INTRODUCTION

As it stands right now, taxpayers will feel “crunched” next year. There are several reasons why:

- The expiration of the Bush-era tax cuts
- The new surtaxes and a new limit on medical expense deductions that are part of the 2010 healthcare law
- The continued non-renewal of the “tax extenders”

The upcoming changes in the federal tax law effective January 1, 2013, are extensive and will increase taxes across the board (especially for high-income taxpayers).

But the prospect of these upcoming changes—along with the much noted “fiscal cliff” tied to the federal budget and debt limit—could also prove to be a “crucible.” In the past, lawmakers have enacted legislation under extreme heat and pressure (figuratively speaking) from constituents and special interest groups. Sometime during the end of 2012 or early 2013, Congress might move to suspend some or all of the anticipated tax increases.

INCOME TAX CHANGES IN 2013

Income Tax Rates

The federal income tax system is progressive; as income increases, it is taxed at a higher rate. Since 2001, there have been six income tax rates applicable to non-corporate taxpayers: 10% - 15% - 25% - 28% - 33% - 35%.

On January 1, 2013, there will only be five income tax rates. The lowest rate of 10% will be dropped and four of the remaining tax rates will increase: 15% - 28% - 31% - 36% - 39.6%.

Income Tax Brackets

The range of income taxed at each rate (known as a “tax bracket”) depends on the status the taxpayer claims: single, head of household, married filing jointly, married filing separately, trust/estate.

Since 2001, the amount of income subject to the 15% tax bracket for married persons filing jointly has been double the amount for single taxpayers in the same tax bracket. This provision alleviates the “marriage penalty,” which is the disadvantage for married persons filing jointly as compared to a single taxpayer.

On January 1, 2013, the amount of income subject to tax in the 15% tax bracket for married persons filing jointly will decrease from double (200%) to only 167% of the amount for single taxpayers. This will increase the tax burden on married couples relative to single taxpayers.

Payroll Taxes

“Payroll taxes” is a common term for the FICA taxes imposed on both the employee and employer based on wages. These taxes are directed to social insurance programs funded by the federal government. The Social Security tax is imposed on a limited taxable wage base that is indexed to inflation ($110,100 for 2012). The Medicare tax is imposed on all of the worker’s wages.

Since 2011, the Social Security tax rate on the employee’s taxable wages has been 4.2% (the employer continues to pay at a 6.2% rate). Since 1990, the Medicare tax has remained constant at 1.45% for both the employee and employer.

On January 1, 2013, payroll tax rates change in two significant ways:

1. The temporary cut on the employee’s Social Security tax rate will end and the rate will jump back up to 6.2%.
2. The tax rate for the employee’s Medicare contribution will increase for high-income earners. A taxpayer will pay an additional tax of 0.9% on wages in excess of $200,000 ($250,000 for married persons filing jointly).

Net Investment Income Tax

New Tax on Unearned Income

On January 1, 2013, a new tax on net investment income will be imposed as a result of the Patient Protection and Affordable Care Act. Individuals with more than $200,000 in income ($250,000 for a married couple filing jointly) who have net investment income will pay an additional tax of 3.8% on the lesser of net investment income or the excess of modified adjusted gross income over the threshold amount.

Net investment income is defined as the sum of gross income from interest, dividends, annuities, royalties, rents and net gain attributable to the disposition of property (i.e., capital gains). Obviously, this does include passive income. However, net investment income does not include retirement plan distributions, nor does it include income from a Subchapter S corporation or partnership subject to self-employment tax.

In the case of an estate or trust, the tax is 3.8% on the lesser of undistributed net investment income or the excess of adjusted gross income over the amount at which the highest tax bracket begins (for 2012, that highest tax bracket is $11,650). Adjusted gross income for estates and trusts is defined under IRC Sec. 67(e). Note that the following trusts are not subject to tax: charitable remainder trusts, trusts exempt under IRC Sec. 501, and trusts for which all unexpired interests are devoted to charitable purposes.

Long-Term Capital Gains

Long-term capital gains are defined as gains from the sale or exchange of capital assets held in excess of one year. Since 2007, the tax rate on long-term capital gains has been 0% for persons in the bottom two tax brackets and 15% for all other taxpayers.

On January 1, 2013, the taxation of long-term capital gains will change in two significant ways:

1. The tax rates on long-term capital gains will jump to 10% for those taxpayers in the lowest tax bracket and 20% for all other taxpayers. Note that lower rates on capital gains attributed to assets held for longer than five years will now be available (8% and 18% respectively).

2. The new tax on net investment income will apply to capital gains.

Qualified Dividends

Qualified dividends are defined as those received during the taxable year from domestic corporations and qualified foreign corporations. Since 2007, the tax rate on dividends has been 0% for persons in the bottom two tax brackets and 15% for all other taxpayers.

On January 1, 2013, the taxation of dividends will change in two significant ways:

1. The tax rates on dividends will correspond to ordinary income instead of long-term capital gains.

2. The new tax on net investment income will apply to dividend income.

Above-the-Line Deductions

An “above-the-line” deduction is an expense or amount deducted from gross income before reaching the adjusted gross income (AGI). A taxpayer need not itemize in order to take an above-the-line deduction. Notable examples include IRA contributions, Health Savings Account contributions, student loan interest, and tuition expenses.

On January 1, 2013, the Bush-era expansion of the availability of the student loan interest deduction will end. The deduction will be available only for interest payments made within the first 60 months of repayment on the loans. In addition, the AGI range for phasing out the deduction will begin much lower than previous years.

The above-the-line deduction for qualified tuition and related expenses expired at the end of 2011.

Standard Deduction

A taxpayer who decides not to itemize deductions can subtract from AGI a standard deduction amount determined by filing status. Since 2001, the standard deduction for married persons filing jointly has been double the amount available to single taxpayers. This provision alleviates the “marriage penalty”—the
disadvantage of married persons filing jointly as compared to each spouse filing as a single taxpayer.

On January 1, 2013, the standard deduction for married persons filing jointly will decrease from double (200%) to only 167% of the amount for single taxpayers. This increases the tax burden on married couples relative to single taxpayers.

Itemized Deductions

An itemized deduction is an expense that can be deducted from adjusted gross income (AGI). From 2006 to 2009, the Pease limitation on itemized deductions for high-income taxpayers was gradually rescinded. From 2010 to 2012, there was no reduction for itemized deductions based on modified AGI.

As of January 1, 2013, itemized deductions will be limited in several ways:

1. The Pease limitations will reduce the amount of certain itemized deductions high-income taxpayers can claim: either 3% of the taxpayer’s income over the modified adjusted gross income limit, or up to 80% of certain deductions (whichever amount is less).

2. The taxpayer threshold for claiming medical expenses as an itemized deduction will be increased from 7.5% of AGI to 10% (though individuals age 65 and older will continue to use the 7.5% threshold from 2013 to 2016).

3. As was the case in 2012, the option to deduct state and local sales taxes rather than income taxes will not be available.

Personal Exemptions

A taxpayer can deduct a personal exemption, an exemption for a spouse and for eligible dependents. The amount of the deduction is referred to as the exemption amount. In 2012, the personal exemption amount is $5,950. From 2006 to 2009, the reduction in personal exemption amounts for high-income taxpayers was gradually rescinded. From 2010 to 2012, there was no reduction for personal exemption amounts based on modified AGI.

As of January 1, 2013, personal exemption amounts will once again be phased out for high-income taxpayers. For every $2,500 (or fraction thereof) over the modified AGI threshold, the exemption will be reduced by 2%. Note that married persons filing separately will phase out the exemption for every $1,250 over the modified AGI.

Credits

A tax credit is an amount subtracted from the taxpayer’s tax liability (which makes a $100 credit much more valuable than a $100 deduction). Notable tax credit enhancements made between 2001 and 2012 include:

- **Child Credit**: Increased to $1,000 per child.
- **Child and Dependent Care Credit**: The applicable percentage of care expenses covered increased to 35% ($3,000 for one, $6,000 for two or more), and the floor of the AGI limit to reduce the credit increased to $15,000.
- **American Opportunity Credit**: The Hope Scholarship Credit renamed and enhanced to permit a maximum credit of $2,500. The AGI limit for reducing the eligibility increased, and availability expanded to the first four years of post-secondary education.
- **Adoption Credit**: The exclusion from income of employer payment of adoption expense, and the increase in the adoption credit to $12,000.

On January 1, 2013, both the amounts and the range of eligibility for these credits will be lowered.

* **Child Credit**: Drops to $500 per child.
* **Child and Dependent Care Credit**: The applicable percentage of care expenses covered drops to 30% ($2,400 for one, $4,800 for two or more), and the floor of the AGI limit to reduce the credit returns to $10,000.

“We’ve agreed to count it as both a wave and a particle for tax purposes.”
Crunch or Crucible?

* Hope Scholarship Credit: Credit drops to a maximum of $2,000, the AGI limit for reducing the eligibility returns to previous levels, and coverage drops back to two years of post-secondary education.
* Adoption Credit: The exclusion from income of employer payment of adoption expense returns to prior levels, the available credit returns to $5,000 ($6,000 for a special needs child), and the credit becomes a nonrefundable personal credit (which can only be used to reduce tax liability).

AMT Exemption

The alternative minimum tax, or AMT, is a parallel tax system originally created to prevent excessive tax avoidance by stripping out certain tax breaks for high-income taxpayers. Individuals and corporations are subject to the AMT if it produces a higher tax than the regular income tax calculation. For the past decade or more, Congress has increased the statutory AMT exemption amount for non-corporate taxpayers on a year-to-year basis. And, under the Bush-era tax cuts, the child tax credit was not subject to reduction under the AMT regime.

On January 1, 2013, the favorable tax treatment of certain credits will end. For example, the child tax credit will be reduced for high-income taxpayers under the AMT. Also, a greater percentage of the excluded gain on the sale of qualified small business stock will be treated as an AMT preference item.

Congress has not (yet) renewed an increased AMT exemption for either 2012 or 2013. The exemption amounts remain at statutory levels:

<table>
<thead>
<tr>
<th></th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single</td>
<td>$33,750</td>
</tr>
<tr>
<td>Married filing jointly</td>
<td>$45,000</td>
</tr>
<tr>
<td>Married filing separately</td>
<td>$22,500</td>
</tr>
</tbody>
</table>

Transfer Tax Exemption Amounts

Similar to tax rates, the exemption amounts for federal estate, gift and generation-skipping transfer taxes often changed, sometimes from year to year, according to a schedule. The estate and gift tax exemption amounts were “de-coupled”—the estate tax exemption rose to $3.5 million in 2009 before disappearing altogether in 2010 and then going to $5 million in 2011. The gift tax exemption rose to $1 million and later rose to $5 million.

On January 1, 2013, the unified gift and estate tax exemption will drop to $1 million. The GST tax exemption will be approximately $1.4 million because it is indexed for inflation.

Estate Tax Credit for State Estate Taxes Paid

Prior to 2005, an estate could take a credit against the federal estate tax for “the amount of any estate, inheritance, legacy, or succession taxes actually paid to any State or the District of Columbia, in respect of any property included in the [decedent’s] gross estate.” However, the credit was replaced by a deduction for state estate taxes paid.

On January 1, 2013, the federal estate tax credit for state estate taxes paid will return. The maximum credit will be $1,082,800 plus 16% of the excess over $10,040,000.

Return of the Qualified Family-Owned Business Interest Deduction

From 1998 to 2003, an estate could elect to deduct up to $675,000 of the adjusted value of the qualified family-owned business interest (QFOBI) from a decedent’s gross estate. To have been eligible for this tax break, the estate must have owned a qualifying farm or business interest that consisted of more than 50% of the value of the adjusted gross estate. There were several other technical requirements for eligibility concerning which family members would inherit, how involved the
decendent was in the business, and how the business was owned.

Congress removed the QFOBI deduction due to the increases in the estate tax exemption under Economic Growth and Tax Relief Reconciliation Act of 2001.

On January 1, 2013, the QFOBI deduction will be restored.

Option of Spousal Portability of Unused Exemption No Longer Available

The Tax Relief Act of 2010 introduced the new concept of the portability of a deceased spouse’s unused applicable exclusion amount to a surviving spouse. If someone died in 2011 or 2012, the decedent’s estate may use some, all or none of the estate tax applicable exclusion amount. For instance, if the decedent’s estate used only some or none of the $5 million applicable exclusion amount available in 2011, the decedent’s spouse could add the unused amount to his or her own applicable exclusion amount upon their death.

On January 1, 2013, portability will no longer be available as an option for the executor of the decedent’s estate. Married couples will again be required to plan in advance in order to avoid losing a portion of the estate tax exemption upon the death of a spouse.

Charitable Giving Changes in 2013

Charitable Giving Tax Incentives Set To Expire

Many enhanced deduction options for charitable contributions have been added to federal tax law over the last decade in an effort to encourage certain kinds of philanthropic gifts.

- Enhanced charitable deduction for contributions of capital gain real property made for conservation purposes—up to 50% of AGI (rather than the standard 30%) in the year the gift is made
- Enhanced charitable deduction for contributions of capital gain real property made for conservation purposes by farmers and ranchers—up to 100% of AGI
- Enhanced charitable deduction for food inventory
- Enhanced charitable deduction for book inventory to public schools
- Enhanced charitable deduction for corporate contributions of computer technology and equipment for educational purposes

As of January 1, 2013, none of these enhanced deduction options will be available.

IRA Charitable Rollover

As part of the Pension Protection Act of 2006, the IRA charitable rollover, the popular term for a qualified charitable distribution from an IRA, was a temporary (two-year) provision permitting donors age 70½ and older to direct a distribution from an IRA to a qualified charity without realizing the amount as taxable income. Congress renewed the provision in 2008, and again in 2010, but the provision expired after December 31, 2011.

There are reasons why an IRA charitable rollover is a good option for donors:

- Many unfavorable provisions in federal tax law apply once the taxpayer reaches a certain level of AGI (e.g., the Pease limitations or PEP). However, if the taxpayer utilizes the IRA charitable rollover, that amount counts toward the required minimum distribution but is not realized as income.
- Taxpayers who do not itemize deductions do not gain a tax benefit from a charitable contribution, but do benefit from the exclusion of the qualified charitable distribution from their income.

Congress still has not renewed the provision for 2012 (or 2013).

Federal Tax Policy Positions of President Obama

President Obama won another four-year term on November 6, 2012. Understanding his policy positions can provide some insight into how the upcoming negotiations over federal tax legislation might go. Admittedly, tracking the policy positions of a presidential candidate over the course of a campaign can be difficult. From the start of primary season to Election Day, there are often refinements, partial reversals, and reference by association. Sometimes the policy positions put forth in a party platform can be ascribed to the candidate. Perhaps the candidate expresses support for third party recommendations such as those in the Simpson-Bowles report.
Still, President Obama’s stated positions will be a starting point to understand how federal legislation meant to address the fiscal cliff will proceed.

Here is a short summary of President Obama’s policies concerning the federal taxation of individuals.

Income Tax Rates

President Obama proposes:

- Maintaining the Bush-era tax cuts for single taxpayers earning less than $200,000 and married taxpayers earning less than $250,000.
- Allowing the Bush-era tax cuts to lapse for those at higher income levels, effectively increasing the top two marginal tax rates to 36% and 39.6%.
- Enacting a “Buffet Rule” to require taxpayers earning more than $1 million a year to pay at least a minimum effective tax rate of 30%.

Long-Term Capital Gains and Qualified Dividends

President Obama proposes:

- Maintaining the Bush-era tax rates of 0% and 15% on capital gains and qualified dividends for taxpayers in the lower tax brackets.
- Allowing the tax rates on capital gains to return to the pre-2001 level of 20% for taxpayers with a 36% or 39.6% marginal tax rate, and repealing the reduced rate for gains on assets held over five years.
- Taxing qualified dividends as ordinary income for taxpayers with a 36% or 39.6% marginal tax rate.
- Reviving a provision to exempt the capital gain realized from the sale of qualified small business stock held five years or longer.

Deductions

President Obama proposes removing the availability of deductions for any taxpayer with more than $1 million in income, and allowing the Pease limitation on itemized deductions for high-income taxpayers to stand.

Tax Credits

President Obama proposes making the American Opportunity Credit permanent.

AMT

President Obama would retain the AMT and reduce the value of certain deductions or exclusions for high-income taxpayers.

Estate Tax

President Obama proposes:

- Setting the tax rates and exemption amounts at 2009 levels (2009 was the last year the estate, gift and GST tax were imposed under Bush-era legislation). The top marginal tax rate would be 45%. The exemption amount would be $1 million for gift tax and $3.5 million for the estate and GST tax.
- Retaining the portability of the unused spousal exemption.