for those with higher incomes you will note that the higher 39.6% tax rate and higher 20% rate on long term capital gains (LTCG) kicks in at $450,000 for married filing jointly <u>*not*</u> *at $800,000 which would represent double the $400,000 single filer threshold.* That is why I qualify the statement above regarding Marriage Penalty Relief *(sort of)* as it depends greatly upon your income level. It is even worse for those who have non-resident alien spouses that do not file. These folks are required to file as married filing separately and *hit the highest tax rates mentioned above at a threshold of $225,000!*

CAPITAL GAINS/DIVIDENDS

The American Taxpayer Relief Act raises the top rate for capital gains and dividends to 20 percent, up from the Bush-era maximum 15 percent rate. That top rate will apply to the extent that a taxpayer's income exceeds the thresholds set for the 39.6 percent rate.

All other taxpayers will continue to enjoy a capital gains and dividends tax at a maximum rate of 15 percent. A zero percent rate will also continue to apply to capital gains and dividends to the extent income falls below the top of the 15 percent income tax bracket—projected for 2013 to be $72,500 for joint filers and $36,250 for singles. Qualified dividends for all taxpayers continue to be taxed at capital gains rates, rather than ordinary income tax rates as prior to 2003.

Without the American Taxpayer Relief Act, the maximum tax rate on net capital gain of all non-corporate taxpayers would have reverted to 20 percent (10 percent for taxpayers in the 15 percent bracket) starting January 1, 2013.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA)
It should be noted that starting in 2013, under the Patient Protection and Affordable Care Act (PPACA), higher income taxpayers must also start paying a 3.8 percent additional tax on Net Investment Income (NII) to the extent certain threshold amounts of income are exceeded ($200,000 for single filers, $250,000 for joint returns and surviving spouses, $125,000 for married taxpayers filing separately). Those threshold amounts stand, despite higher thresholds now set for the 20 percent capital gain rate that previously had been proposed by President Obama to start at the same levels. The NII surtax thresholds are not affected by the American Taxpayer Relief Act. Starting in 2013, therefore, taxpayers within the NII surtax range must pay the additional 3.8 percent on capital gain, whether long-term or short-term. The effective top rate for net capital gains for many "higher-income" taxpayers thus becomes 23.8 percent for long term gain and 43.4 percent for short-term capital gains starting in 2013.

PEASE LIMITATION

The American Taxpayer Relief Act officially revives the "Pease" limitation on itemized deductions, which was eliminated by EGTRRA. The Pease limitation, named after the member of Congress who sponsored the original provision, reduces the total amount of a higher-income taxpayer's otherwise allowable itemized deductions by three percent of the amount by which the taxpayer's adjusted gross income exceeds an applicable threshold. However, the amount of itemized deductions is not reduced by more than 80 percent. Certain items, such as medical expenses, investment interest, and casualty, theft or wagering losses, are excluded.

However, higher "applicable threshold" levels apply under the new law:

1. $300,000 for married couples and surviving spouses;
2. $275,000 for heads of households;
3. $250,000 for unmarried taxpayers; and
4. $150,000 for married taxpayers filing separately.

The applicable threshold for the Pease limitation for 2013, as adjusted for inflation and as computed under the sunset rules, would have been $178,150 ($89,075 for individuals married filing separately). Thus, the American Taxpayer Relief Act does not call for a full revival of the Pease limitation at former levels.

PERSONAL EXEMPTION PHASEOUT

The American Taxpayer Relief Act also officially revives the personal exemption phaseout rules, but at applicable income threshold levels slightly higher than in the past:

1. $300,000 for married couples and surviving spouses;
2. $275,000 for heads of households;
3. $250,000 for unmarried taxpayers; and
4. $150,000 for married taxpayers filing separately.

Under the phaseout, the total amount of exemptions that may be claimed by a taxpayer is reduced by two percent for each $2,500, or portion thereof (two percent for each $1,250 for married couples filing separate returns) by which the taxpayer's adjusted gross income exceeds the applicable threshold level.

PERMANENT ALTERNATIVE MINIMUM TAX RELIEF (but AMT does not go away entirely)

The alternative minimum tax (AMT) exemption amounts for individuals have been increased for tax years beginning in 2012 and made permanent. The exemption amounts for the 2012 tax year are $78,750 for a joint return or surviving spouse, $50,600 for an unmarried individual not a surviving spouse, $39,375 for married individuals filing separately. The exemption amounts will be indexed for inflation for calendar years beginning after 2012.

Although the AMT exemption amounts for individuals have increased for 2012, the threshold levels for calculating the exemption phaseout remain unchanged, except as to an estate, trust or corporation. Thus, the exemption amount for tax years beginning in 2012 is still reduced by 25 percent for each $1 of alternative minimum taxable income (AMTI) in excess of: (1) $112,500 in the case of unmarried individuals, (2) $150,000 in the case of married individuals filing a joint return and surviving spouses, and (3) 50 percent of the dollar amount applicable to married taxpayers filing jointly in the case of married individuals filing separate returns. However, because the calculation of the phaseout amount is affected by the amount of AMTI exempted, an increase in the exemption amount will also increase the maximum amount of AMTI a person can have before the exemption amount is phased out. *Regardless many with higher incomes will remain subject to the AMT.*

EDUCATION INCENTIVES

The American Taxpayer Relief Act makes permanent or extends a number of enhancements to tax incentives designed to promote education. Many of these enhancements were made in Bush-era legislation, extended by subsequent legislation and were scheduled to expire after 2012. Some enhancements, notably the American Opportunity Tax Credit, were made in President Obama's first term.

American Opportunity Tax Credit

The American Opportunity Tax Credit (AOTC) is extended through 2017. The AOTC is an enhanced, but temporary, version of the permanent HOPE education tax credit. The AOTC gives qualified taxpayers a tax credit of 100 percent of the first $2,000 of qualified tuition and related expenses and 25 percent of the next $2,000, for a total maximum credit of $2,500 per eligible student. Additionally, the AOTC applies to the first four years of a student's post-secondary education. The HOPE credit is less and applies only to the first two years of post-secondary education.

Deduction for Qualified Tuition and Related Expenses

The American Taxpayer Relief Act extends until December 31, 2013 the above-the-line deduction for qualified tuition and related expenses. The bill also extends the deduction retroactively for the 2012 tax year.

Student Loan Interest Deduction

The American Taxpayer Relief Act permanently extends suspension of the 60-month rule for the $2,500 above-the-line student loan interest deduction. The American Taxpayer Relief Act also permanently expands the modified adjusted gross income range for phase out of the deduction and repeals the restriction that makes voluntary payments of interest nondeductible.

Coverdell Education Savings Accounts

The American Taxpayer Relief Act permanently extends Bush-era enhancements to Coverdell education savings accounts (Coverdell ESAs). These enhancements include a $2,000 maximum contribution amount and treatment of elementary and secondary school expenses as well as postsecondary expenses as qualified expenditures.

Employer-Provided Education Assistance

The American Taxpayer Relief Act permanently extends the exclusion from income and employment taxes of employer-provided education assistance up to $5,250. The employer may also deduct up to $5,250 annually for qualified education expenses paid on behalf of an employee.

Federal Scholarships

The American Taxpayer Relief Act makes permanent the exclusion from income for the National Health Service Corps Scholarship Program and the Armed Forces Scholarship Program.

MORE INDIVIDUAL TAX EXTENDERS

- *Exclusion of Cancellation of Indebtedness on Principal Residence*. Cancellation of indebtedness income is includible in income, unless a particular exclusion applies. This provision excludes from income cancellation of mortgage debt on a principal residence of up $2 million. The American Taxpayer Relief Act extends the provision for one year, through 2013.

- *Mortgage Insurance Premiums.* This provision treats mortgage insurance premiums as deductible interest that is qualified residence interest. The American Taxpayer Relief Act extends this provision through December 31, 2013. The provision originally expired after 2011.

- *Contribution of Capital Gains Real Property for Conservation.* The Act extends for two years, through December 31, 2013, the special rule for contributions of capital gain real property for conservation purposes. The special rule allows the contribution to be taken against 50 percent of the contribution base. The Act also extends for two years the special rules for contributions by certain corporate farmers and ranchers.

- *IRA Distributions to Charity.* The American Tax Relief Act extends for two years, through December 31, 2013, the provision allowing tax-free distributions from individual retirement accounts to public charities, by individuals age 701/2 or older, up to a maximum of $100,000 per taxpayer per year.

ESTATE TAX

Federal transfer taxes (estate, gift and generation-skipping transfer (GST) taxes) seem to have been in a constant state of flux in recent years. The American Taxpayer Relief Act aims to provide some certainty. Effective January 1, 2013, the maximum estate, gift and GST tax rate is generally 40 percent, which reflects an increase from 35 percent for 2012. The base exclusion amount for estate and gift taxes goes from $5,120,000 in 2012 to an *estimated* $5,250,000 (*awaiting IRS announcement of inflation indexing)* for 2013. Subsequent years are also indexed for inflation. The new law also makes permanent portability and some enhancements made in previous tax laws. The GST exclusion amount for 2013 and beyond is also $5M indexed for inflation per the above.

RETIREMENT SAVINGS

The American Taxpayer Relief Act makes a valuable change to the treatment of retirement savings and opens up an important planning opportunity. Generally, participants with 401(k) plans and similar plans have been allowed to roll over funds to designated Roth accounts in the same plan subject to certain qualifying events or age restrictions. The American Taxpayer Relief Act lifts most restrictions, and now allows participants in 401(k) plans with in-plan Roth conversion features to make transfers to a Roth account at anytime. *Congress made this change because conversion is a taxable event and will raise revenue.*

Obviously, the American Tax Relief Act (ATRA) is significant and impacts all of us. This letter provides some of the highlights of the ATRA. As we move forward with the tax filing season we will be evaluating the impact to your individual returns and may be contacting you with suggestions regarding 2013 tax planning opportunities in light of this new legislation. *By all means, if you have any questions regarding the above please do not hesitate to call me or any of my associates at 305-361-1014 or e-mail at* richard.reed@lancaster-cpas.com.

Sincerely,

Lancaster & Reed, LLC

Richard A. Reed, CPA, M.Tax

Note: The above represents a brief overview of the 2012 American Taxpayer Relief Act (ATRA). Before implementing any tax planning as a result of ATRA please contact your Lancaster & Reed tax advisor for advice specific to your needs.