From the Fiscal Cliff to Taxpayer Relief:

Planning for 2013

As revelers celebrated the beginning of 2013, many eyes around the world were fixed on Washington, D.C. to see how the White House and Congressional leadership would negotiate the pending Fiscal Cliff. While many Americans had hoped that the Fiscal Cliff's draconian spending cuts and tax increases would result in a "grand bargain" between President Obama and GOP leadership, the likelihood of a widespread deficit reduction plan seemed to dwindle as we approached Christmas and the end of 2012. What Congress and the White House ultimately agreed upon and passed into law is the American Taxpayer Relief Act (ATRA) of 2012, which will have a significant impact on higher earning individuals and sets the table for Washington's next round of negotiations involving the raising of the debt ceiling in March.

The pending adjustment to our tax laws, especially in regard to income and estate tax, has added additional challenges as investors and their advisors plan. The ATRA has answered many outstanding questions regarding tax law that have lingered for decades by making many temporary tax laws permanent. In this article, we explore the ramifications of the ATRA, as well as other legislation that could impact various aspects of financial planning in 2013 and beyond.

Income and Payroll Tax

While much of the discussion leading up to the Fiscal Cliff deadline centered upon raising income taxes on income levels of $250,000 for married couples, $200,000 for individuals, Congress ultimately ended up raising taxes on those households earning $450,000 for married couples, $400,000 for individuals. This means that individuals who earn in excess of the $400,000/$450,000 threshold will see their income taxes go up from 35% to 39.6%. This threshold also has ramifications on the tax treatment of long-term capital gains and qualified dividends, which we explore later in this article.

2013 Federal Income Marginal Tax Rates

Rate	Single Filers	Married Joint Filers	Head of Household Filers
10%	$0 to $8,925	$0 to $17,850	$0 to $12,750
15%	$8,925 to $36,250	$17,850 to $72,500	$12,750 to $48,600
25%	$36,250 to $87,850	$72,500 to $146,400	$48,600 to $125,450
28%	$87,850 to $183,250	$146,400 to $223,050	$125,450 to $203,150
33%	$183,250 to $398,350	$223,050 to $398,350	$203,150 to $398,350
35%	$398,350 to $400,000	$398,350 to $450,000	$398,350 to $$425,000
39.60%	$400,000 and up	$450,000 and up	$425,000 and up

One of the great ironies of this tax "relief" legislation is that anyone who draws a paycheck in 2013 will see less money in their check due to increased taxes. This is because part of new ATRA legislation allows for the expiration of the Tax Relief Act of 2010, setting payroll taxes back to 2009 levels of 6.2%, as opposed to the 4.2% levels of the last two years. The wage limit for payroll taxes this year is $113,700, and once that limit is realized, an individual stops paying the tax. This means that a household earning $113,700 in 2013 will pay an additional $2,274 in payroll taxes ($113,700 x 2% = $2,274). For individuals who are self-employed, a 12.4% Social Security tax will be levied against self-employment income up to the same threshold.

Long-term Capital Gains and Qualified dividends

For many taxpayers, income realized on long-term capital gains and qualified dividends will remain permanently taxed at the 15% level. For individuals who find themselves above the new $400,000/$450,000 threshold, however, taxes on long-term capital gains and qualified dividends will be raised from 15% to 20%. Short-term capital gains, which are incurred from assets held less than one year, will continue to be calculated based on federal income tax rates, and therefore, have a top-end rate of 39.6%. It should also be noted that unearned income for certain taxpayers may face an additional taxation under the new Medicare surtax, which is detailed below.

Single Taxpayer	Married Filing Jointly	Long Term Capital Gain/ Qualified Dividend Tax Rate	Medicare Surtax*	Combined Tax Rate
$0 - $36,250	$0 - $72,500	0.00%	0.00%	0.00%
$36,250 - $200,000	$72,500 - $250,000	15.00%	0.00%	15.00%
$200,000 - $400,000	$250,000 - $450,000	15.00%	3.80%	18.80%
$400,001+	$450,001+	20.00%	3.80%	23.80%

*3.8% Medicare surtax only applies the lesser of new investment income or income above $200,0000 (individual)/$250,000 (joint) threshold.

Medicare Surtax

While separate from the American Taxpayer Relief Act of 2012, an equally important element of planning for 2013 and beyond has to do with new Medicare surtaxes being assessed to certain taxpayers as part of the Patient Protection and Affordable Care Act (PPACA) of 2010. In 2013, certain taxpayers may be subject to additional Medicare taxes under the PPACA signed in March of 2010. There are two separate taxes under this Act: a tax increase on wages and a new tax levied on net investment income.

1. **Medicare tax increase on wages**

   The current Medicare tax on wage income is 2.9%, half of which is paid by employers and half of which is paid by employees. This 2.9% is levied on all sources of earned income, including wages/salaries, active business income (from pass-through entities), and direct self-employment income. Keep in mind, there's no maximum limit on the amount of earned income subject to Medicare taxes.

   Starting in 2013, a 0.9% Medicare Hospital Surtax will be added to the existing 2.9% Medicare tax for some individuals. This tax applies to those with wages in excess of $200,000 (for individuals) or $250,000 combined (for married couples) and will be assessed on individuals at a rate of 3.8% (2.9% + .9% = 3.8%).

2. **Medicare Tax on Net Investment Income**

   In addition to the Medicare Hospital Surtax, a separate 3.8% surtax will be applied to the lesser of an individual's net investment income for the tax year, or the amount by which the individual's modified gross adjusted income (MAGI) exceeds the threshold amounts for that tax year. The MAGI threshold amounts for 2013 are $200,000 for individuals and $250,000 for couples filing jointly.The 3.8% tax is in excess of the tax increases on dividends, capital gains and ordinary income. For the purposes of the Medicare Contribution Tax, net investment income includes:

   - Gross income from interest, dividends, annuities, royalties and rents
   - Gross income from passive activity (e.g., real estate investing) or a trade or business of trading in financial instruments or commodities
   - Net gain attributable to the disposition of property (i.e., capital gains)

   For example, a couple that is married and filing jointly with earnings of $200,000 and net investment income of $100,000, would have a total MAGI of $300,000. This couple would see the 3.8% surtax assessed to $50,000 as this is the lesser amount of their net investment income ($100,000) and the amount of their MAGI over the threshold of $250,000.

   It is important to note that anything that would otherwise be excluded from gross income for general tax purposes is also excluded from net investment income for Medicare contribution tax purposes. This includes:

   - Tax-exempt municipal bond interest
   - Excluded gain from the sale of a principal residence
   - Distributions from certain retirement accounts, including Roth IRAs and Roth 401(k)s

Deduction Limits: PEP and Pease Returns

Perhaps one of the most overlooked provisions of the new bill is how it treats limits on tax deductions for people who actually fall below the new $400,000/$450,000 income threshold. The new deduction limits affect individuals with income levels above $250,000 and married couples making more than $300,000. To be clear, these "new" limits really aren't that new. These limits were in place prior to the 2001 Bush-era tax cuts and were originally passed by Congress in 1990. Known as the

PEP (personal exemption phase-out) and Pease (the Democratic senator who was the force behind the legislation) limits, these limits on deductions serve to reduce a household's itemized deductions over the set threshold. These new tax deduction limits affect the amount people can itemize on their tax returns and include, among other potential deductions, mortgage interest, state income tax payments and charitable deductions.

Alternative Minimum Tax

The Alternative Minimum Tax (AMT) has remained one of the more puzzling elements of the tax code and has grown to affect far more people than its authors originally intended. When initially signed into law, the AMT was designed to close tax loopholes and keep wealthier households from taking advantage of the tax system. One of the original oversights of the law is that it was never indexed to inflation and, as a result, has come to affect more and more middle class households every year. In fact, this year it was estimated to affect roughly 30 million taxpayers. In 2012, the AMT exemption was raised to $78,750 for married couples and $50,600 for single filers. In order to refocus the originally intended scope of the AMT, this new legislation permanently patches the AMT by indexing it with inflation, which will keep Congress from having to reassess this element of the tax code each year. This change is also retroactively effective for tax years beginning after December 31, 2011.

Estate Tax

One of the more dramatic potential ramifications of going over the Fiscal Cliff would involve how assets are transferred from one generation to the next and how much is owed in estate taxes. In 2012, estates of up to $5.12 million per individual could be transferred without being subject to federal tax due to the federal estate tax exemption. Any amount over this threshold would then be subject to a 35% federal estate tax rate. The Fiscal Cliff, however, threatened to move that threshold to $1,000,000 per individual with a top rate of 55% being assessed on assets over that amount. The new law makes the 2012 federal estate tax levels of $5,120,000 permanent and indexes them for inflation before being assessed a top rate of 40% for assets over that threshold. This makes the inflation-adjusted gift amount $5.25 million for 2013.

Additionally, the rules for the portability of unused federal estate tax exemptions were also made permanent. This means that any unused exemption may be transferred to a surviving spouse, so that the surviving spouse can use that exemption, along with his or her own exemption, to transfer assets upon death. To understand the significance of portability, consider the two examples below:

- Scenario without portability: In 2013, Mr. Smith dies and passes all of his assets directly to Mrs. Smith, as all of his assets were either jointly titled or named her as direct beneficiary. As a result, Mr. Smith did not use any of his $5.25 million estate tax exemption. At the time of Mrs. Smith's death, she now has a taxable estate of $9 million. Because no portability exists to use Mr. Smith's unused exemption, she can only use her own exemption. As a result, her estate is will owe $1.5 million at her death:

  $9 million estate - $5.25 million exemption = $3.75 million

  $3.75 million taxable estate x 40% estate tax rate= $1.5 taxable estate

- Scenario with portability: Consider the same scenario above, in which Mr. Smith dies and passes his estate to Mrs. Smith and does not use his $5.25 million estate tax exemption. Also assume that Mrs. Smith dies and is again left with a $9 million estate. In this scenario, however, Mrs. Smith has the benefit of portability and is able to use Mr. Smith's unused exemption, in addition to her own, leaving her with a $10.5 million exemption:

  $9 million estate - $10.5 million exemption = $0 taxable estate

Qualified Charitable Distributions

As part of ATRA, individuals age 70 ½ and older are able to make qualified charitable distributions from IRAs directly to qualified charities. Qualified charitable distributions are excluded from income tax up to $100,000 and count toward the owner's required minimum distributions (RMDs). This is particularly good news for individuals who may have waited on making this type of charitable distribution in 2012 due to uncertainty about the tax treatment of these types of distributions on an ongoing basis. To address this issue, individuals still have until the end of January 2013 to make a qualified charitable distribution for 2012. This window of opportunity is also open for individuals who may have missed the traditional December 31st deadline to take their regular 2012 RMDs.

Roth 401(k) Conversion Opportunity

One of the more popular financial planning strategies discussed in the days and months leading up to the Fiscal Cliff was the ability to convert part or all of an existing traditional IRA to a Roth IRA. Part of the ATRA legislation takes this idea a step further and allows current 401(k) participants to convert their existing accounts to a Roth 401(k), assuming this option is available as part of their employer-sponsored plan. This type of conversion was previously allowed with restrictions on the type of funds that could be included in Roth conversion. These restrictions have been lifted and now any type of money can be transferred into the new account. For individuals who are interested in this type of strategy, funds converted from the traditional 401(k) to the Roth 401(k) will be taxed at ordinary income levels for the year the transfer occurred. Once the funds are in the Roth account, they would grow tax-deferred and would not be subject to RMDs or income tax on withdrawals. This may be an especially good strategy for investors in the following situations:

- Younger people who are just getting started with retirement planning and have time to make back the money they would pay out as tax during the conversion.
- Individuals who would like to pass on their 401(k) to their heirs and can, in effect, pay the taxes now that would otherwise be passed down to their beneficiaries. For this strategy to work most efficiently, an individual should have funds available to pay the taxes in a taxable account, as opposed to another qualified account.
- Individuals who are anticipating that they will be in a higher tax bracket in retirement than while they are working.

Additional Family and Education Benefits

- Coverdell education savings account annual contribution limits were scheduled to drop to $500 in 2013, but have been set to maintain their current $2,000 limit. In addition, the expansion of the definition of qualified education expenses now includes expenses most directly associated with elementary and secondary education expenses.
- A permanent extension of the 35% dependent care credit that applies to eligible child care expenses for children under 13 years of age and disabled dependents.
- A permanent $1,000 child tax credit for dependents under 17 years of age. This credit was scheduled to revert back to the 2002 levels of $500.
- In 2001, the Economic Growth and Tax Relief Reconciliation Act protected some dual earning couples from the so-called marriage penalty. The Act called for expanding the standard deduction for joint filers to twice that of single filers. It also expanded the 15% tax bracket for joint filers to twice the size of the corresponding bracket for single filers. These provisions have been made permanent for taxable years beginning after December 31, 2012.

Planning for 2013 and Beyond

Over the last several years, one of the most common concerns voiced by economists in regard to the slow growth of U.S. markets was a lingering uncertainty about taxes and how taxpayers should plan for the future. One of the understated benefits of ATRA is that it provides permanent answers for long -standing questions in the areas of estate and income tax, among others.

And while ATRA has provided answers to many tax planning questions, many taxpayers remain concerned about how these implications are going to directly affect them and their finances moving forward. Given all the information within the new legislation, it's important to remember that tax planning is just one facet of an overall financial plan. Before making any decisions regarding what actions to take in response to any tax changes that may affect you, it's critical to consult with your wealth advisor, as well as tax and legal consultant. At First Point Financial, our holistic planning approach takes into consideration all aspects of your current financial situation. We'll work with your existing tax and legal counsel to construct a financial plan that meets your goals now and into the future.

For more information on the American Taxpayer Relief Act or how First Point Financial can help you achieve your goals, please contact us at 913-647-9700 or visit our website, www.firstpointfinancial.com.