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2013 TAX LAW ALERT

Now is a good time to start thinking about tax planning for calendar year 2013. On January 2, 2013, President Obama signed the American Taxpayer Relief Act of 2012 ("ATRA") into law. ATRA adds many new tax provisions and extends the application of some old tax provisions. In addition to the tax law changes brought about by ATRA, there are other taxes (enacted by earlier Congressional legislation) that will apply to certain taxpayers beginning in 2013. This letter serves as an outline of the major tax law changes you should be aware of to minimize taxes. Please note that some of the changes below could be altered again by Congress this year during upcoming budget negotiations.

New Tax Provisions Beginning in 2013

Here is a summary of some of the new tax provisions that may apply to you:

- 3.8% Net Investment Income Tax: This is a new tax on individuals equal to the lesser of 3.8% of the taxpayer's *net investment income* or the excess (if any) of the taxpayer's *modified adjusted gross income* over a threshold amount. The threshold amount is $250,000 for married couples filing joint returns, $125,000 for married couples filing separately, and $200,000 for single taxpayers. This tax will not be due if the taxpayer has no net investment income for the year or the taxpayer's modified adjusted gross income for the year does not exceed the applicable threshold amount. The tax also applies to estates and trusts and equals 3.8% of the lesser of the undistributed net investment income for the tax year or the excess (if any) of the adjusted gross income of the estate or trust over $11,950 (threshold amount in effect for 2013). Net investment income includes gross income from interest, dividends, annuities, royalties and rents (other than from a trade or business), income from passive activities or from trading in financial instruments or commodities, reduced by income tax deductions properly allocable to such income. However, net investment income does not include distributions from retirement plans and does not include income from an active trade or business (other than income derived from trading financial instruments or commodities). The tax does not apply to nonresident aliens. This tax is in addition to other income taxes that are imposed on taxpayers and is not deductible for other federal income tax purposes.

- 0.9% Medicare Payroll Tax for Higher Income Taxpayers: The hospital insurance tax on *wages and self-employment income* in excess of $200,000 for individuals ($250,000 for married couples filing a joint return) is increased by 0.9%. These threshold amounts are not indexed for inflation. The deduction for one-half of self-employment taxes does not apply to the additional tax.

- Increased Threshold for Medical Expense Deduction: The itemized deduction for medical expenses is available only to the extent that the medical expenses exceed 10% (stays at 7.5% for a taxpayer or a taxpayer's spouse who has attained age 65 before the close of the tax year) of the taxpayer's adjusted gross income.

- Increased Income Tax Rates: There is a permanent extension of the 10%, 15%, 25%, 28%, 33% and 35% tax brackets on taxable income at or below $400,000 (individual filers), $425,000 (heads of households), $450,000 (married filing jointly), and $225,000 (married filing separately). For taxpayers *above* these threshold amounts the rate is 39.6% (top federal income tax bracket). These threshold amounts will be adjusted for inflation after 2013. Note that these threshold amounts for federal income tax purposes are different than the threshold amounts that apply for the 3.8% tax on net investment income. For "high income taxpayers" the increase in the top federal income tax bracket together with the imposition of the 3.8% tax on net investment income will result in a combined federal tax rate of 43.4% (not including state income taxes).

- Increased Capital Gains Rates: The capital gains rate rises from 15% to 20% for taxpayers in the 39.6% federal income tax bracket. "Qualifying dividends" continue to be taxed like capital gains and not as ordinary income. The 15% capital gains rate continues to apply for all taxpayers who are in the 25%, 28%, 33%, and 35% federal income tax brackets. A 0% capital gain rate applies for taxpayers in the 10% and 15% federal income tax brackets.

- Phase-out of Itemized Deductions and Personal Exemptions: Itemized deductions for taxpayers with incomes over $250,000 ($300,000 for married couples filing joint returns) will be limited. In addition, the personal exemption will be phased-out for individual taxpayers with adjusted gross income over $250,000 ($300,000 for married couples filing jointly).

- Permanent Alternative Minimum Tax (AMT) Relief: ATRA provides permanent AMT relief after 11 years of temporary patches designed to prevent the tax from affecting lower-income taxpayers. For calendar year 2012, the AMT exemption amounts were $78,750 for married couples filing jointly, $39,375 for married couples filing separately and $50,600 for singles and heads of household. For 2013, the exemption amounts are adjusted for inflation and are $80,800 for married couples filing jointly, $40,400 for married couples filing separately, and $51,900 for singles and heads of households.

- Estate, Gift and Generation-Skipping Transfer Tax Changes: ATRA permanently unified the estate, gift, and generation-skipping tax rate structure. The unified federal estate and lifetime gift tax exclusion amount — the amount each taxpayer can transfer without incurring estate, gift or generation-skipping taxes — is $5,000,000, *adjusted for inflation* after 2011. The 2012 amount was set at $5,120,000. The 2013 amount is $5,250,000 per taxpayer; for a married couple, the aggregate amount for 2013 is $10,500,000. Lifetime gifts and assets inherited at death that exceed the unified exclusion amount are subject to a graduated tax rate with a 40% maximum rate. As an aside and not part of ATRA, for federal gift tax purposes, the "annual exclusion" amount for gifts increased for 2013 from $13,000 to $14,000 per gift recipient; this annual exclusion amount is in addition to the unified estate and lifetime gift tax exclusion amount.

- Portability of Exclusion Amount: ATRA also made permanent the so-called "portability" provisions. For married couples, if a spouse dies without exhausting his or her estate and lifetime gift tax exclusion amount, the deceased spouse's exclusion amount can be used by his or her surviving spouse, thereby increasing the amount of exclusion available for the surviving spouse to use to make lifetime gifts and pass assets at death. This portability provision does not apply to gifts made or inheritances passing to grandchildren (i.e., generation-skipping transfers).

Some of the Deductions and Exclusions Extended for Tax Years 2012 and 2013

The following deductions and exclusions expired at the end of 2011. ATRA extends them for 2012 (where 2012 tax returns are on extension) and 2013:

- The above-the-line deduction for up to $4,000 of qualified tuition and related expenses.

- The exclusion from taxable income of debt forgiven in a foreclosure proceeding or write-down of principal on qualified principal residence indebtedness.

- Treatment of mortgage insurance premiums as qualified residence interest.

- The deduction for state and local general sales taxes in lieu of state and local income taxes.

- The increased contribution limits and carry-forward period for contributions of appreciated real property for conservation easement purposes.

In addition to these provisions affecting individuals, there are a slew of important tax provisions that apply for businesses, including for corporations that are taxed as "S" corporations for federal income tax purposes.

Planning Implications

You may wish to review your estate planning documents and gift plans. The now "permanent" (as much as anything can be "permanent") changes in the federal gift, estate and generation-skipping transfer tax exclusion amount affords opportunity to make sizable, tax-free transfers, thereby enabling future income and appreciation to be shifted to younger generation family members. In addition, lifetime gift planning may be advantageous from an income tax perspective, including potential minimization of the 3.8% tax on net investment income. A variety of techniques can be used to accomplish gifting objectives. There is some urgency to create and fund certain types of trusts and make transfers of assets that are valued with certain discounts. The urgency stems from the fact that the President's budget proposals for the last few years have included provisions to restrict entity-based valuation discounts and limit the use of certain types of trusts in transfer tax planning.

Finally, if you have not had your Will, Revocable Trust and other estate planning documents updated or reviewed recently, let me suggest that you contact me to do so. Your documents may contain "old" language that will no longer operate properly under the new tax laws and thus, your objectives may be frustrated.

Please do not hesitate to contact me if you have any questions about how any of the tax law changes would affect you or if you would like to review your estate planning documents and gift planning options. I would be happy to assist you.

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