Taxation and Retirement

(1/2013)

Tax laws **post-fiscal cliff**

Highlights and insights

In early January 2013 Congress passed and the President signed into law the American Taxpayer Relief Act (the Act). Passage of the new tax law may have avoided some of the issues related to a potential “fiscal cliff” at year end 2012. The “fiscal cliff” is the term used to describe a potential economic situation that otherwise may have occurred at the end of 2012 due to the expiration of the Bush tax cuts, automatic spending cuts starting in 2013, and various other tax and fiscal changes scheduled to occur at the same time. Though the new legislation did not address all components of the “fiscal cliff,” it avoided the major tax increases scheduled for 2013 and kept some tax breaks scheduled to expire. It also increased income taxes for certain high-income individuals and slightly increased the estate and gift tax rates. The following are brief discussions of the more important issues covered in the Act.

Major individual income tax provisions in the Act

Tax rates

Under the new law the income tax rates for individuals in 2013 and beyond were made permanent at 10%, 15%, 25%, 28%, 33% and 35%, and a new 39.6% rate will apply to those with income exceeding a certain threshold. The threshold is $450,000 for joint filers; $425,000 for heads of household; $400,000 for single filers; and $225,000 for married taxpayers filing separately. The threshold amounts are adjusted for inflation for tax years after 2013.

Personal exemption phase-out for high-income taxpayers

The personal exemption is phased out in 2013 and beyond for those making over $300,000 for joint filers; $275,000 for heads of household; $250,000 for single filers; and $150,000 for married taxpayers filing separately. The personal exemptions are reduced by 2% for each $2,500 by which the taxpayer’s adjusted gross income exceeds the applicable threshold amount. The threshold amounts are adjusted for inflation for tax years after 2013.

Limitations on itemized deductions

There is also limitation on itemized deductions in 2013 and beyond for those making over $300,000 for joint filers, $275,000 for heads of household, $250,000 for single filers, and $150,000 for married taxpayers filing separately. The total itemized deductions are reduced by 3% of the excess of the taxpayer's adjusted gross income (AGI) over the threshold amount. The reduction in itemized deductions cannot exceed 80% of the otherwise allowable itemized deductions. These threshold amounts are adjusted for inflation for tax years after 2013.

INSIGHT

Many individuals will not be impacted by the new highest tax rate and the phase-outs. However, those individuals with income over $450,000 for joint filers, $425,000 for head of household, $400,000 for single filers, or $225,000 for married taxpayers filing separately, could have a major tax increase with the combination of the increased top tax rate, personal exemption phase-outs, and itemized deduction limitations.

Increased capital gains and dividend tax rates

For taxpayers whose ordinary income is generally taxed at a rate below 25% (10% or 15%), capital gains and qualified dividends will permanently be subject to a 0% rate. Taxpayers who are subject to a 25%-or-greater rate on ordinary income, but whose income levels fall below a threshold of $400,000 for single filers/$450,000 for married taxpayers filing jointly, will continue to be subject to a 15% rate on capital gains and qualified dividends. The top rate for capital gains and qualified dividends will permanently rise to 20% (up from 15%) for taxpayers with incomes exceeding the threshold of $400,000 for single filers/$450,000 for married taxpayers filing jointly.

INSIGHT

The new 3.8% surtax on net investment income for high income taxpayers was implemented previously for 2013 in the 2010 Patient Protection and Affordable Care Act. This is **in addition to** the capital gains and dividend taxes. Thus, the total tax rate on capital gains and dividends could be as high as 23.8%. Keep in mind that the definition of high income for the 3.8% Medicare surtax starts at $200,000 for single and $250,000 married, filing jointly, $125,000 for married filing separately, for a tax of 18.8%.

Permanent alternative minimum tax relief

The alternative minimum tax (AMT) involves a separate tax calculation and historically applied only to high-income taxpayers due to an exemption from the AMT that reduced its impact for many. However, the exemption amounts were never made permanent in the tax law, and Congress had to pass new AMT exemption amounts (an "AMT patch") every year. The new tax law has changed that by permanently increasing the exemption amounts to $50,600 for unmarried taxpayers, $78,750 for joint filers and $39,375 for married persons filing separately, and adjusting them for inflation for tax years after 2013.

INSIGHT

The change is estimated to reduce the number of taxpayers paying the AMT from approximately 30 million to 5 million for the 2012 tax year.[1]

IRA qualified charitable distributions

The ability of a traditional or Roth IRA owner age 70½ or older to make a tax-free IRA distribution of up to $100,000 directly to a charity was reinstated retroactively to 2012 and also applies to 2013. The new rules allow traditional or Roth IRA distributions from 2012 to be transferred by the IRA owner tax-free to a charity for a limited period of time in 2013, and certain 2013 distributions can be deemed to have been made in 2012.

INSIGHT

Since the IRA qualified charitable distribution is considered a tax-free IRA distribution, the taxpayer may not take a charitable income tax deduction for the amount contributed to the charity. A CPA can help with how this would need to be documented on the 1040 tax form.

Qualified retirement plan Roth conversion

Certain qualified retirement plans such as a 401(k) plan can allow participants to elect to transfer amounts in the plan to a designated Roth account in the same plan with the transfer being treated as a tax qualified Roth conversion. Previously transfers within a qualified plan to an employer provided designated Roth account were allowed only if the taxpayer separated from service, reached age 59½, died, became disabled, or received a qualified reservist distribution.

INSIGHT

Employees in lower income tax brackets may wish to take advantage of this conversion possibility and pay income taxes on the conversion to obtain the tax advantages of qualified Roth distributions.[2] This may not be immediately available since plan documents may have to be amended to allow the employee to exercise this option.

Payroll tax holiday not extended

In 2011 and 2012 employees had a 2% reduction in their employee contributions to the Social Security payroll withholding tax. For the self-employed, the 2% reduction applied only to the employee portion of their contributions. The new law did not extend this payroll tax holiday further.

INSIGHT

This change will negatively impact all employees and the self-employed at all income levels in 2013 and beyond. For example, an employee making $60,000 per year ($5,000 per month) will have a $1,200 total reduction in take home pay for 2013 (or $100 per month). For FICA purposes the Social Security limit for 2013 is $113,700.

Increased employee Medicare withholding

Though not part of the new tax law, a new employee withholding of 0.9% on earned income for high earners was part of the health care legislation and is effective starting in 2013. Employers will be required to withhold an additional 0.9% from an employee's wages once they exceed $200,000 for the year. For the self-employed, the additional 0.9% withholding will apply to the employee contribution portion only. The additional withholding is required due to a 0.9% surtax on earned income.

INSIGHT

Employers will withhold the additional 0.9% once the employee's wages exceeds $200,000 threshold. But, if the employee is married and files a joint return, the threshold for the surtax is $250,000. The extra surtax applies to the total of both spouses wages that exceeds the $250,000. Therefore, in dual income households, there may be some additional taxes to pay along with the filing of their joint tax returns if income is pushed above these levels.

[1]Steve Leimberg's Income Tax Planning Newsletter, "Michael Jackson & Jared Szychter's Analysis of the American Taxpayer Relief Act of 2012," January 3, 2013

[2]Please remember that converting a non-Roth account to a designated Roth account is a taxable event. Increased taxable income from the Roth conversion may have several consequences including (but not limited to) a need for additional tax withholding or estimated tax payments, the loss of certain tax deductions and credits, and higher taxes on Social Security benefits and higher Medicare premiums. Be sure to encourage your clients to consult with a qualified tax advisor before making any decisions regarding their qualified plan.

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Estate and gift tax provisions

The Act avoided major increases to estate, gift and generation-skipping transfer (GST) taxes that were scheduled for 2012 by permanently retaining the estate, gift, and GST tax exemption at $5,000,000 (as indexed for inflation). However, the Act also permanently increased the top estate, gift, and GST tax rate from 35% to 40%. The portability feature that allows the estate of the first spouse to die to transfer his or her unused exclusion to the surviving spouse was also made permanent. These changes are effective for individuals dying, and gifts made, after 2012.

INSIGHT

These permanent estate and gift tax changes should make It easier to implement an estate plan for the long-term when working with an estate planning attorney. Continued unification of the estate and gift tax system with the estate and gift tax exemptions being the same should eliminate potential clawback issues which could otherwise happen if the estate tax exemption upon death was lower than the gift tax exemption when taxable gifts were made.

Other provisions

The new tax law includes a number of other extensions and enhancements for certain tax benefits including, among others, the credit for qualified tuition and related expenses, the earned income tax credit, the deduction for certain expenses of an elementary and secondary teacher, the ability to deduct state and local sales taxes, and other.

The future

Though parts of this new tax law are scheduled to continue and may be considered "permanent," Congress could always change the tax law again in the future. In addition, Congress will need to address the deficit and spending cuts which this legislation did not address.

For more information on the 2013 tax law changes and how they may affect your clients retirement strategies, call the Sales Desk at 800.542.5427 or the FASTeam at 800.950.7372 (877.796.6880 for New York) and ask for the Advanced Markets information line.

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