# 9 Key Tax Rules for 2013

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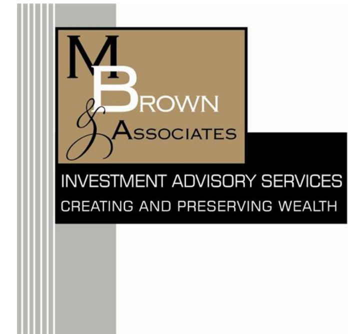


**By Charles Sherry, M.Sc.**

## The new tax law brings both good and bad news to almost every investor. Here are nine significant provisions that could matter to you and tax situation.

Negotiations ran up against the midnight hour, and dealmakers tiptoed past deadline, but Congress managed to craft a compromise that prevented a host of tax hikes and spending cuts that popularly have been called the fiscal cliff.

For the most part, the 154-page bill, officially dubbed the American Taxpayer Relief Act (ATRA), permanently enshrines major portions of the Bush tax cuts into law. When it comes time to crunch the numbers for 2013, the vast majority of taxpayers won't be dealing with the nuances imposed by the new rules.

However, there are some important changes that will impact those at the top of the income scale. The early consensus suggests that the new provisions will not be as onerous on upper-middle-income taxpayers as some expected. There are also a few welcome surprises.

Let's take a look at some of the key changes in the tax code and the potential ways you may be affected.

**1. Individual tax rates**

All of the marginal tax rates under the Bush-era tax cuts have been made permanent by the new law. But taxable incomes that exceed new thresholds will be subject to the Clinton-era top rate of 39.6%. This new rate will apply to individual taxpayers with taxable income over $400,000, married folks with income over $450,000, heads of household who earn over $425,000, and married individuals who file separately and have income above $225,000. Note: these thresholds apply to *taxable income after deductions,* not adjusted gross income (AGI).

The good news: a sizable portion of the population that had originally been targeted for higher tax rates will escape the net cast by Congress, at least under this provision. But for investors who will see their cash outflow to the IRS rise, it's time to take a look at ways to minimize the bite.

- **Debt instruments such as municipal bonds may be an option.** Further, you can avoid paying the new 3.8% Medicare surtax on income earned from municipals.

- **Maximize contributions to retirement accounts**. The new tax law didn't change the deferral of retirement account contributions,

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as many expected. However, the conversion of an IRA into a Roth may thrust some into a higher bracket or into the new top bracket, which could increase the total tax liability of the conversion.

- **Charitable donations or donor-advised funds.** Especially when income spikes from the sale of a business, charitable giving could be another method that maximizes tax savings.

But caution is in order. A phaseout of itemized deductions (more in a moment) could limit the value of charitable donations as a vehicle to minimize taxes.

## Added complications

An owner of an S Corporation that exceeds the new income threshold will have an added tax expense. C Corporations are still taxed at a maximum rate of 35%, and converting is an option. But both the individual and the corporation are responsible for paying taxes. In addition, there may be other costs to consider, such as tax and business filings and increased tax compliance.

Finally, the marriage penalty might complicate tax planning, because two individuals in the 35% tax bracket who are contemplating marriage would likely find themselves paying a marginal rate of 39.6%. An adjustment in withholdings may be in order.

**2. Expiration of the payroll tax holiday**

The two-percentage-point reduction in payroll taxes was allowed to expire at the end of 2012. Consequently, most Americans will experience a tax increase from the passage of the American Tax Relief Act (ironic).

However, some Americans stand to benefit from other provisions, including a change to the AMT and the estate tax (more on that below).

**3. Phaseout of itemized deductions and personal exemptions**

The phaseout is akin to a stealth tax and is likely to surprise some taxpayers. The personal exemption and itemized deduction phaseout will be reinstated at a threshold of $250,000 (adjusted gross income or AGI) for single taxpayers, $300,000 for married filing jointly, $275,000 for heads of household, and $150,000 for married and filing separately. The thresholds will be indexed to inflation.

The phaseout for itemized deductions, which is called the Pease limitation after the congressman who originally proposed the idea in 1990, reduces most itemized deductions by 3% of the amount that tops the threshold. The reduction can't exceed 80% of the total deductions.

So what does this mean? If Jake and Jane have an AGI of $400,000 and have $60,000 in qualifying itemized deductions (some deductions are excluded), they exceed the threshold by $100,000. Hence, 3% x $100,000 translates into itemized deductions totaling $57,000, or $3,000 less than they could have deducted under the previous law.

A $3,000 reduction in itemized deductions in the above example may sound like a relatively small amount, but the new provision is expected to enrich government coffers to the tune of about $150 billion over the next 10 years. That compares to a total expected take from the implementation of ATRA of about $620 billion (excluding increased revenues from the expiration of the payroll tax holiday), including $395 billion from higher tax rates.

The personal exemption phaseout (PEP) works in a similar manner and the same thresholds apply. The PEP reduces the value of each personal exemption from its full value by 2% for each $2,500 or portion thereof by which the taxpayer's AGI exceeds the applicable threshold. The net impact: each rule increases the marginal tax rate by about 1%.

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**4. Estate and gift taxes**

The ever-changing estate exemption introduced by the 2001 Bush tax cuts has finally been replaced by a high degree of certainty. For most high-net-worth families and financial planners, the news is long overdue.

ATRA permanently establishes an exclusion of $5 million and a top rate of 40%. Further, the exclusion will be indexed to inflation, which puts the 2012 exemption at $5.12 million.

The same thresholds will apply to gift taxes.

ATRA also makes "portability" between spouses permanent, allowing the unused portion of a deceased spouse's estate and gift tax exemption to be transferred to the surviving spouse.

Many wealthier Americans will breathe a sigh of relief, and rightfully so. But don't be lulled into complacency. It's time to review your estate plan and update as appropriate.

For example, a review is in order for any irrevocable trusts. If you had a trust to distribute annual gifts, the permanency of the $5 million exemption (assuming no future changes) could make it obsolete for estate tax purposes. The same holds true for life insurance put in place for estate taxes.

For those who have deferred planning amid the uncertainty, it's time to act and tie up loose ends. And it's important to make sure any adjustments that maximize benefits of the $5 million limit peacefully coexist with applicable state laws.

**5. Permanent AMT relief for many**

Here is another welcome measure: a permanent patch for the alternative minimum tax. Ideally, the AMT would have been scrapped, but the fix is more than most had dared to hope for.

New limits: the exemption amount reaches $78,750 for married couples and $50,600 for individuals in 2012. These will be indexed to inflation. Without the patch, the 2012 limits would have been set at $33,750 for individual and $45,000 for married taxpayers.

**6. Capital gains and dividends**

Rock-bottom interest rates have chased investors out of the safety of cash into higher-dividend-paying blue chips. Plus, the 2003 JGTRRA legislation offered an extra incentive: a reduced tax rate on qualified dividends.

Taxpayers who will be greeted by the Clinton-era top rate can, in some respects, breathe a sigh of relief.

Qualified dividends and long-term capital gains will be taxed at 20% for those in the 39.6% bracket. The tax rate on dividends was set to be taxed as ordinary income.

Those in the 10% and 15% brackets will continue to enjoy a rate of zero, and those who pay a marginal rate between 25% and 35% will still pay 15% on qualified dividends and capital gains.

A warning, however. The new 3.8% Medicare surtax will apply to unearned income, including dividends, for individual taxpayers who have a modified AGI above $200,000 and those that file jointly and have a modified AGI in excess of $250,000. That becomes an effective rate of 18.8% and 23.8%.

**7. Increased ability to convert defined-contribution plans into Roths**

You may now convert a 401(k), a 403(b), or a similar defined-contribution plan into a Roth 401(k) if the plan has the Roth feature. Previously, a participant had to change jobs, reach 59½, or retire before such a rollover was permitted.

The advantages of tax-free growth and withdrawals, the elimination of the required minimum distribution (RMD), and for some, protection from creditor and claimants could spur conversions.

The provision was included as a way to help pay for a two-month delay in about $110 billion in spending cuts (the sequestration) slated to go into effect on Jan. 1.

**8. No change to the new Medicare taxes that accompanied health care reform**

A new 3.8% surtax on investment income isn't going away and will be applied against the lesser of the taxpayer's investment income or modified adjusted gross income (MAGI) in excess of the respective thresholds of $200,000 for individuals and $250,000 for married filing jointly.

Look for ways to reduce income, including contributions to qualified plans and tax-exempt or deferred investments.

Furthermore, an additional 0.9% increase in Medicare taxes on earned income above $200,000 for single filers and $250,000 for married filing jointly is still in place.

**9. Coverdell Education Savings Accounts**

Overlooked by many, the act permanently extends education savings accounts (ESAs), including a $2,000 maximum contribution limit.

## Tax extenders through 2013

ATRA also extended some older provisions, including items for energy, individuals, and businesses (some which had expired in 2011). Some tax extenders that may be relevant to you include:

- The ability to make tax-free rollovers from an IRA to a qualified charity
- The deduction of mortgage insurance premiums treated as qualified residence interest
- A $500,000 limit for small-business expensing, with a $2 million investment limit
- A deduction for state and local general sales taxes in lieu of state and local income taxes
- Exclusion of the cancellation of debt on the principal residence (up to $2 million)
- Various energy incentives
- 100% exclusion for gain on the sale of qualified small-business stock

## The bottom line

ATRA did exactly what it was intended to do and nothing more: it averted the fiscal cliff. Washington has yet to fully address the fiscal imbalances that still plague the nation. Though some wealthier taxpayers will feel a modest tax bite from the bill, the vast majority of Americans will not see their taxes rise, and the increase was not as onerous as some of the earlier proposals.

Moreover, there were a couple of pleasant surprises, including a permanent patch for the AMT and an end to the estate-planning roller-coaster ride. But before making any financial decisions, consult with a professional for guidance on how these new tax rules could impact your individual situation.

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