



Highlight of this Edition

- *Understanding the “Fiscal Cliff” Bill and its Effect on your Upcoming Taxes*

The “Fiscal-Cliff” Compromise

On January 1, Congress passed the American Taxpayer Relief Act, saving the country from the so-called “Fiscal Cliff.” President Obama signed the Act into law the next day. The Act is a 157-page, confusing piece of legislation. It includes tax increases, extensions, limitations, and many other complex provisions. Unfortunately, it is difficult to grasp the actual effect it will have on individual taxpayers.

We all understand the simple fact that our taxes will likely increase this year. For many, the mystery is in the amount of increased taxes and where they will be felt.

The purpose of this Update is to break the Act down into easily understandable terms and give you a basic overview of the Act and how it may affect your taxes.

New Income Tax Bracket

For most taxpayers, income taxes will remain the same. The 10, 15, 25, 28, 33, and 35 tax brackets are unchanged. However, the Act has created an additional tax bracket of 39.6% for the highest-income earners. This new tax bracket applies to individuals with income levels above:

- \$400,000 for single-filers;
- \$450,000 for married, joint-filers;
- \$225,000 for married, separate-filers.

As you can see, the 39.6% tax bracket affects only the highest-income earners. However, this does not mean that all others are off the hook. Indeed, all taxpayers will feel increased taxes in more subtle ways, as discussed below.

Limits on Itemized Deductions

Many individuals will feel increased taxes from new limits on their itemized deductions. Once adjusted gross income reaches a certain level, itemized deductions will now face limits. The threshold at which these limits begin is:

- \$250,000 for single-filers;
- \$300,000 for married, joint-filers;
- \$150,000 for married, separate-filers.

Itemized deductions are reduced by 3% of the amount of adjusted gross income in excess of the above levels. Thankfully, itemized deductions may not be reduced by more than 80%.

Many common itemized deductions are subject to this limitation, including: property taxes, state and local taxes, mortgage interest, charitable contributions, and miscellaneous itemized deductions. Contrastingly, there are exceptions to these limits, such as medical and investment interest expenses.

Phasing-out Personal Exemptions

Similar to limits on itemized deductions, many taxpayers will feel increased taxes from a “phase-out” on personal exemptions. This provision uses the same threshold levels as those involved in the limitations on itemized deductions above. In other words, the phase-out begins if your adjusted gross income reaches the applicable threshold.

In simple terms, the value of your personal exemptions reduces, or “phases-out,” as your income increases. The value of personal and dependency exemptions is reduced by 2% for every \$2,500 in excess of the above thresholds.

State Sales Tax Deduction

For individuals residing in Washington, or similar states with no state income tax, the Act revives a beneficial state sales tax deduction. This allows you to choose to deduct either (1) actual sales tax paid, or (2) an amount dictated by an IRS table.

Unfortunately, the sales tax deduction is subject to the limitations on itemized deductions, so what Congress gave on one hand, they took away on the other (at least in part).

Alternative Minimum Tax “Patch”

In general, the “alternative minimum tax,” or AMT, is a tax-system that commonly applies to middle-to-high income taxpayers. Unlike the regular tax-system, the AMT does not allow for several important deductions, such as property taxes and state income and sales taxes.

Individuals who may be subject to the AMT must do two separate calculations to determine their tax liability: one under the AMT, and one under the regular system. If an individual's taxes are higher under the AMT, that amount is used for his or her overall tax-liability.

In the past, Congress relieved many taxpayers from the AMT by creating certain exemption amounts. For many middle-income taxpayers, these exemptions reduced their AMT calculation to a value low enough to avoid the AMT.

Thankfully, Congress used the Act to "patch" the AMT and make the exemptions permanent. The AMT exemption amounts are now:

- \$50,600 for single-filers;
- \$78,750 for married, joint-filers;
- \$39,375 for married, separate filers.

This "patch" likely saves over 60 million taxpayers from being subject to the AMT on their upcoming tax returns.

Estate, Gift & Generation Skipping Taxes ("GST")

The federal estate, gift, and generation skipping taxes are now unified. The Act has created a permanent exclusion amount of \$5,250,000 for all three taxes. In other words, you could make a total of \$5.25 million in transfers during your lifetime or at death without being subject to federal estate and gift taxes. However, the Act increased the tax rate for estates and gifts over the exclusion amount from 35% to 40%.

Also, the Act renews an important provision known as "portability." In simple terms, portability allows an unused exemption of a deceased spouse to be used by a surviving spouse. The ability to use an unused exemption can be extremely helpful in certain estate planning situations. Lastly, the Act extends many useful GST related provisions scheduled to expire after 2012. Mimicking the estate tax rate, the GST rate is now 40%.

When planning, keep in mind that the State of Washington still has an estate tax on estates over \$2 million, and does not have the portability feature.

Increased Taxes on Capital Gains & Dividends

The Act has increased the maximum tax rate for capital gains and dividends from 15% to 20%. However, the 20% rate applies only to those income amounts exceeding the new 39.6% income tax bracket threshold. All other taxpayers will continue to enjoy a maximum rate of 15%.

Note, these rates apply only to long-term capital gains (and some qualified dividends). A long-term capital gain is value obtained from the sale of a capital asset held for more than one year. Short-term capital gains are still subject to normal income-tax rates.

Patient Protection & Affordable Care (AKA "Obamacare")

Under the PPACA, certain taxpayers must pay an additional 3.8% tax on "Net Investment Income." In addition to the capital gains rates discussed above, this 3.8% tax is imposed on individuals with income exceeding:

- \$200,000 for single-filers;
- \$250,000 for married, joint-filers;
- \$125,000 for married, separate-filers.

If a taxpayer's income exceeds the applicable threshold, the tax is imposed on investment income, regardless of whether it's capital gain or ordinary income (e.g., interest income). Essentially, a high-income taxpayer could face a 23.8% rate on long-term capital gains, and as high as a 43.4% rate on short-term capital gains and ordinary investment income!

The End of the Payroll Tax Holiday

For the past two years, Congress enacted a temporary payroll tax reduction. This reduction dropped the FICA rate from 6.2% to 4.2% on the first \$100,000 of an individual's wages or earnings from self-employment.

As part of the compromise to get the tax bill passed, Congress chose not to extend this "holiday" and the FICA rate returns to 6.2%, indirectly resulting in a 2% tax increase on the first \$100,000 of wages or earnings from self-employment. As a result, all wage-earners will experience an increase in FICA taxes being withheld from their paychecks, as compared to the prior two years.

Business Tax Extensions

Many business-owners were unsure whether Congress would renew many business-related tax provisions. Fortunately, the Act extends many business-friendly tax incentives, such as:

- Small business expensing;
- Bonus depreciation;
- The work opportunity tax credit; and
- Research tax credits.

It's Only Temporary

As should be apparent from the rhetoric from Washington ("the other Washington"), this is all subject to change, because many provisions are extended only through 2013, and the federal budget is still a hot topic.

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