Crisis Delayed… Not Quite Averted

A Summary of the American Taxpayer Relief Act of 2012

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With the ink still wet on President Barack Obama’s signature, the American Taxpayer Relief Act of 2012 (hereinafter the 2012 Act) is now law. Strange that an Act voted on by the Senate and the House on January 1, 2013 and signed by the President the evening of January 2nd has 2012 in the title but, thankfully, Congress was finally able to reach an agreement and provide us with some degree of certainty, at least for the next few months…

THE FISCAL CLIFF

The 2012 Act was a direct (albeit, some have argued weak) response to the so-called “fiscal cliff,” a term coined to describe the estimated $670 billion effect of automatic spending cuts and tax increases on the U.S. economy, both of which were set to take effect on January 1, 2013.

FEDERAL SPENDING

The 2012 Act did not effectively deal with the automatic spending reductions. It appears as if the only bipartisan solution that could be agreed upon was to punt to the 113th Congress to confront the issue in March of 2013. The approximately $24 billion in 2013 spending cuts are now to be ordered by the President on March 1, 2013, evaluated and then implemented on March 27, 2013.

Congress is also left to deal with a permanent solution to Medicare and Unemployment Compensation payments as cuts to both programs were granted a one year reprieve to December 31, 2013 or January 1, 2014 (depending on the program).

By “kicking the can” on entitlement spending, this will likely continue to be a point of contention and the stage is set for the drama to play out in the first quarter of 2013.

TAXES

Congress was able to make permanent the tax cuts of 2001 and 2003, at least for the great majority of taxpayers, which is something its predecessors were unable to accomplish.
Top estate and gift tax rates have been raised to 40%.

Highlights at a Glance:

- Top marginal income tax rate increased to 39.6% for married couples earning over $450,000 (singles over $400,000).
- Long-term capital gains and qualifying dividends tax rates increased to 20% for taxpayers in the 39.6% tax bracket.
- Bush-era tax cuts from 2001 and 2003 permanently extended for all other taxpayers.
- Phase-out of personal exemptions and overall limitation on itemized deductions reinstated for married couples earning over $300,000 (singles over $250,000).
- Top estate and gift tax rates raised to 40%, but exemption amounts kept at $5 million (adjusted for inflation).
- Payroll tax holiday ended. Social Security tax rate returns to 6.2% in 2013.
- AMT “patched” for 2012 and made permanent going forward. Exemption amount adjusted for inflation.
- Certain individual tax benefits extended through 2013, including: deduction of sales taxes in lieu of state income taxes, tax-free IRA charitable distributions, qualified education expenses deduction, teacher expenses deduction, conservation easement deduction special rules and relief from cancellation of debt for principal residences.
- American Opportunity Tax Credit to pay for higher education extended.
- Special relief for families with 3 or more children for the refundable portion of the child tax credit and increased percentage for the earned income tax credit extended through 2018.
- Certain business tax provisions that expired at the end of 2011 extended through 2013 including: the research credit, Section 179 expensing of up to $500,000 and 50% bonus depreciation.
- Certain energy tax incentives extended that expired at the end of 2011.

The individual income tax brackets (10%, 25%, 28%, 33%, 35%) originally set to expire on December 31, 2012 have been made permanent for taxpayers with income below $400,000 for individual filers and $450,000 for those married filing jointly (amounts to be adjusted for inflation). For taxpayers above the thresholds, the 39.6% bracket has been reinstated.

While not specifically addressed in the 2012 Tax Act, estates and trusts are projected to hit the top bracket of 39.6% in 2013 at approximately $12,000 in income.
The tax preferences for qualified dividends and long-term capital gains have also been extended permanently for taxpayers below the 39.6% tax bracket. Below the threshold, the tax rates for long-term capital gains and qualified dividends will remain at 15% (0% for taxpayers below the 25% bracket). For taxpayers in the highest tax bracket, the rate on long-term capital gains and qualified dividends will increase to 20%. It is this author’s opinion that the 20% top rate is a welcome alternative to the previously scheduled increase to 39.6% for qualified dividends.

The 2012 Act also made permanent the repeal of the phase-out for personal exemptions and the limitation on itemized deductions for taxpayers with adjusted gross income below $250,000 or $300,000 (individual and married filing jointly respective limitations). However, for taxpayers above the thresholds, the phase-out and limitation return: itemized deductions will be reduced by the lesser of 3% of the excess of adjusted gross income over the threshold amounts or 80% of the otherwise allowable itemized deductions.

Gone are the days of the annual Alternative Minimum Tax patch. The 2012 Act permanently set the AMT exemption amount at $78,750 for joint filers in 2012 with adjustments for inflation in 2013 and thereafter ($50,600 for single filers in 2012 and likewise adjusted for inflation in later years).

The 2012 Act also extended the following individual tax benefits through 2013: tax-free distributions from IRA accounts for charitable purposes, the election to deduct state and local sales taxes in lieu of income taxes, the above the line deduction for teacher expenses, relief from cancellation of debt income for principal residences, the deduction for mortgage insurance premiums as interest, the special deduction rules for conservation easement contributions and the above the line deduction for qualified education expenses.

The unification of the Estate, Gift and Generation-Skipping Transfer tax exemption amounts continues in 2013 and beyond at an inflation-adjusted amount of $5 million per person. Quite a gift from Congress, considering the exemption amounts were scheduled to return to $1 million per person. Additionally, the portability of a deceased spouse’s unused exemption amounts has been made permanent by the 2012 Act. However, in exchange for the increased exemption amounts come increased transfer tax rates (relatively speaking).

The maximum rate of tax on transfers at death, gifts during life and generation-skipping transfers has been set at 40% for transfers after December 31, 2012. An increase over the 35% tax rate of 2012 but pale in comparison to the 55% rate previously scheduled to take effect on January 1, 2013.

Other notable extensions for business owners are the one year extension of the $500,000 maximum cost of Section 179 property that can be expensed rather than depreciated, and the Section 168(k) 50% bonus depreciation for qualified property placed in service before January 14, 2014 (January 1, 2015 for certain aircraft and longer production period property).
The Affordable Care Act’s 3.8% investment income surtax remains unchanged and will effect net investment income in 2013 (and thereafter). Note that the definition of net investment income includes long-term capital gains and qualified dividends. Note also that estates and trusts are subject to the investment income surtax on the lesser of undistributed net income or the dollar amount at which the top tax bracket is reached (projected to be approximately $12,000 in 2013).

The payroll tax holiday is officially over and the Social Security tax rate returns to 6.2% in 2013. This seems to be by far the largest tax increase based on the number of affected taxpayers. The Tax Policy Center estimates this will hit middle-income households to the tune of a 1.5% reduction in their after tax incomes.

In addition to the Social Security withholding increase for all taxpayers, the Medicare tax rate will increase by 0.9% for single filers with income in excess of $200,000 and joint filers with income over $250,000 (another consequence of the Affordable Care Act).

**The Sum of It All**

Entitlement, military and other government spending will continue at current levels through the first quarter of 2013. The President and Congress are tasked with coming up with a balanced budget (and a bipartisan agreement on spending) before the end of March.

Virtually all taxpayers (77% as estimated by the Tax Policy Center) will be subject to additional taxes in 2013 and beyond through the increased Social Security withholding amounts (2%) on wages, and high income earners (income in excess of $200,000 for singles and $250,000 for joint filers) will also pay an increased Medicare withholding tax (0.9%) on wages.

Individual tax rates will remain unchanged for the majority of U.S. taxpayers, with 2012 rates extended in perpetuity (or until changed by congress). However, taxpayers with adjusted gross income in excess of $400,000 and $450,000 (individual and joint filers, respectively) will see rates on ordinary income increase to 39.6%. These high income earners will also be subject to a 20% rate on qualified dividends and long-term capital gains (versus 0% or 15% for those below the threshold).

Individual income tax deductions will likewise remain unchanged for taxpayers with adjusted gross incomes of $250,000 or $300,000 (individual and joint filers, respectively). However, taxpayers with adjusted gross income in excess of those amounts will see a phase-out of their personal exemptions and a limitation (up to 80%) of their itemized deductions.

The exclusion amounts for estate, gift and generation-skipping transfer taxes remain at $5 million per person and are indexed for inflation. The continued unification of the exemption amounts is a much appreciated and unexpected gift as is the fact that portability of a deceased spouse’s exemption amounts was made permanent. In addition, the top rate
of tax on transfers in 2013 and beyond has been set at 40% which could be seen as an increase or a decrease depending on your perspective. No matter how you look at it, exemption amounts of $5 million and tax rates of 40% seem to be a win-win situation when compared to a $1 million exemption and tax rates of 55%.

VENTURING INTO THE UNKNOWN

While the fiscal cliff is no longer looming on the horizon, it is still too early to gauge the effects the 2012 Act will have on the U.S. economy. Additionally, as nice as it is to have certainty on a number of fronts (such as tax rates and itemized deductions), the 2012 Act merely extended a number of individual tax benefits and business tax provisions through the end of 2013, and in our opinion the dire need for long term tax reform remains.

With the imminent need to raise the debt ceiling, the battle over entitlement spending, the question of how to offset the cost of the 2012 Act (the Congressional Budget Office estimate is $293 billion in 2013 alone and consists of $13 billion in additional spending and a reduction of $280 million in tax revenue), the picture of the U.S. economy and the Act’s effects are hazy at best. With that being said, Dan Clifton, in Strategas’ January 2nd fiscal cliff tearsheet, has estimated the impact of the 2012 Act will be approximately 1% of gross domestic product or approximately $162 billion in 2013 (Strategas is an independent private partnership providing macro research, advisory and capital market services).

If Strategas’ data holds, it would appear as if our fiscal cliff has been reduced to a slope or “stair steps,” as they have called it. Our slow descent down this fiscal slope seems to be tenuous at best given all of the variables in the equation, and one can only hope that this slope is not a slippery one.

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