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Wealth Management Update

Tax Changes for 2013

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After more than 10 years of uncertainty, Congress passed legislation (American Taxpayer Relief Act of 2012) that addresses the sunset of the Economic Growth and Tax Relief Reconciliation Act of 2001 and the 2010 Tax Relief Act. The American Taxpayer Relief Act of 2012, together with the Patient Protection and Affordable Care Act, changes the tax landscape significantly. While the legislation is quite comprehensive, some of the significant changes occurring in 2013 are outlined below. Additionally, many of the significant items, such as income tax brackets and exemption amounts are linked to inflation in future years. For a more detailed discussion, together with an analysis of how these changes might impact your financial life specifically, please consult with your tax and legal advisors.

Income Taxes

The following permanent individual income tax changes occur in 2013:

- The top income tax rate increases to 39.6 percent for taxable income in excess of $400,000 for individuals and $450,000 for married couples filing jointly. All other existing income tax rates are made permanent.
- An additional 3.8 percent unearned Medicare surtax applies to the lesser of net investment income or the excess of modified adjusted gross income (AGI) over $200,000 for individuals and $250,000 for married couples filing jointly. This surtax was enacted as part of the Affordable Care Act.
- The Medicare tax rate of 0.9 percent (another tax stemming from the Affordable Care Act) applies to compensation or self-employment income in excess of $200,000 for individuals and $250,000 for married couples filing jointly. Please reference our June 2012 Wealth Management Update, "Planning for 2013's 3.8% Medicare Surtax," for a more detailed discussion.
- Both qualified dividends and capital gains are taxed at 20 percent for those with taxable income in excess of $400,000 for individuals and $450,000 for married couples filing jointly. The 2012 rates for dividends and capital gains remain unchanged for individuals with taxable income less than $400,000.
- Personal exemptions and itemized deductions will be phased out for those with AGI in excess of $250,000 for individuals and $300,000 for married couples filing jointly. Personal exemptions will be completely phased out when income exceeds the threshold amount by $125,000. The maximum reduction in itemized deductions under this limitation is 80 percent. The itemized limitation does not apply to investment interest, medical expenses or casualty losses (although medical expenses must now exceed 10 percent of AGI to be deductible).

- The Alternative Minimum Tax (AMT) is permanently "patched," meaning that exemptions from AMT are increased to $51,900 for individuals and $80,800 for married couples filing jointly. Nonrefundable credits are now allowed as credits against AMT. These provisions are retroactive to 2012.
- The reduced rate of 4.2 percent for the employee portion of Social Security was allowed to expire. Beginning in 2013, the tax rate will revert to 6.2 percent.
- For 2012 and 2013 only, charitable distributions from individual retirement accounts (IRAs) are reinstated. Individuals over age 70½ can make direct distributions (up to $100,000) to charity from an IRA and exclude these distributions from their income (although no charitable deduction is allowed). A transition rule allows direct charitable distributions in January 2013 to count as 2012 charitable contributions. Distributions made to individuals in December 2012 can be considered to be donated to charity in 2012 if the gross amount of the distribution is contributed to charity before February 1, 2013.
- The maximum income tax rate for trusts with income over $11,950 increases to 39.6 percent. The 3.8 percent unearned Medicare surtax will also apply to trust income.

Several deductions and credits were extended only through 2013. One such extension allows taxpayers to claim state sales taxes paid as an itemized deduction in lieu of state income taxes paid. This is particularly attractive for taxpayers residing in states with no income tax.

A chart illustrating these changes is set out below:

Individual Income Tax Rates for 2013

Taxable Income				Medicare Tax	
Single	Joint	Ordinary Income	Capital Gains and Dividends	Earned Income[1]	Investment Income
$0+	$0+	10%	0%	2.90%	0%
$8,925+	$17,850+	15%			
$36,250+	$72,500+	25%	15%		
$87,850+	$146,400+	28%			
$183,250+	$223,050+	33%			
$200,000+ (AGI)	$250,000+ (AGI)			3.80%	3.80%
$250,000+ (AGI)	$300,000+ (AGI)[2]				
$398,350+	$398,350+	35%			
$400,000+	$450,000+	39.60%	20%		

[1] Earned income Medicare tax includes 1.45% employer portion

[2] Phaseout of personal exemptions and itemized deductions begins

Source: Wells Fargo Wealth Management, 01/13

Estate, Gift, and Generation-Skipping Transfer (GST) Taxes, and Other Estate Planning Provisions

Much was made of the need to make year-end gifts in 2012 because the maximum amount that you could give away free from estate, gift, and GST taxes ("transfer taxes") was set to drop to $1 million in 2013. Fortunately, this problem has been eliminated. The changes to taxes affecting estate planning are as follows:

- The maximum transfer tax rate is increased to 40 percent from the 2012 rate of 35 percent. While this is an increase over 2012 rates, it still represents a decrease from the maximum rate of 55 percent that would have applied had Congress not acted.
- The applicable exclusion amount (the amount an individual can give away free from transfer taxes) of $5 million is now indexed for inflation beginning in 2012. As a result, the applicable exclusion amount for 2013 is $5.25 million.
- The gift, estate, and GST exemptions are permanently unified. Previously, the gift tax exemption was lower than the estate tax exemption.
- A deceased spouse's applicable exclusion amount is now permanently "portable," which means that after December 31, 2012, the surviving spouse is able to claim the deceased spouse's unused exemption amount, conditioned upon timely filing of the appropriate estate tax return for the deceased spouse. This may eliminate the need for clients to do some kinds of trust planning.
- The annual exclusion amount remains indexed for inflation. The result of this inflation adjustment is an increase from $13,000 to $14,000 for 2013.

Some Impact of These New Laws

While it's too soon to provide a thorough analysis, some initial thoughts come to mind. First, there are several differing income tax thresholds to consider; the maximum income tax rate, for example, applies to higher income levels than the income level used to apply the surtax from the Affordable Care Act. Those who make estimated payments should talk to their tax advisors fairly soon about additional payments that will need to be made.

Second, in light of the increased tax burden for higher-income taxpayers, consideration should be given to the possibility of shifting income among family members to more effectively minimize the family's total income tax burden.

Third, the character of income becomes even more important, especially for those who can recharacterize to some extent whether a payment is salary vs. a business distribution. Again, talking to your tax advisor will be critical, especially for closely held business owners.

Fourth, those who were considering estate planning changes, like making gifts, at the end of 2012 but who didn't quite implement those changes should not give up the effort. Although the $5 million exemption has been made permanent, the rate has gone up, and planning is still important, both for tax and non-tax reasons. Further, those who did create irrevocable trusts should talk with their advisors about the impact of the increased income tax rates for trusts.

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