Titanium Advisors, LLC
Financial Planning + Investment Management

A Summary of the American Taxpayer Relief Act of 2012

The American Taxpayer Relief Act of 2012 not only avoided the fiscal cliff at the last possible moment: it also added even more complexity to the tax code. The good news is that after a decade of "temporary" tax laws in constant danger of looming sunset, all of the significant income and estate tax changes have been made permanent. This allows tax planning to be performed with a much higher degree of certainty.

While the law provides relief to many whose taxes would have increased had the Bush tax cuts been allowed to expire, "high income" taxpayers will find their tax bill increasing in 2013. Unfortunately, determining exactly who is a "high income" taxpayer is a bit complicated as the law does not apply a consistent standard. For example, the phase-in of the various tax increases are in some cases based upon adjusted gross income (AGI), which measures income before deductions and exemptions, while other provisions utilize taxable income (TI), i.e., AGI as reduced by all applicable deductions and exemptions.

The following bullet points summarize the key provisions of the new law. Of course, the applicability of these complex rules will vary from client to client.

- The current estate and gift tax exemption is made permanent at $5 million per person (increased annually for inflation). For married couples, this amount is made "portable" so that any unused portion when the first spouse dies may be carried over for use by the surviving spouse. As a result, married couples with less than $10 million of taxable assets will pay no federal estate tax.

- The top 35% income tax bracket has lapsed back to the "old" 39.6% tax rate, but only for TI amounts above $400,000 for individuals ($450,000 for married couples). The net result of this change is the permanent addition of a new tax bracket, resulting in increased taxes on higher incomes.

- The phase-out of itemized deductions and personal exemptions returns permanently in 2013, after having been eliminated for the past several years. The reinstatement of these rules occurs with a new threshold of $250,000 in AGI for individuals ($300,000 for married couples). The net result of these provisions is to increase a taxpayer's marginal tax rate by about 1% for the itemized deduction phase-out and another 1% per exemption for the phase-out of personal exemptions.

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- In a similar fashion, the tax rate on qualified dividends and long-term capital gains increases from 15% to 20% for individuals with TI above $400,000 ($450,000 for married couples).

- The alternative minimum tax (AMT) exemption amounts for 2012 and beyond will be permanently indexed for inflation. As a practical matter, clients already subject to AMT liability will not receive much relief from these changes. However, significantly fewer taxpayers will become subject to the AMT for the first time in future years.

- For those taxpayers already subject to AMT, the new income tax increases may have little or no impact as they are already paying a higher effective tax rate under the AMT system.

- The Medicare tax surcharges imposed by the Patient Protection and Affordable Care Act (a/k/a Obamacare) remained unaffected by the new law and so will commence in 2013 as scheduled. Taxpayers with AGI over $200,000 ($250,000 for married couples) will pay a 3.8% surtax on all investment income (interest, capital gains, dividends, etc.) in addition to their income tax or AMT liability.

- Similarly, taxpayers with over $200,000 of earned income ($250,000 for married couples) will pay an additional 0.9% Medicare tax on the amount exceeding these thresholds. Employers are required to collect this increase as a payroll tax. However, if both spouses work, their employers most likely will not have collected all of the required Medicare surtax amounts and so the couple will need to pay the remaining balance when filing their annual tax return.

In conclusion, taxpayers with AGI below $200,000 ($250,000 for married couples) will see no tax increases at all. Everyone else will be subject to tax increases in 2013, the scope and severity of which will vary depending upon the amount and types of income earned.