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On January 1, 2013 Congress passed H.R 8, titled the American Taxpayer Relief Act of 2012. President Obama quickly signed the bill on Jan. 2, 2013.

Here are some of the highlights of the new law:

**Provisions Primarily Affecting Individuals**

**Income tax rate increases for the wealthiest**

The rate brackets remain as they have been for the past 10 years, adjusted annually for inflation. The six existing tax rates – 10, 15, 25, 28, 33 and 35 percent – are retained. However, beginning Jan. 1, 2013, the act imposes a new 39.6 percent bracket that will apply to taxable income above the following amounts:

|  |  |
| --- | --- |
| **39.6% bracket starts at taxable income of** | **For filing status** |
| $450,000 | Married filing jointly |
| $425,000 | Head of household |
| $400,000 | Unmarried |
| $225,000 | Married filing separately |

The new law also imposes a stealth type of rate increase by phasing out the personal exemption deduction and certain itemized deductions for those with adjusted gross income (AGI) above the following amounts:

|  |  |
| --- | --- |
| **Phaseout starts at AGI of** | **For filing status** |
| $300,000 | Married filing jointly |
| $275,000 | Head of household |
| $250,000 | Unmarried |
| $150,000 | Married filing separately |

Once AGI exceeds the applicable threshold by more than $122,500, the personal exemption deduction is lost entirely. Similarly, certain itemized deductions are lost as AGI exceeds the same threshold due to a 3 percent threshold phaseout.

Medical deductions, investment interest, casualty, theft and wagering losses are not subject to this phaseout. When planning charitable giving for 2013, taxpayers should keep in mind that their contribution deduction could be subject to this phaseout.

For itemized deductions subject to phaseout, taxpayers will always be entitled to at least 20 percent of the total, since the phaseout cannot eliminate more than 80 percent of their itemized deductions.

**Maximum tax on capital gains and dividends**

For tax years beginning after 2012, a new 20 percent tax rate will apply to dividends and long-term capital gains for married taxpayers with taxable incomes exceeding $450,000 ($400,000 for single taxpayers) to the extent they exceed these thresholds. For taxpayers between the 25 percent and 39.6 percent brackets, capital gains and dividends will continue to be taxed at 15 percent, while the lower bracket individuals will still enjoy a zero percent tax rate.

To avoid the effect of the 20 percent tax rate, more people may want to consider electing out of the installment sale method in 2012. In addition, the new 3.8 percent Medicare tax on investment income may apply (see below for more detail).

**Estate and gift tax rate increases**

For decedents dying and gifts made after Dec. 31, 2012, the top estate and gift tax rate is 40 percent. The estate and gift tax exemption remains unified at $5 million, indexed for inflation. For 2012, the exempt amount is $5.12 million.

In addition, the act made the portability election permanent. This election allows a surviving spouse’s estate to benefit from the deceased spouse’s unused exemption, providing shelter for married couples.

**Alternative minimum tax adjusted for inflation**

After years of annually patching the alternative minimum tax (AMT), Congress has finally added an automatic inflation adjustment provision. The act sets the AMT exemption for 2012 at $78,750 for joint filers, $50,600 for unmarried individuals and $39,375 for married people filing separately.

Beginning in 2013, these amounts are adjusted for inflation. Personal nonrefundable credits are able to offset the AMT.

**Adoption credit/assistance permanently enhanced**

Prior enhancements to the adoption credit and the income exclusion for employer-paid and/or reimbursed adoption expenses are made permanent for both non-special needs and special needs adoption. The credit phases out at specified inflation-adjusted levels of modified adjusted gross income (MAGI).

|  |  |  |
| --- | --- | --- |
|  | **2012** | **2013** |
| **Maximum credit/exclusion** | $12,650 | $12,770 (projected) |
| **Phaseout begins at MAGI of** | $189,710 | $191,530 (projected) |

**Charitable distributions from IRAs reinstated**

The provision allowing individuals age 70½ and older to contribute up to $100,000 from their IRA to charity without having to include the distribution as income had expired at the end of 2011. The act reinstates this provision for 2012 and 2013.

Because passage occurred after Dec. 31, 2012, the act contains two important savings provisions:

1. Charitable contributions made from an IRA to a charity before Feb. 1, 2013, can be designated as a 2012 contribution.
2. Cash distributions received from an IRA during December 2012 can be treated as a direct contribution from the IRA to a charity to the extent that amount is actually contributed to a charity prior to Feb. 1, 2013.

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**Personal tax credits extended**

These credits are extended through 2017:

* The $1,000 child tax credit
* The enhanced earned income tax credit
* The enhanced American Opportunity credit for college tuition

**Other expired tax provisions extended for two years**

The following provisions, which expired at the end of 2011, are extended for 2012 and 2013:

* The exclusion from income for discharged home mortgage debt
* The up-to-$250 non-itemized deduction available to teachers who purchase classroom supplies
* The itemized deduction for mortgage insurance premiums
* The alternate itemized deduction for state and local sales taxes in lieu of state and local income taxes (This provision primarily benefits residents of states without an income tax.)
* The $4,000 non-itemized deduction for college tuition and fees

**Various temporary tax provisions made permanent**

Temporary tax provisions that are now permanent include:

* Some marriage penalty relief (i.e., the increased size of the 15 percent rate bracket and increased standard deduction for married taxpayers filing jointly), although many newly enacted provisions exacerbate the marriage penalty because the income thresholds that cause married couples to pay higher taxes are set far lower than double the comparable threshold for unmarried individuals
* The liberalized child and dependent care credit rules that allow the credit to be calculated based on up to $3,000 of expenses for one dependent or up to $6,000 for more than one dependent
* The exclusion of up to $5,250 for employer-provided educational assistance
* The enhancements to Coverdell education savings accounts



**Payroll tax holiday allowed to expire**

The 2-percentage-point reduction in the Social Security tax paid by workers, including self-employed individuals, has been allowed to expire. For 2013, a worker earning $50,000 will pay an additional $1,000.

Those with earnings above the $113,700 Social Security wage base will pay an additional $2,274.

**Provisions Primarily Affecting Businesses**

**Expired business provisions extended**

Several popular business provisions that had already expired were reinstated retroactively and temporarily extended, including:

***R&D tax credit*** *–* The credit for increasing research and development activities, which expired at the end of 2011, is extended through 2013. A modification allows for partial inclusion of research expenses and gross receipts of an acquired business.

***Higher expensing limit*** – The enhanced Section 179 small business expensing election is extended through 2013. The dollar limit for 2012 and 2013 is $500,000, with a $2 million investment limitation. The rule allowing off-the-shelf computer software is also extended.

***Bonus depreciation*** – 50 percent bonus depreciation is extended through 2013. This extension allows for an increase of the first-year limit for luxury autos to $8,000 (not yet adjusted for inflation). In addition, the act extends the ability for taxpayers to forgo bonus depreciation in order to increase AMT credit limitations.

Some transportation and longer production period property is eligible through 2014.

***Work Opportunities Tax Credit*** – This provision provides a credit of up to $2,400 (up to $9,600 for qualified veterans) to employers hiring workers from a variety of difficult-to-employ groups. The credit is extended for workers hired through 2013.

***Qualified leasehold improvements***– The 15-year recovery period for qualified leasehold improvements, qualified retail improvements and qualified restaurant property is extended through 2013.

***Other business extenders*** – A number of other business provisions that expired at the end of 2011 have been extended through 2013, including:

* New Markets Tax Credit
* 100 percent exclusion for gain on the sale of small business stock
* Extension of reduced recognition period (five years) for S corporation built-in gains
* Enhanced deduction for contributions of food inventory

***Energy tax extenders*** *–* The act also extends through 2013, and in some cases modifies, a number of energy credits and provisions that expired at the end of 2011, including credits for:

* Energy-efficient existing homes
* Alternative fuel vehicle refueling property
* Energy-efficient new homes
* Energy-efficient appliances

**New Healthcare Taxes Taking Effect in 2013**

In addition to the various provisions contained in the new act, a number of new tax laws took effect Jan. 1, 2013, as a result of 2010’s healthcare reform legislation.

**Hospital insurance tax on high-income individuals**

The employee portion of the hospital insurance tax portion of FICA (which funds Social Security), normally 1.45 percent of covered wages, is increased by 0.9 percent on wages that exceed a threshold amount. The additional tax is imposed on the combined wages of both spouses filing a joint return.

The threshold amount is $250,000 in the case of a joint return or surviving spouse and $200,000 for an unmarried individual. Any portion of the tax not collected through payroll withholding will be paid with the annual income tax return. Self-employed individuals are also subject to the additional tax if the combination of their net earnings from self-employment and any wages exceeds the threshold amount.

**Medicare tax on investment income**

An additional tax at the rate of 3.8 percent applies to the lesser of:

1. An individual’s net investment income for the year, or
2. The amount by which the individual’s AGI for the year exceeds a threshold amount.

The threshold amounts are the same as those for the new health insurance tax – $250,000 for a joint return or surviving spouse and $200,000 for an unmarried individual.

**Medical expense itemized deduction threshold**

The threshold for the itemized deduction for medical expenses not covered by insurance is increased to 10 percent of AGI. In the years 2013-2016, if the individual or either spouse on a joint return has turned age 65, the threshold remains at 7.5 percent of AGI.

**Tax Planning Considerations**

A common theme of recent tax legislation has been to place most, if not all, of the burden of new taxes on “wealthy” individuals. In so doing, Congress has defined the wealthy as those with an income above a certain threshold.

Unfortunately, Congress has chosen multiple different income levels. For example, a married couple filing a joint return is wealthy if:

* Taxable income exceeds $450,000 for purposes of the 39.6 percent tax rate.
* Adjusted gross income exceeds $300,000 for purposes of the phaseout of the exemption deduction and certain itemized deductions.
* Adjusted gross income exceeds $250,000 for purposes of the new healthcare taxes on earned income and net investment income.

Taxpayers should expect a significant element of future tax planning to include trying to manage their annual income to stay below the various thresholds. To do so, they will want to avoid income spikes – such as large one-time gains on the sale of a business or another investment, a large one-time bonus from their employer, or election of a lump-sum payout if they win the lottery.

Techniques like installment sales in the case of gains, deferred compensation arrangements for bonuses and annuitizing lottery winnings may prove advantageous in some cases. And, since the top tax rate on conventional C Corporations remains at 35 percent, which is now lower than the top rate that applies to individuals, it may make

sense to consider this entity structure for current or future businesses.

Now is an excellent time to visit with your tax adviser, who can help you plan to minimize these tax increases and take maximum advantage of the extended tax breaks.

**Future Tax Legislation**

The new legislation does not come close to solving the budget issues that Congress faces. Expect the debate to continue about future spending cuts and revenue enhancements.

If you have any questions or would like to discuss any of the above items in greater detail and how they may apply to your specific tax situation, please call our office.



**2013 Refund Cycle Chart**

“When can I expect to receive my refund?” is the most frequently asked question of a tax preparer. This year your tax preparer may not be able to give you an answer. The IRS is not producing a 2013 IRS e-file refund cycle chart for tax preparers to answer the question. The commonly used chart has been discontinued and Publication 2043 has been dramatically revised due to IRS uncertainty about issuing refunds. The IRS states “In a change from previous filing seasons, taxpayers won’t get an estimated refund date right away.” From a customer service standpoint, this presents a problem in managing your clients expectations. The IRS states that “most taxpayers will have their refunds within 23 days”, a significant delay from recent years.

The delay in issuing refunds is due to a new processing method with an emphasis on fraud. The IRS’s new processing method includes multiple fraud checks based on the information in your tax return. Tax returns will be analyzed for what the IRS calls “Incoming transactions” and placed in a different category for funding. The IRS has not stated what denotes an incoming transaction but it could be anything from a change in dependents to a change in address. “The IRS has fraud filters built into their new system and they don’t truly know what category the tax returns will fall into based on the filters in place at the time of review and how many returns are going to be delayed. Those filters could change throughout the tax season” says Joseph Mahaffey, CPA. “The IRS’s priority has shifted from getting you your refund quickly to fraud prevention and identity theft.”