What the American Taxpayer Relief Act May Mean for You

On January 2, 2013, President Obama signed the American Taxpayer Relief Act of 2012 into law. The act makes significant changes to the tax code that will primarily affect upper-income taxpayers. Now that we have some finality, it’s important to take a look at the changes to understand how they may impact you.

**Itemized deductions phase-out**

Under the act, itemized deductions will be phased out for taxpayers whose income exceeds certain thresholds. For married taxpayers filing jointly, the phase-out begins at $300,000 of adjusted gross income (AGI). Taxpayers filing single will have a threshold of $250,000 of AGI. Beyond these thresholds, allowable itemized deductions will be reduced by 3 percent of the amount by which the taxpayer’s AGI exceeds the threshold amount. The reduction cannot exceed 80 percent of previously allowable itemized deductions.

For example, Jim and Sandy are a married couple filing jointly. With a combined AGI of $750,000, they have exceeded the threshold for their filing status ($300,000) by $450,000. Therefore, their allowable itemized deductions will be reduced by $13,500 ($450,000 x 0.03, with a maximum 80 percent reduction).

**Where it might really count.** Charitable donations are one of the five biggest categories of itemized deductions. If you are a high income taxpayer who has historically made large charitable contributions, you may be surprised by how the new phase-out affects your deduction. Assume a married taxpayer has an AGI of $2,500,000 and contributes $100,000 to charity. Because this taxpayer is $2,200,000 over the threshold, his $100,000 deduction is reduced to just $34,000.

**New 10 percent floor on medical expenses.** The medical expense deduction is also one of the five biggest itemized deductions. Because the floor is now 10 percent of AGI, you’ll want to be cognizant of expenditures like dental work and eyeglasses. For example, if you can push the purchase of a new pair of glasses into a tax year when you know you are scheduled for expensive medical procedures, you may be able to bundle these costs to take advantage of the deduction.

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The effect on capital gains and dividends
Taxpayers with taxable income above $400,000 (individual) and $450,000 (married filing jointly) will see an increase in their long-term capital gain and qualified dividend tax rates, from 15 percent to 20 percent. It’s important to note that this significant increase will be compounded by legislation that takes effect in 2013; see “The Medicare surtax” below.

The only real way to manage this tax increase is to minimize your taxable income or take gains in years when you have not exceeded the threshold. Look to maximize contributions to your retirement accounts, as well as other above-the-line deductions, to reduce taxable income.

The Medicare surtax
The Patient Protection and Affordable Care Act of 2010 extends a 3.8 percent Medicare surtax to the lesser of net investment income or the excess of modified adjusted gross income (MAGI) over $200,000 (individual) or $250,000 (married filing jointly). It also adds a 0.9 percent surtax on earned income above $200,000 (individual) or $250,000 (married filing jointly). Net investment income includes net rental income, dividends, taxable interest, net capital gains from the sale of investments, the sale of second homes and rental properties, royalties, and passive income from investments in which the taxpayer does not actively participate, including partnerships and the taxable portion of the nonqualified annuity payments.

For example, Robert and Emma are married taxpayers filing jointly, with a MAGI of $400,000. Of this, $350,000 is wages and $50,000 is net investment income. Their MAGI is $150,000 over the $250,000 threshold for married couples filing jointly, so they’ll owe 3.8 percent on their $50,000 in investment income, as it is less than $150,000. They’ll also owe 0.9 percent on the $100,000 by which their wages exceed the $250,000 earned income threshold for married couples filing jointly. The couple’s total Medicare surtax will by $2,800—3.8 percent of $50,000 ($1,900) plus 0.9 percent of the $100,000 ($900).

What to consider in planning around the surtax. As mentioned above, pay attention to when you take capital gains. If you can spread gains over different tax years or take them in years when your earned income is lower or under the threshold, you may be able to minimize your tax liability. Also consider your unearned income and how it is affected by the surtax. If the tax hit is substantial, you may want to consider tax-free income sources like municipal bonds.

New top individual rate higher than corporate rate
Because the American Taxpayer Relief Act has added a new 39.6 percent income tax bracket, the top individual income tax rate is now higher than the top corporate tax rate, which is 35 percent. If you are self-employed, you may want to revisit your business entity selection. Depending on your income level, the choice of entity could result in a net tax savings.

Be aware that determining whether C corporation status makes sense from a tax perspective will require an in-depth analysis of the business. If you find yourself exposed to the new 39.6 percent individual income tax bracket, seek the advice of a tax expert who specializes in this area to help you decide on the best course of action.

Defer income, if possible
Considering the impact a higher individual income tax bracket can have on your financial situation, you may want to explore income deferral strategies to help reduce your taxable income. You may already be contributing to a qualified retirement plan, such as a 401(k), but if your employer offers a non-qualified deferred compensation plan, that may be worth considering as well.

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Nonqualified deferred compensation plans provide an opportunity for taxpayers to defer income on pretax basis, and accumulated investment earnings will grow tax-deferred, much like they do in a qualified retirement plan. There are also no IRS limits on contributions. The idea is to defer the income while you are in a higher tax bracket and then have it pay out when you move into a lower bracket, such as during retirement.

What hasn't changed?

**Gift tax exemption.** In 2012, many wealthy taxpayers took advantage of the $5,125,000 gift tax exemption to pass assets to the next generation. Fear that the exemption would revert to $1,000,000 and the top estate tax would jump to 55 percent was the catalyst for many of these transactions. In a somewhat surprising move, the American Taxpayer Relief Act made the $5,000,000 exemption permanent and indexed it for inflation. The 2013 exemption amount has increased to $5,250,000 per individual, while the top estate tax rate has increased to 40 percent from 35 percent. The annual exclusion amount has also increased, to $14,000 per donee in 2013.

Although the gift tax exemption is now permanent, it continues to be a strategy you should consider today. As Congress searches for deficit-reduction revenue, the exemption will remain a target, and it’s always possible that future legislation will reduce the exemption amount. Also, because future appreciation of gifted assets has now been removed from the estate, you may want to consider the impact of appreciation when deciding which assets to gift.

**GRATs and dynasty trusts.** The last few years have been fraught with proposed legislation designed to limit the benefits of grantor-retained annuity trusts (GRATs) and dynasty trusts. Fortunately, the act didn’t incorporate any of those proposals. GRATs remain a viable planning tool in this historically low-interest-rate environment. And there continues to be no limitation on the length of dynasty trusts. That said, there may be a shelf life on these planning techniques if previous legislative proposals resurface, so it would be wise to consider them now.

**Life insurance.** Another product that hasn’t been affected by the American Taxpayer Relief Act is life insurance—and in today’s environment, its potential tax advantages may offer a more compelling argument than ever before. Life insurance can be used to provide supplemental retirement income; it’s a viable way to achieve tax-deferred cash value accumulation and to create a tax-free stream of income during retirement. If you recently found yourself in a new top tax bracket, you may be looking for a hedge against future tax increases. This strategy, which avoids the income phase-outs and contribution limitations of more traditional retirement savings vehicles, may be the answer.

The American Taxpayer Relief Act has resulted in numerous changes to our country’s tax code, and it’s important to understand when and how you may be affected. Be sure to seek the advice of your tax advisor or lawyer to help ensure that you are properly positioned to both minimize your tax burden and take advantage of new opportunities.

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Authored by Commonwealth Financial Network®
Schedule of Events

- May 27: Memorial Day Holiday. Our offices and the NYSE will be closed. We will reopen at 8:00 a.m. on Tuesday, May 28th.

- June 3: Jeff’s Birthday!

- June 6: Junk to Jewels Antique Appraisal event at our offices, 7:00 p.m. Watch for further details.

- July 4: Independence Day Holiday. Our offices and the NYSE will be closed. We will reopen at 8:00 a.m. on Friday, July 5th.

DFP Happenings

- Kim heads to Puerto Rico the week of April 22nd to attend the Commonwealth’s Leaders Conference. This is an invitation-only education event hosted by Commonwealth Financial Network. Only 2% of Commonwealth’s network of 1,400 advisors are awarded Leader’s status and able to participate in this conference!

- We held our Annual Valentine Dessert Soiree’ in February. This continues to be our most popular event.

- Kim has once again, been named a Five Star Wealth Manager. This 2013 award is achieved by fewer that 7% of the wealth managers in the area.