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Dear Clients and Friends:

The American Taxpayer Relief Act of 2012 (better known as the fiscal cliff legislation) became law on 1/2/13. Due to the expiration of the so-called payroll tax holiday, all workers will pay higher federal taxes this year, but the Act cancels most other income tax increases that would have resulted in added misery for just about every individual taxpayer. In addition, many popular tax breaks for individuals were extended. The bad news is that, starting in 2013, higher-income folks will face higher taxes. The Act also extended lots of business tax breaks (some with modifications).

Here is a quick summary of most-important tax changes—starting with those that affect individuals.

Payroll Tax Holiday Is Dead (So Far)

For 2011 and 2012, the Social Security tax withholding rate on your salary was temporarily reduced by 2%, from the normal 6.2% to 4.2%. If you're self-employed, the Social Security tax component of the self-employment tax was reduced by 2%, from the normal 12.4% to 10.4%. Last year, this so-called payroll tax holiday could have saved one person up to $2,202 or a working couple up to $4,404. Somewhat surprisingly, the Act does not extend the holiday through 2013.

Note: For 2013, the Social Security tax can hit up to $113,700 of salary or self-employment income. Thus, loss of the 2% payroll tax holiday could cost one person up to $2,274 or a working couple up to $4,548.

Tax Increases for Higher-income Individuals

Rates on Ordinary Income. For most individuals, the federal income tax rates for 2013 will be the same as last year: 10%, 15%, 25%, 28%, 33%, and 35%. However, the Act increases the maximum rate for higher-income folks to 39.6% (up from 35%). For 2013, this change only affects singles with taxable income above $400,000, married joint-filing couples with taxable income above $450,000, heads of households with taxable income above $425,000, and married individuals who file separate returns with taxable income above $225,000. After 2013, these taxable income amounts will be adjusted for inflation. These changes are permanent (until further notice).

Note: Higher-income folks may also get hit by the new 0.9% Medicare tax on wages and self-employment income and the new 3.8% Medicare contribution tax on net investment income. If so, they can face combined tax rates in excess of the advertised rates.

Rates on Long-term Gains and Dividends. The tax rates on long-term capital gains and dividends will also remain the same as last year for most individuals. However, the Act increases the maximum rate for higher-income folks to 20% (up from 15%). For 2013, this change only affects singles with taxable income above $400,000, married joint-filing couples with taxable income above $450,000, heads of households with taxable income above $425,000, and married individuals who file separate returns with taxable income above $225,000. After 2013, these taxable income amounts will be adjusted for inflation. These changes are permanent (until further notice).

Note: Higher-income folks may also get hit by the new 3.8% Medicare contribution tax on investment income, which can result in a maximum 23.8% federal tax rate on long-term gains and dividends instead of the advertised 20%.

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Personal and Dependent Exemption Deduction Phase-out. The last time we saw a phase-out rule for personal and dependent exemption deductions was 2009. Sadly, the Act brings back the phase-out deal. As a result, your personal and dependent exemption write-offs can be reduced or even completely eliminated. For 2013, phase-out starts at the following Adjusted Gross Income (AGI) thresholds: $250,000 for singles, $300,000 for married joint-filing couples, $275,000 for heads of households, and $150,000 for married individuals who file separate returns. After 2013, these threshold amounts will be adjusted for inflation. This change is permanent (until further notice).

Itemized Deduction Phase-out. The last time we saw a phase-out rule for itemized deductions was also in 2009. Unfortunately, this phase-out provision is back too, thanks to the Act. As a result, you can potentially lose up to 80% of your mortgage interest, state and local taxes, charitable contributions, and miscellaneous itemized deductions if your AGI exceeds the applicable threshold. For 2013, the thresholds are $250,000 for singles, $300,000 for married joint-filing couples, $275,000 for heads of households, and $150,000 for married individuals who file separate returns. After 2013, these threshold amounts will be adjusted for inflation. This change is permanent (until further notice).

Alternative Minimum Tax Patch Made Permanent

It had become a tiresome annual ritual for Congress to "patch" the Alternative Minimum Tax (AMT) rules to prevent millions more households from getting socked with this add-on tax. The patch job consisted of allowing larger inflation-indexed AMT exemption amounts and allowing various personal tax credits to offset the AMT. The Act makes the patch permanent, starting with 2012. As a result, about 30 million households a year will be kept out of the dreaded AMT zone. For 2012, the AMT exemption amounts are $50,600 for unmarried individuals, $78,750 for married joint-filing couples, and $39,375 for married individuals who file separate returns. For 2013 and beyond, the AMT exemptions will be adjusted for inflation.

Other Individual Tax Breaks

Option to Deduct State and Local Sales Taxes Extended. In past years, individuals who paid little or no state income taxes were given the option of instead claiming an itemized deduction for state and local sales taxes. The option expired at the end of 2011, but the Act retroactively restores it for 2012 and extends it through 2013.

Charitable Donations from IRAs Extended. In past years, IRA owners who had reached age 70½ were allowed to make tax-free charitable donations of up to $100,000 directly out of their IRAs. The donations counted as IRA required minimum distributions. Thus, charitably inclined seniors with more IRA money than they need could reduce their income taxes by arranging for tax-free IRA donations to take the place of taxable IRA required minimum distributions. This break expired at the end of 2011, but the Act retroactively restores it for 2012 and extends it through 2013. To take advantage of the retroactive deal, you can treat donations from your IRA made in January of this year as having been made in 2012. You can also treat IRA distributions taken in December of last year as 2012 IRA donations if you transfer the money to qualifying charities by 1/31/13.

$250 Deduction for K-12 Educators' Expenses Extended. The $250 deduction for teachers and other K-12 educators for school-related expenses paid out of their own pockets was retroactively restored for 2012 and extended through 2013.

100% Gain Exclusion for Qualified Small Business Corporation Stock Extended. The Act retroactively restores the temporary 100% gain exclusion (within limits) for sales of Qualified Small Business Corporation (QSBC) stock issued in 2012 and extends the deal to cover eligible shares issued in 2013. Note that you must hold QSBC shares for more than five years to be eligible for the 100% gain exclusion privilege.

Relatively Favorable Gift and Estate Tax Rules Made Permanent

For 2013 and beyond, the Act permanently installs a unified federal estate and gift tax exemption of $5 million—adjusted annually for inflation—and a 40% maximum tax rate (up from last year's 35% rate). For 2013, the inflation-adjusted exemption amount is expected to be around $5.25 million. The Act also makes permanent the right to leave your unused federal estate and gift tax exemption to your surviving spouse (the so-called exemption portability deal).

Business Depreciation and Cost Recovery Provisions

50% Bonus Depreciation Extended. The Act extends 50% first-year bonus depreciation for an additional year to cover qualifying new (not used) assets that are placed in service in calendar-year 2013. However, the placed-in-service deadline is extended to 12/31/14 for certain assets that have longer production periods including transportation equipment and aircraft. Under the extended deadline privilege, only the portion of a qualifying asset's basis that is allocable to costs incurred before 1/1/14 is eligible for 50% bonus depreciation.

For a new passenger auto or light truck that is subject to the luxury auto depreciation limitations, the 50% bonus depreciation provision increases the maximum first-year depreciation deduction by $8,000.

Generous Section 179 Deduction Rules Extended and Qualifying Real Estate Expenditures Are Again Eligible. For qualifying assets placed in service in tax years beginning in 2012 and 2013, the Act restores the maximum Section 179 deduction to $500,000 (same as for tax years beginning in 2011). Without this change, the maximum deduction would have been only $139,000 for 2012 and only $25,000 for 2013. The Act also restores the Section 179 deduction phase-out threshold to $2 million for tax years beginning in 2012 and 2013 (same as for tax years beginning in 2011). Without this change, the phase-out threshold would have been only $560,000 for 2012 and only $200,000 for 2013.

Somewhat surprisingly, the temporary rule that allowed up to $250,000 of Section 179 deductions for qualifying real property placed in service in tax years beginning in 2010 and 2011 was retroactively restored for tax years beginning in 2012 and extended through tax years beginning in 2013.

Key Point: For tax years beginning in 2014, the maximum Section 179 deduction is scheduled to be only $25,000, the phase-out threshold is scheduled to fall to $200,000, and the Section 179 deduction privilege for real estate expenditures will be off the table.

15-year Depreciation for Leasehold Improvements, Restaurant Property, and Retail Space Improvements Extended. The Act retroactively restores the 15-year straight-line depreciation privilege for qualified leasehold improvements, qualified restaurant property, and qualified retail space improvements for property placed in service in 2012 and extends the deal to cover property placed in service in 2013.

Conclusion

As you can see, the fiscal cliff legislation includes lots of tax changes. We did not cover them all here because we did not want this to turn into a book. If you have questions or want more complete information, please contact us.

Very truly yours,

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