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# American Taxpayer Relief Act of 2012

*Agreement avoids most ramifications of fiscal cliff, but more work remains*

After weeks of negotiations, and many more months of uncertainty, the President and Congressional Republicans and Democrats agreed on a series of tax provisions that would effectively avoid what has come to be called the "fiscal cliff". This agreement enables the majority of Americans to avoid the most significant tax increases that would have happened upon reaching the cliff, but imposes several other increases on taxpayers at varying levels of income.

This bill provides permanent extensions to many of the items that in the past had received just temporary extensions – items such as most of the marginal tax rates, lower tax rates on capital gains and dividends, and a patch that will limit the ever-increasing scope of the Alternative Minimum Tax (AMT). As a result, there is at least one major benefit to this bill – certainty over the future of the most significant aspects of the tax code. And while taxpayers at higher income levels will pay more tax in 2013 and beyond than they would have in 2012, the key thing is that at least everyone knows what rules apply and can more effectively plan to manage their future tax costs.

That certainty may be short-lived, however, as there are also plenty of reasons to think this isn't the end of the legislative back-and-forth.

- With the latest debt ceiling having been reached at the end of 2012, Republicans have already said spending cuts must be enacted before there is another extension of the ceiling. This bill deferred many scheduled spending cuts for two months to allow Congress to modify exactly how those are to be applied.
- In addition, the Congressional Budget Office (CBO) has said this bill will increase the national debt by nearly $4 trillion over the next ten years (as compared to what would have happened if there were no legislation and the tax increases and spending cuts were allowed to happen). This increase to the deficit will further prompt Republicans to push for spending cuts.
- President Obama continues to say that any spending cuts must still be matched with tax increases, although this bill contains $41 of tax increases for every $1 of spending cuts, according to the CBO. This bill is projected to generate $600 billion of new tax revenue over the next ten years, well short of President Obama's post-election goal of $1.6 trillion in new revenue, meaning that future tax increases are clearly on the President's agenda.

Below is an explanation of the key provisions of the American Taxpayer Relief Act of 2012.

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### Change to Ordinary Tax Rates

The biggest potential tax increase upon expiration of the Bush tax cuts would have been increases in the ordinary tax rates for all tax brackets. Under this agreement, all the current rates will remain in place. The only change will be the addition of a new 39.6% rate on taxable income over $450,000 for couples ($400,000 for single taxpayers). These changes are permanent and not subject to a sunset, unlike other recent tax acts. As a result, the tax brackets for married couples filing jointly and singles would be approximately as follows:

| Tax Rate | Married Filing Joint | | Single | |
|---|---|---|---|---|
| | 2012 Brackets | 2013 Brackets* | 2012 Brackets | 2013 Brackets* |
| 10% | $0 - $17,400 | $0 - $17,400 | $0 - $8,700 | $0 - $8,700 |
| 15% | $17,400 – 70,700 | $17,400 – 70,700 | $8,700 – 35,350 | $8,700 – 35,350 |
| 25% | $70,700 – 142,700 | $70,700 – 142,700 | $35,350 – 85,650 | $35,350 – 85,650 |
| 28% | $142,700 – 217,450 | $142,700 – 217,450 | $85,650– 178,650 | $85,650– 178,650 |
| 33% | $217,450 – 388,350 | $217,450 – 388,350 | $178,650 – 388,350 | $178,650 – 388,350 |
| 35% | $388,350+ | $388,350-450,000 | $388,350+ | $388,350-400,000 |
| 39.6% | | $450,000+ | | $400,000+ |

* All 2013 income levels (except for the start of the 39.6% bracket) are 2012 amounts that would be adjusted for inflation for 2013.

### New Top Tax Rate on Long-Term Capital Gains, Dividends

Similar to what was adopted for ordinary tax rates, this bill contains a combination of maintaining the current tax treatment of long-term capital gains and qualified dividends with a change that applies to high-income taxpayers. This bill maintains the existing 0% and 15% tax rates that applied for 2012, but also adds a new 20% tax rate for those taxpayers in the top tax bracket. These will apply under both the regular tax system and under AMT.

As a result, there are now three different base tax rates that will apply to these two income items beginning in 2013. The exact income ranges won't be known until the full 2013 brackets are published, but below are the rough estimates:

- 0% to the extent that taxpayers are in the 15% ordinary tax bracket or lower (taxable income below roughly $70,700 for couples, half that for singles)
- 15% to the extent that taxpayers are in the 25%, 28%, 33% or 35% tax bracket (taxable income from roughly $70,700 to $450,000 for couples, or $35,350 to $400,000 for singles)
- 20% to the extent that taxpayers are in the new 39.6% ordinary tax bracket (taxable income over $450,000 for couples in 2013, $400,000 for singles).

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Because of the 3.8% Medicare tax on investment income that is part of the health care act, which also takes effect in 2013, the 20% rate will actually never apply. The new Medicare tax will apply to couples with Modified AGI exceeding $250,000 ($200,000 for singles) which causes the 15% rate to increase to 18.8% for those over those levels. A taxpayer who would be subject to the new 20% rate will already be subject to the 3.8% tax, making the real top rate 23.8%.

The different rates that apply to collectibles (28%) and depreciated real estate (25%) will remain in effect. These changes are permanent and not subject to a sunset.

### Return of the Itemized Deduction Phaseout

Much of the focus of this bill has been on the new top tax rate for couples with income over $450,000. In reality, though, the tax increases start at a much lower level of income due to the return of the phaseout of itemized deductions. This phaseout is similar to what had been in place for many years, but was gradually eliminated under the Bush tax cuts. This phaseout was last applied in 2008, but will return permanently in 2013.

Beginning with 2013, married couples with Adjusted Gross Income (AGI) over $300,000 (and singles over $250,000) will begin to lose the benefit of their itemized deductions. These thresholds will be adjusted annually for inflation. The deduction phaseout will equal 3% of the taxpayer's AGI over that threshold, although the total phaseout is capped at 80% of the total deductions claimed.

- **Example**: A married couple has AGI of $350,000, which is $50,000 over the threshold amount. Their phaseout amount is equal to 3% of that excess amount, or $1,500. Their gross itemized deductions were $30,000, but that amount is reduced by $1,500 to a net amount of $28,500.
- **Planning Point** – A common misconception of this itemized deduction phaseout is that it can be avoided by not claiming deductions such as charitable contributions. In reality, this phaseout is almost entirely driven by a taxpayer's income level. In the example above, the phaseout amount would have been $1,500 regardless of the couple's itemized deduction level (other than the 80% phaseout cap). In most cases, the only way to reduce the impact of this phaseout is to reduce AGI.

Another change affecting itemized deductions for 2013 is a revised floor for deducting medical expenses. For 2013, medical expenses must exceed 10% of AGI, rather than 7.5% as was the case in 2012. This provision was included in the health care of 2010 and was unchanged in this latest bill.

### Return of the Personal Exemption Phaseout

This bill also returns the phaseout of personal exemptions for taxpayers at those same income levels. This rule reduces, and for some taxpayers eliminates, the deduction each taxpayer claims for themselves, their spouse and their dependents. For 2012, this exemption amount is $3,800 per person; the 2013 amount has not been announced.

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This phaseout will apply to married couples with AGI over $300,000 (singles over $250,000) and is equal to 2% of the total exemptions claimed for every $2,500 of AGI over that threshold. Married couples with income over $425,000 (and singles over $375,000) will lose 100% of the value of their exemptions.

- **Example**: A married couple has AGI of $350,000, which is $50,000 over the threshold amount. The $50,000 is then divided by $2,500. That result is 20, which means that 40% of the couple's total personal exemptions are lost to the phaseout.
- **Example**: If that couple's AGI was $450,000, they would be $150,000 over the threshold, which is then divided by $2,500. That result is 60, which would mean that 100% of the exemption amount is lost.
- **Planning Point** – Taxpayers who will be affected by this phaseout may feel it is advantageous to not claim their children or others as dependents. That can be done, but only if that person begins to provide at least 50% of their own support. Taxpayers can't simply decide not to claim someone as a dependent because the tax benefit of the exemption is lost.

### Permanent Extension of Bush Tax Cuts

In addition to extending the more significant items noted above, this bill permanently extended all other aspects of the 2001 and 2003 tax acts, collectively known as the Bush tax cuts. This means that each of the following items will remain in effect:

- The child tax credit will remain at $1,000 per qualifying child, rather than falling to $500.
- The 10% and 15% tax brackets and the standard deduction for married couples will remain twice that for single individuals, thereby helping to reduce what is often referred to as the "marriage penalty".
- The maximum adoption credit and the maximum amount of tax-free employer-provided adoption assistance will both remain at $10,000, rather than falling to $5,000.
- The calculation of the dependent care credit will remain the same, meaning the maximum credit will remain $1,050 for one child and $2,100 for two or more.
- Coverdell Education Savings Accounts will be unchanged, meaning:
  - The maximum annual contribution will remain $2,000.
  - The contribution phaseout range for married taxpayers will remain at Modified AGI of $190,000-$220,000.
  - These accounts can continue to be used for K-12 expenses as well as college costs.
  - The contribution deadline will remain April 15 of the year following the year the contribution is attributed to, rather than moving up to December 31.
- The eligibility for the deduction for student loan interest will remain at the higher income levels, rather than falling back to pre-2001 amounts.
- Employer-provided education assistance of up to $5,250 will remain tax-free.

### Changes to the Estate Tax

When the Bush tax cuts were last extended at the end of 2010, that extension also included an increase in the estate tax exemption amount (to $5 million) and a reduction in the top marginal rate (to 35%). These

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amounts were set to change to $1 million and 55% beginning in 2013. Instead, this act permanently maintains the $5 million estate tax exemption, but increases the tax on estates over that amount to 40%. President Obama had previously proposed a $3.5 million exemption and a 45% tax rate, but this bill keeps the current system virtually intact. Because the $5 million exemption amount is indexed for inflation, the 2012 amount was $5.12 million, and is expected to be $5.25 million for 2013. Lastly, the bill also extends the unification of the exemption for estate and gift tax purposes, meaning this exemption may be used during life to make tax-free lifetime gifts, or at death to shield bequests from the estate tax.

By removing the expiration of the Bush tax cuts, all other estate, gift and generation skipping tax provisions, including portability, remain in place from 2012. It was previously announced that annual exclusion gift threshold would increase to $14,000 for 2013, and that is unchanged.

### Permanent Alternative Minimum Tax Relief

Millions of taxpayers will no longer have to worry about falling under the Alternative Minimum Tax, as this bill permanently "patched" the system. The AMT exemption was raised to $78,750 for married couples in 2012 ($50,600 for singles), and will now be adjusted annually for inflation. These two changes will allow as many as 30 million taxpayers to avoid paying the AMT for 2012, and ensure that future taxpayers are not inadvertently caught in this tax trap.

### Qualified Charitable Distributions from IRAs Extended

In a move that will be popular with seniors but that may have come too late for most of them to take advantage of for 2012, IRA owners are now able to make charitable gifts directly from an IRA and have it count towards the owner's RMD through 2013. All other eligibility rules remain in place, including the $100,000 annual limit and the requirement to be at least 70½ years old.

Because many taxpayers were likely waiting to see whether this would apply for 2012, the bill provides some relieve for those who took IRA distributions in December 2012. Taxpayers who took distributions during that month have until the end of January 2013 to gift that amount in cash to charity and have it be considered a Qualified Charitable Distribution (QCD) for 2012 (assuming it would have otherwise qualified had it been done under the normal process).

In addition, any distribution made from an IRA to a charity during January 2013 may be treated as a QCD for 2012. This clause will benefit those who were first subject to the RMD rules in 2012, but were deferring their first RMD until up to April 1, 2013. They will now be able to take their 2012 RMD in January 2013 and have it be considered a 2012 distribution. It will also benefit those who for whatever reason did not take their 2012 RMD by the traditional December 31 deadline.

### Enhanced Roth Conversion Opportunity

This bill includes a new opportunity for employees to convert existing 401(k) balances to a Roth 401(k). A similar provision had been in place since 2010, but only allowed conversions in cases where the assets

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were eligible for distribution from the plan. This new provision removes that requirement, meaning any employee can move money from the 401(k) to a Roth 401(k) plan offered by that employer.

While this provision does provide some added flexibility, it will not likely create a significant amount of Roth conversion activity. Only a relatively small number of employers offer Roth 401(k) plans, meaning most employees won't have the option to do this type of conversion. This change does not allow employees to convert plan balances to a Roth IRA while still working, unless the employer already allows what are called "in service" distributions, in which case the employee could already have done what this bill allows.

For those employees who do this type of conversion, the tax treatment is the same as if the money were going to a Roth IRA. The amount converted is taxable in the year of conversion, while subsequent appreciation can be withdrawn tax-free during retirement.

### Extension of Various Other Expired Provisions

Several tax credits and deductions that had expired at the end of either 2011 or 2012 were extended under this bill:

- The American Opportunity Tax Credit, used to offset higher education costs, was extended through 2017.
- The deduction for certain classroom expenses incurred by elementary and secondary school teachers was extended through 2013.
- The discharge of debt related to a qualified home mortgage will remain tax-free through 2013.
- Mortgage insurance premiums will continue to be deductible as mortgage interest through 2013.
- Taxpayers can choose to deduct their state and local sales taxes rather that state income taxes through 2013. This provision is especially popular in states such as Florida and Texas that don't assess an income tax.
- The above-the-line deduction for qualified tuition and related expenses will remain in place for expenses incurred through 2013.

### Business Tax Extenders

This bill contained the extension of several deductions and tax credits that apply to businesses, including:

- The credit for increasing research activities was extended through 2013.
- The credit for employing active duty members of the uniformed services was extended through 2013.
- The Work Opportunity Credit, which is available for employers hiring members of targeted groups, was also extended through 2013.
- The gain on the sale of certain small business stock will continue to be 100% excluded from income, rather than just 50%, through 2013.

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- The bonus depreciation rules were extended through 2013.
- A wide variety of credits related to alternative energy production and use were extended through 2013.

### Expiration of Reduced FICA Tax

One of the items not included in this bill was an extension of the 2% reduction in Social Security taxes on wages. Beginning January 1, 2013, the tax rate applied to earned income will be 6.2%, up from the 4.2% that applied in 2012. This tax applies to the first $113,700 of earned income, meaning this will be an increase of $2,274 for those earning above that amount, less for those below. This tax is often cited as why this bill will raise taxes on the majority of Americans. However, this tax reduction was originally a temporary tax cut meant for just 2011, but one that received a subsequent extension through 2012.

### Coming Up Next

As noted above, this bill is expected to be just the first phase of tax reform for 2013. Many members of congress continue to push for a larger bill that fundamentally reforms the way our current tax structure operates. However, by making so many of these latest changes permanent, there is no longer the sense of urgency to do something on a bigger scale before automatic changes happen. Despite that, there are still many items that have been discussed throughout the course of last year – either in President Obama's past budget proposals, during the recent campaign, or elsewhere – that could resurface later this year. Among those items are the following:

- President Obama's last budget proposal included raising the tax rates on income over $250,000 for couples ($200,000 for singles). It was a significant concession to have this increase only apply to income over $450,000/$400,000, so look for this topic to come up again.
- Raising the top tax rate on long-term capital gains to 20% had been on the President's agenda for a while, albeit at a lower level of income. He had also proposed taxing dividends as ordinary income for higher-income taxpayers, but as of now dividends continue to be taxed the same as long-term gains.
- The President has often spoken about broader limitations on itemized deductions. In particular, limiting the tax benefit of deductions to 28%, which would result in a tax increase on anyone with income above that bracket. This proposal was made at the same time he proposed increasing tax rates on couples with income over $250,000. With that increase now only happening on income over $450,000, this proposed limitation on deductions may be adjusted to meet that higher income level.
- The President has also proposed a similar cap on the tax benefit of retirement plan contributions, employer-provided health insurance and interest from municipal bonds. None of those items were addressed in this bill.
- Carried interest, the income earned by partners in an investment partnership, is currently taxed as capital gain income. This provision has long been a target of Democrats, and could find its way back into a future tax proposal.

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