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Planning Implications of the American Taxpayer Relief Act of 2012

By Robert S. Keebler

Now that a fiscal cliff deal has finally been reached, we can start thinking about what it means for tax and financial planning. After summarizing the key provisions in the new law, this article will offer some preliminary thoughts.

On January 1, 2013, Congress enacted the American Taxpayer Relief Act of 2012 (ATRA). The law extends most of the favorable income and estate tax provisions enacted in 2001 as part of the Bush tax cuts but also raises the rates on some high-income taxpayers.

Income Tax

ATRA made the Bush tax cut rates permanent for most individuals. It does increase the 35% rate to 39.6%, however, for ordinary income above the following threshold levels (note that these amounts will be adjusted for inflation). (See the Editor's Note at the end of this article.)

Single taxpayer	$400,000
Head of household	$425,000
Married filing jointly or surviving spouse	$450,000
Married filing separately	$225,000
Trusts	$11,950

When the 3.8% Medicare surtax is factored in, the tax rate for these taxpayers could be as high as 43.4%.

Long-Term Capital Gains and Qualifying Dividends

The maximum rate on this income stays at 15% for most taxpayers but increases to 20% on income above the thresholds listed previously. If the 3.8% surtax applies, the top rate would increase to 23.8%.

Phaseout of Deductions and Exemptions

Prior to the Bush tax cuts, personal exemptions were phased out by 2% for every $2,500 of income above certain threshold amounts. In addition, itemized deductions were reduced by 3% of adjusted gross income above the threshold amounts, up to a maximum reduction of 80%. The most important itemized deductions are for mortgage interest, state and local taxes, and charitable contributions. The personal exemption phaseout and the itemized deduction limitation (Pease) are reinstated beginning in 2013 for income above the following amounts (again, the amounts will be adjusted for inflation):

Single taxpayers	$250,000
Head of household	$275,000
Married filing jointly or surviving spouse	$300,000
Married filing separately	$225,000

Roth 401(k) Conversions

Under prior law, taxpayers had to be at least 59 ½ or leave their employer to convert a traditional 401(k) to a Roth 401(k). ATRA lifts these restrictions and allows participants to transfer vested amounts from a traditional 401(k)

About the Author

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into a designated Roth account if permitted by the plan. Taxpayers who take advantage of this provision will pay tax on the deemed distribution but will avoid the early distribution penalty tax.

Alternative Minimum Tax

ATRA permanently increases the alternative minimum tax exemption amount to $50,600 for single filers and $78,750 for married taxpayers filing jointly for 2012. These amounts are indexed for 2013 and later years.

Transfer Tax

Under sunset provisions, the following changes were scheduled to go into effect in 2013:

	2012	2013
Top estate, gift, and GST tax rate	35%	55%
Estate and gift tax exclusion amount	$5.12 million	$1 million

ATRA creates a permanent $5 million exclusion for the estate, gift, and generation-skipping transfer (GST) taxes with inflation adjustments after 2011. With the inflation adjustment, the amount for 2013 is $5.25 million ($10.5 million for a married couple). ATRA also creates a 40% tax rate, higher than the 2012 rate, but still much lower than the 55% rate that would otherwise have gone into effect.

Estate Planning Provisions Not Enacted

The Obama Administration's Green Book tax proposals suggested a number of changes that would have severely curtailed estate planning opportunities. These included a minimum term for grantor-retained annuity trusts, a maximum term for dynasty trusts, new rules for valuation discounts, and the inclusion of the value of a grantor trust in the grantor's estate at death. None of these provisions were incorporated into ATRA.

Extension of Tax Benefits

ATRA extended numerous tax benefits. Some of the most important benefits include:

- Bonus depreciation
- Enhanced Section 179 expensing
- Accelerated depreciation for qualified leasehold, retail, and restaurant improvements
- The Work Opportunity credit
- The Research and Development credit
- Home- and energy-related tax breaks

Significantly, ATRA did not extend the 2% reduction in the payroll tax rate.

Planning Implications

The following points present some initial thoughts on how ATRA will affect tax and financial planning

- Higher tax rates should make income tax planning more important.
- Income tax deferral strategies, such as life insurance and deferred annuity products, should become more popular; this includes tax-free build-up and smoothing income to stay in lower tax brackets.
- Other income-smoothing strategies will become more important for managing tax brackets on large capital gain sales, including charitable remainder trusts and installment sales.
- Loss harvesting and managing income from year to year will become more important because of added progressivity in the tax rates.
- Buy and hold investment strategies may become more popular.
- Low or no tax investments, for example, SPIDERS (Standard & Poor's Depositary Receipts) or tax-exempt bonds, may become more popular.
- Asset location decisions will be affected; taxpayers will be encouraged to transfer more to qualified plans, IRAs, and 529 education plans.
- Charitable lead trusts might be used to reduce the limitation on itemized deductions.
- Income-shifting strategies should become more popular.
- Increased income tax rates on individuals may affect the choice of entity decision; C corporations may become more favorable relative to S corporations.
- Estate planning will become less important for many taxpayers because of the higher exclusion amounts.
- Fewer taxpayers may need life insurance to pay estate tax.
- The income tax basis step-up at death will become more important; here, there will be higher capital gains rates, fewer taxpayers

Three New Podcasts on the Resolution of the Fiscal Cliff

In this series of new podcasts, Robert S. Keebler discusses various aspects of the fiscal cliff settlement and planning opportunities under the American Taxpayer Relief Act of 2012:

- 2013 Income Tax Aspects of the Fiscal Cliff Settlement
- Estate, Gift and GST Planning Under the Act
- Trusts and Estates and the Impact of the 3.8% Surtax and the Fiscal Cliff Tax Increases

Tax Planning After the Healthcare Surtax: Tools, Tips, and Tactics

The Medicare surtax will affect your clients in 2013 and beyond. *Tax Planning After the Healthcare Surtax*, by Robert S. Keebler, Stephen J. Bigge, Michelle J. Ward, Peter J. Melcher, and Christopher W. Schuler, analyzes and explains the application of the 3.8% surtax, strategies to avoid the surtax, and more. In addition to an explanation of the issues, it provides a variety of tools, including client letters, checklists, PowerPoints, charts and flowcharts. This downloadable (PDF) book is packed with citations, explanations and examples. Learn how to protect your clients' interests, minimize the effects of this surtax, implement practices that will yield benefits in 2013 and beyond and preserve client assets. PFP/PFS members save an additional 10% off the already reduced AICPA member price.

will be subject to estate and gift tax, and more taxpayers will simply die with assets rather than trying to remove them from their estates.

- Taxpayers who will not be subject to estate tax because of the increased exclusion may try to unwind existing estate planning strategies, for example, qualified personal resident trusts.
- Taxpayers may consider additional strategies, including charitable remainder retirement trusts, IRA trusts, capital gains trusts, and income tax rate trusts.

Expect quite a bit of continued discussion about ATRA, especially now that we are several weeks into the new year. As the year progresses, stay tuned for updates and more information from the AICPA.

Editor's Note: In mid-January, the IRS updated its inflation adjustments; read this article from the *Journal of Accountancy* for more information.