KLS PROFESSIONAL ADVISORS GROUP, LLC
Complete Financial Management

American Taxpayer Relief Act

The recently passed American Taxpayer Relief Act which averted the fiscal cliff contained several tax provisions relevant for high income individual taxpayers. Herein we summarize the salient provisions of the Act.

Income Tax Rates

A new 39.6% bracket was added for all ordinary taxable income in excess of $450,000 for married taxpayers filing joint (MFJ) returns ($400,000 for single (S) taxpayers). The prior brackets as in effect for 2012 at lower income levels were preserved going forward, subject to threshold indexing for inflation. The effective rate of tax on taxable income under the income tax rates contained in the Act on the first $450,000 is 28% for MFJ and 29% on the first $400,000 for S. These new brackets thresholds are indexed for inflation going forward.

In addition to these income taxes, the Affordable Care Act (ACA) enacted a new tax of 3.8% on net investment income (including capital gains) where the taxpayer's net investment income is less than the excess of his adjusted gross income (AGI) over $250,000 (MFJ) [$200,000 (S)]. In cases where the excess over $250,000/$200,000 is less than the net investment income, the lesser amount is subjected to the 3.8% tax. For taxpayers with high earned income, the entirety of their net investment income will likely be subjected to this additional tax. [The ACA also increased the Medicare payroll tax on employees by .9% on wages (and self-employment income) in excess of $250,000 (MFJ) and $200,000 (S).]

Capital Gains

The law in effect in 2012 taxed capital gains and qualified dividends at a 15% rate for taxpayers whose income tax bracket exceeded the threshold for the 15% income tax bracket. This 15% rate will continue for taxpayers whose taxable income does not exceed the $450,000 (MFJ)/$400,000 (S) threshold. For those taxpayers whose taxable income exceeds these thresholds, a 20% rate will apply for capital gains and qualified dividends.

Phase-out of Itemized Deductions and Personal Exemptions

Itemized deductions will be reduced for high income taxpayers by 3% of the amount that AGI exceeds $300,000 (MFJ) or $250,000 (S), provided that the reduction shall not exceed 80% of itemized deductions prior to phase-out. The effect of this provision is to increase the effective rate of income tax on high income taxpayers by approximately 1%. High income taxpayers who have itemized deductions attributable to significant state and local income taxes and are not subject to AMT will realize full federal tax benefit for the deduction of their charitable contributions. For those who have insufficient other itemized deductions, bunching of contributions may mitigate the impact of the phase-out as applied to a portion of the charitable contributions.

Personal exemptions are also phased-out for high income taxpayers. The phase-out begins at taxable income levels of $300,000 (MFJ) and $250,000 (S). Exemptions are fully phased-out at AGI levels of $425,000 (MFJ) and $375,000 (S).

Alternative Minimum Tax

The Act increased the threshold at which AMT applies for 2012 and permanently enacted inflation indexing for these thresholds.

Estate and Gift Tax

The Act fixed the top estate, gift, and generation skipping (GST) tax rate at 40% and made permanent the $5,000,000 unified exclusion for estates or lifetime gifts and the GST exclusion. The $5,000,000 exclusion is indexed for inflation after 2011 forward. In the absence of the Act, the exclusions would have been $1,000,000 and the top rate would have been 55%.

The Act also made permanent portability of unused exclusion between spouses. That is, to the extent that one spouse did not use their exclusion during lifetime or for their estate, the second spouse could use such in addition to their own exclusion, thus allowing as much as $10,000,000 to be passed by husband and wife (combined) free of transfer taxes.

401(k) Roth Conversions

The Act allows individuals to convert their existing 401(k) balances to Roth balances under the plan where the plan offers a Roth designated option. Unlike IRA conversions, once the 401(k) conversion is made, it cannot be reconverted back (even if value shortly thereafter declines).

IRA Distributions to Charity

The Act extended for 2012 and 2013 a provision allowing tax free distributions from IRA accounts (maximum $100,000 per annum) to public charities by individuals at least 70.5 years of age. Distributions made in January 2013 may be treated as made in December 2012 and distributions received by the taxpayer in December 2012 may be treated as a charitable distribution if transferred to the charity in January 2013.

Looking Ahead and Reflecting

Revenue raising alternatives that were not addressed in the Act include a hard ceiling on itemized deductions, elimination of or caps on certain itemized deductions, and taxation of municipal bond interest (or limiting the value of the exemption to a benefit that would be realized by a 28% bracket taxpayer). As the debate re-engages over the debt ceiling, deficits and the budget these issues may be revisited and new ones may appear.

For now, in aggregate, high income taxpayers received a substantial increase in rates: a 16% increase in marginal rate on earned income (including the Medicare tax), a 24% marginal rate increase on ordinary investment income (excludes qualified dividend income) and a 58.6% increase in the capital gains tax rate plus the effective rate increase resulting from phase-out of deductions.

Spending Reductions? None

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