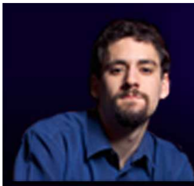
The Kitces Report
Advancing knowledge in financial planning...
November/
December 2012

The Financial Planning Implications of the American Taxpayer Relief Act of 2012

Executive Summary

- The American Taxpayer Relief Act of 2012 (ATRA) not only averted the fiscal cliff at the last possible moment; it also introduces a new era of tax planning, as nearly all of ATRA's most significant provisions for income and estate planning are *permanent*, bringing an end to a decade's worth of "temporary" tax laws in constant danger of looming sunset.

- The new rules allow the top 35% tax bracket to lapse back to the "old" 39.6% tax rate, but only for amounts above $400,000 of taxable income for individuals, and $450,000 for married couples. The net result of this change is the permanent addition of a new 7th tax bracket, resulting in a more progressive (higher rates on higher incomes) tax system.

- The high income phaseout for itemized deductions and personal exemptions returns permanently in 2013, after having been eliminated for the past several years. The reinstatement of these rules occurs with a new threshold of $250,000 of AGI for individuals and $300,000 for married couples. The net result of these provisions is to increase a client's marginal tax rate by about 1% for the itemized deduction phaseout, and another 1% *per exemption* for the phaseout of personal exemptions. Notably, though, after $122,501 of income beyond the threshold, personal exemptions are phased out entirely.

- In a similar manner to ordinary income tax brackets, the top long-term capital gains tax rate permanently lapses back to 20% for "high income" individuals and couples (at the $400,000 / $450,000 income thresholds, respectively). With the inclusion of the new 3.8% Medicare tax on investment income, and its own thresholds of $200,000 and $250,000 of AGI (for individuals and married couples, respectively), this essentially results in four long-term capital gains tax brackets in 2013: 0%, 15%, 18.8%, and 23.8%.

- Qualified dividend treatment is made permanent as well, although since the taxation of such dividends are tied to the long-term capital gains tax rate, the top dividend tax rate in 2013 has risen to 23.8%. Notably, the true top marginal tax rate on both long-term capital gains and qualified dividends are even higher once accounting for personal exemption and/or itemized deduction phaseouts.

- The AMT exemption amount is patched retroactively for 2012, and permanently going forward; both the 2012 and future AMT exemption amounts are indexed for inflation as well. This will reduce a potentially dramatic shift in the number of clients that would have been exposed to the AMT in 2012, but notably doesn't fully resolve the ongoing challenge that clients may be subject to one tax system or the other from year to year.

- Numerous miscellaneous tax deductions and credits were temporary reinstated for 2012 and/or extended for 2013, although most such extender rules are still temporary and not permanent. This includes the return of the state and local sales tax deduction, and the ability to make qualified charitable distributions from an IRA directly to a charity.

- ATRA relaxes restrictions on intra-plan Roth conversions for employer retirement plans. Separately, ATRA also authorizes the creation of a new national Long-Term Care Commission to try to determine new solutions to the country's long-term care challenges given the failure (and now repeal) of the CLASS Act (which was originally part of the Affordable Care Act).

- The current estate tax exemption is made permanent at its $5M level (and still increased annually for inflation), and the gift and estate tax systems remain unified. Portability is made permanent as well. However, the top estate (and gift and GST) tax rate rises to 40%.

About the Author

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Introduction

Income and estate tax planning has been remarkably difficult for the past decade, inhibited by an ongoing series of temporary rules and important tax planning provisions that are perpetually scheduled to lapse or about to sunset. Due to the never-certain-for-long environment, many clients (and their planners!) have struggled to engage in effective long-term income and estate tax planning.

This uncertainty culminated in the so-called "fiscal cliff" at the end of 2012, where an incredibly wide swath of tax laws were scheduled to lapse back to their old 2001 levels. Ultimately, Congress averted the Fiscal Cliff with H.R. 8 – the American Taxpayer Relief Act of 2012 – but what's most notable about the new legislation is not just that it avoided a lapse back to 2001 rules, but that the new provisions of the law are mostly *permanent*, providing some certainty in tax planning again for the first time in nearly a decade.

In this issue of The Kitces Report, we look in depth at the new income and estate tax rules that will apply in 2013, and their financial planning implications, from the old laws that were extended and made permanent, to some extensions that are still temporary, to a few entirely new rules that were introduced.

Tax Brackets

Technical Rules

For the past several years, individuals have been subject to a six tax bracket system, with 10%, 15%, 25%, 28%, 33%, and 35% tax rates. Without the American Taxpayer Relief Act of 2012 (ATRA), the tax brackets would have lapsed back to the old rates that applied when President Clinton left office, which were 15%, 28%, 33%, 36%, and 39.6%.

Under TRA2012, the existing six tax brackets remain and are made permanent, with their existing (annually indexed for inflation) income thresholds. In addition, a seventh tax bracket is added: income in excess of $400,000 for individuals, and $450,000 for married couples (a compromise from the originally proposed $200,000/$250,000 thresholds for tax brackets to rise) will now be subject to a top tax rate of 39.6%, effectively lapsing high income individuals back to the "old" top tax bracket. The new 7-bracket system, and the associated thresholds, are shown in Figure 1 (below).

The $400,000 / $450,000 income thresholds for the new 39.6% tax bracket are indexed for inflation (as are all the income tax bracket thresholds).

Figure 1. Projected Tax Brackets for 2013.

Individuals	
Taxable Income	**Tax Liability**
Up to $8,925	10% of taxable income
Over $8,925 but less than $36,250	$892.50 + 15% of excess over $8,925
Over $36,250 but less than $87,850	$4,991.25 + 25% of excess over $36,250
Over $87,850 but less than $183,250	$17,891.25 + 28% of excess over $87,850
Over $183,250 but less than $398,350	$44,603.25 + 33% of excess over $183,250
Over $398,350 but less than $400,000	$115,586.25 + 35% of excess over $398,350
More than $400,000	$116,163.75 + 39.6% of excess above $400,000

Married Couples (Filing Jointly)	
Taxable Income	**Tax Liability**
Up to $17,850	10% of taxable income
Over $17,850 but less than $72,500	$1,785 + 15% of excess over $17,850
Over $72,500 but less than $146,400	$9,982.50 + 25% of excess over $72,500
Over $146,400 but less than $223,050	$28,457.50 + 28% of excess over $146,400
Over $223,050 but less than $398,350	$49,919.50 + 33% of excess over $223,050
Over $398,350 but less than $450,000	$107,768 + 35% of excess over $398,50
More than $450,000	$125,846 + 39.6% of excess above $450,000

Tax bracket thresholds are estimates based on projected inflation adjustments.

Planning Implications

There are several important planning implications to the new tax rate structure under ATRA.

The first is simply to acknowledge that there is now a new top tax bracket – 39.6% – that affluent clients must contend with; as always, higher tax rates make it slightly more appealing to engage in tax deferral and tax management and minimization strategies. Given

some states that now have top state (and local) tax rates that exceed 10%, the reality is that the combined top tax bracket for many clients may exceed 50%... and that's before accounting for the impact of the phaseout of itemized deductions and personal exemptions (discussed later in this newsletter), and the onset of the new Medicare taxes.

On the other hand, it's notable that because of the additional Medicare taxes and high income phaseouts that now apply – each with their own income thresholds – using "just" the tax brackets to determine a client's marginal tax rate is actually less relevant than ever, at least for clients above $200,000 of income (where the new taxes and phaseouts begin to apply). Instead, it will be necessary to look at the impact of all of these factors when evaluating a client's true marginal tax rate (in addition to determining whether the income is earned income, unearned income, interest, dividends, capital gains, etc., as different income types have different rules and rates that apply).

It's also important to note that with the new rules, some tax brackets are much wider than others. For instance, because the existing threshold for the 35% tax bracket is already estimated to be approximately $398,350 in 2013 (for both individuals and married couples), the 35% tax bracket is now a very narrow tax bracket (especially for individuals!), as shown earlier in Figure 1.

By contrast, the 33% bracket is far wider; it will run from about $183,250 to $398,350 for individuals, and from $223,050 to $398,350 for married couples. As a result, climbing from $250,000 to $350,000 of income doesn't even change a client's 33% tax bracket, but rising further from $350,000 to $450,000 results in a 6.6% jump in tax rates (from 33% to 39.6%). Expect to see many clients and planning strategies focused on keeping income below the $400,000 / $450,000 threshold (especially given its further impact on long-term capital gains rates and qualified dividends, as discussed in a later section). *(Editor's Note: The 33% and 35% tax bracket thresholds indicated above are merely estimates; please refer to published IRS tax tables when available for the actual thresholds of the 33% and 35% tax brackets.)*

Overall, the primary impact of the new rules is simply that our income tax system is now more "progressive" (which means higher tax rates on higher incomes), which at the margin will make tax deferral strategies more and more appealing as income rises. This may increase interest for higher income clients in the use of tax-deferred annuities (especially the new lower-cost options starting to be released by a few companies), life insurance strategies (although be careful not to let the tax tail wag the investment dog!), qualified retirement plans and deferred compensation, as well as the value of tax-exempt savings options like Section 529 college savings plans.

Marriage Penalty (Relief)

A long-standing issue of the tax code is the so-called "Marriage Penalty" – the fact that most of the tax bracket income thresholds for married couples are only slightly higher than (or in some cases, the same as) they are for singles, which means a dual earner married couple may owe more in taxes than the same two people would if they were single and each filed separate individual tax returns.

For example, imagine a couple where husband and wife each have $400,000 of taxable income after deductions in 2013. If they filed their own tax returns individually, the income for each would fill the current six tax brackets, end just short of the 39.6% tax bracket, and the tax liability (per Figure 1) would be $116,163.75 each (or $232,327.50 total).

However, as a married couple, their income "stacks" to a total of $800,000 of taxable income. As a result, one spouse's income fills the bottom six tax brackets, and the other spouse's income falls entirely in the 35% bracket (from $400,000 to $450,000 of income) and 39.6% for the remainder (the last $350,000). The total tax liability for the married couple would be $264,446, for a total "marriage penalty" of $32,118.50. *(Notably, the rather unfavorable provisions that apply to the Married Filing Separately status are designed to prevent couples from just filing separately to avoid this "marriage penalty" result.)*

In the original 2001 tax legislation, a partial "marriage penalty relief" provision was included, which made the 10% and 15% tax brackets for married couples twice the size of the individual bracket – and fortunately, after being scheduled to sunset, ATRA instead has made that permanent. However, the marriage penalty still remains in effect to varying degrees for the remaining tax brackets, and while a $450,000 threshold for the 39.6% bracket for married couples (compared to $400,000 for individuals) provides a small amount of relief, the marriage penalty still substantively remains for all those who exceed the 15% tax bracket.

Higher tax rates also increases the relevance and potential impact of proactive year-to-year tax planning (especially if income is volatile at all, and there may be income/deduction timing opportunities).

Phaseout of Itemized Deductions and Personal Exemptions

Technical Rules

Prior to the Economic Growth and Tax Relief Reconciliation Act of 2001 (the first of President Bush's two major pieces of tax legislation), high-income taxpayers were subject to a phaseout of their personal exemptions and itemized deductions as income increased. To the extent that AGI income exceeded specified thresholds, taxpayers would lose:

- 2% of their personal exemption amounts for each $2,500 (or partial amount thereof) beyond the threshold; notably, this phased out 2% times the *total* number of exemptions (for however many family members there were), until 100% of exemptions were phased out; and

- Itemized deductions were reduced by 3% of the amount that AGI exceeded the threshold.

These phaseouts continued to apply until a maximum of 100% of personal exemptions and 80% of itemized deductions were phased out.

Under the 2001 tax legislation, these phaseouts were themselves phased out from 2006 to 2009; by 2010 they were eliminated entirely, which meant that all individuals kept all of their personal exemptions and itemized deductions, regardless of income level. However, the phaseouts were scheduled to return in 2013 with the fiscal cliff, and under ATRA they are in fact allowed to return, albeit with new income thresholds.

Under the new rules, the "Pease limitation" (the phaseout of itemized deductions) and the PEP (Personal Exemption Phaseout) both apply beginning at $250,000 of AGI for individuals, and $300,000 of AGI for married couples (higher than the approximately $180,000 AGI thresholds that would have otherwise applied if the prior rules had simply been reinstated without change).

Notably, because personal exemptions are fully phased out over an income range of $122,501, at an income level of $372,501 for individuals, and $422,501 for married couples, the impact of the personal exemption phaseout ceases. The itemized deduction phaseout continues to apply regardless of how high income rises, though, until/unless the phaseout reaches its maximum impact (no more than 80% of total itemized deductions can be phased out).

Planning Implications

To the extent that itemized deductions and personal exemptions are being phased out again starting in 2013, the net impact is a higher marginal tax rate once income reaches the phaseout thresholds, as the phaseout of both the personal exemptions and itemized deductions push up the 33% and higher tax brackets.

Example 1a. In 2013, a married couple is just above the $300,000 AGI threshold, which means they will likely be in the 33% tax bracket after deductions. If the couple earned another $2,500 of income, this would phase out another 3% x $2,500 = $75 of tax deductions, resulting in a total taxable income increase of $2,575. At a 33% tax rate, this leads to another $849.75 of taxes, which is the equivalent of a $849.75 / $2,500 = 33.99% marginal tax rate. Thus, the net effect of the itemized deduction phaseout is to increase the marginal tax rate by 3% (phaseout) x 33% (tax bracket) = 0.99%. Notably, if the couple was subject to the 39.6% tax bracket, the net impact would be 3% x 39.6% = ~1.2% increase in the marginal tax rate, instead of just ~1%.

Example 1b. Continuing the prior example, the additional income would also phase out another 2% of personal exemptions. If each personal exemption is worth $3,900

Out and About

- Michael will be presenting on "The Future of Financial Planning in the Digital Age" for FPA Ventura County on January 18th

- Michael will be speaking about income and estate planning after the fiscal cliff for the AICPA Personal Financial Planning National conference on January 21st to 23rd

- Michael will also be presenting on "Market Valuation and Safe Withdrawal Rates" for FPA Seattle on February 15th

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(estimated for 2013), then the additional income would eliminate $78 of each personal exemption, which would result in an additional 33% x $78 = $25.74 of taxes. Relative to an income increase of $2,500, this results in an increase in the marginal tax rate of $25.74 / $2,500 = ~1%. Notably, as a married couple, the total impact would be twice this amount (approximately 2% increase in marginal tax rate), as *each* of the couple's personal exemptions phase out simultaneously.

In the end, the net impact of the phaseout of itemized deductions and personal exemptions is an increase in the client's marginal tax rate as income rises; the itemized deduction phaseout adds approximately 1% to 1.2% to the tax rate, and the personal exemption phaseout adds another 1% to 1.2% *per exemption* (e.g., multiplied across a family of 5, the net impact would be a 5% to 6% increase in the marginal tax rate!).

As noted earlier, though, the impact of the personal exemption phaseout ends once income reaches the upper thresholds ($372,501 for individuals, or $422,501 for married couples). In point of fact, this means the marginal impact for individuals is contained entirely within the 33% tax bracket (which starts below the $250,000 PEP threshold and ends above the $372,501 maximum phaseout threshold); for married couples, the impact is spread across the 33% and 35% tax brackets (but since the impact ends at $422,501 of AGI, it never reaches the 39.6% tax bracket for married couples). Although the PEP never impacts the 39.6% tax bracket, it can still be quite significant; for a family of five, the personal exemption phaseout essentially creates an extra "bubble" in the marginal tax rate, boosting it by more than 5% from $300,000 to $422,501 of AGI. As a result, the impact of the PEP for a family of five boosts the 35% tax bracket to a marginal rate near 40% already!

Determining which tax bracket applies during the personal exemption phaseout is also complicated by the fact that while tax brackets are based on taxable income (after deductions), the personal exemption phaseout is based on AGI (as is the itemized deduction phaseout); as a result, the impact may be less for a client with high deductions, whose AGI is high enough to trigger the phaseout even though income after deductions is low enough to fall in the 28% tax bracket. On the other hand, because the phaseout of personal exemptions is 2% of the exemptions for each $2,500 of AGI *or partial amount thereof*, the marginal tax rate on small amounts of income is very erratic.

Example 2. A individual client has AGI of $325,000. Adding another $1 of income – which is a partial amount of the next $2,500 – results in a phaseout of 2% of his/her personal exemption, resulting in $78 of lost deductions and another $25.74 of taxes; in other words, adding $1 of income resulted in a whopping $25.74 of taxes, or a nearly 2,500% marginal tax rate! On the other hand, if the additional income had been $1,000 instead, the same $25.74 of taxes would result, which is a marginal tax rate of only 2.57%; if the additional income had been $2,000, the same tax impact would have resulted in a marginal tax rate of only 1.33%; and if the additional income was $2,500, the impact is only about 1.0%. Although these increments are likely sliced too narrowly for much tax planning, it may become relevant in scenarios like deciding whether or how much of a Roth conversion to recharacterize to optimize the associated tax liability.

On the other hand, while the impact of personal exemption phaseouts occurs only at the 33% and 35% tax brackets, the phaseout of itemized deductions can span the 33%, 35%, and 39.6% brackets, as it continues to apply until/unless the maximum phaseout cap is reached. In practice, though, the cap rarely is reached, as higher income tends to result in additional itemized deductions (such as state and local income tax liabilities that have to be paid), and when deductions are phased out at "only" 3% of income, even a client with $1,000,000 of AGI only phases out $700,000 x 3% = $21,000 of deductions (and in practice, most individuals with $1,000,000 of AGI have *far* more than "just" $21,000 of deductions).

Due to the passive nature of these phaseouts - they either apply, or they don't, based on income - little planning can be done to directly mitigate or avoid them. Instead, the net impact is simply that it makes tax planning all the more valuable, as tax rates for higher income individuals are even higher once accounting for the impact of phaseouts. For instance, most income in the 33% bracket is already subject to a true marginal tax rate of 35% (or 36% for married couples, rising higher with larger families), and married couples in the 35% bracket may already be taxed at 38% or higher (including the phaseout of itemized deductions and at least two personal exemptions). The 39.6% bracket is

closer to 40.8% for most clients as itemized deductions continue to phase out.

However, it's also crucial to note that because the phaseout of itemized deductions is based on *income*, not the amount of deductions, *it's still worthwhile to pursue tax deduction strategies*. In other words, the presence of the itemized deduction phaseout generally does not make it less valuable to engage in strategies like charitable giving. After all, if a client has $1,000,000 of AGI and $100,000 of itemized deductions, then $21,000 of itemized deductions are phased out, and the net deductions are $79,000; if charitable contributions are then added to that (or any other deduction), the tax benefit of *that* charitable deduction is unaffected by the already-phased-out $21,000 of deductions. The charitable contribution will still produce tax savings at the marginal tax rate. Thus, the phaseout of itemized deductions should be viewed as an increase to the marginal tax rates that applies to additional *income*, not as a reason to avoid/minimize/reduce *deductions*.

Long-Term Capital Gains and Qualified Dividends

Technical Rules

Prior to the Bush tax cuts, the long-term capital gains tax rate was 10% for those in the lowest ordinary income tax bracket, and 20% for those in the remaining four tax brackets. These capital gains rates were reduced to 5% (for those in the bottom two ordinary income tax brackets) and 15% for the upper brackets under the Jobs Growth and Tax Relief Reconciliation Act of 2003 (JGTRRA), and the 5% rate was subsequently reduced to 0% (beginning in 2008). The 0% and 15% capital gains tax rates continued through the end of 2012, and were scheduled to lapse back to 10% and 20% in 2013.

In addition, JGTRRA also created the so-called "qualified dividend" treatment, which allowed investors to have dividends taxed at the favorable long-term capital gains rates if they were "qualified" (which meant meeting a 60-day holding period requirement {90-days for preferred stocks} and that the business was a domestic C corporation {or certain foreign companies traded on US exchanges}).

Under ATRA, the 0% and 15% long-term capital gains rates were made permanent for most, but allowed to lapse for high-income individuals, creating a new 20% long-term capital gains rate for those subject to the new top 39.6% tax bracket (for taxable income in excess of $400,000 for individuals or $450,000 for married couples).

Thus, in 2013 and going forward, there are now three tiers of long-term capital gains tax rates:

- 0% (for those in the 10% and 15% ordinary income tax brackets);

- 15% (for those in the 25%, 28%, 33%, and 35% ordinary income tax brackets); and

- 20% (for those in the 39.6% tax bracket)

In addition, under ATRA the rules for qualified dividends are also made permanent, albeit still tied to the long-term capital gains tax rate, which means qualified dividends for high-income individuals will also be subject to the new 20% rate.

Planning Implications

As with the increase in ordinary income tax brackets, the most immediate impact of the new long-term capital gains rates is simply that high income clients must now contend with a higher tax rate, and that overall the taxation of both long-term capital gains and qualified dividends is now more progressive (meaning higher tax rates on higher income individuals).

However, in the context of long-term capital gains and qualified dividends in particular, it's important to remember that 2013 also marks the onset of the new 3.8% Medicare tax on net investment income, which applies to individuals with more than $200,000 of AGI (and married couples over $250,000 of AGI).

As a result, the reality is that clients won't actually face a 20% long-term capital gains rate at $400,000 of income. Instead, the long-term capital gains and qualified dividend rates will rise from 15% to 18.8% (including the 3.8% surtax) at the $200,000 and $250,000 AGI thresholds, and will then rise to 23.8% (i.e., 20% capital gains + 3.8% Medicare surtax) once taxable income crosses the $400,000 and $450,000 thresholds. In essence, this means there are actually four long-term capital gains tax rates: 0%, 15%, 18.8%, and 23.8%, although notably the 18.8% threshold is based on AGI (before itemized deductions) while the rest are based on taxable income (after all deductions). In addition, the reality is that the top long-term capital gains and qualified dividend tax rate is actually even higher than 23.8%, once accounting for the marginal

impact of itemized deduction and/or personal exemption phaseouts.

Notwithstanding these varying thresholds, it's important to note as well that the various capital gains rates only apply to gains that fall within the applicable income thresholds. Thus, for example, if married couple had precisely $0 of taxable income and then began to sell investments to generate long-term capital gains, the first ~$72,500 of gains (up to the upper threshold for the 15% ordinary income bracket) would be taxed at 0%, subsequent gains would be taxed at 15%, which would continue until AGI rose high enough to reach $250,000 and then capital gains would be taxed at 18.8%, and that rate would continue until taxable income reached $400,000 and long-term gains (and qualified dividends) began to be taxed at 23.8%. This means a client with $401,000 of taxable income only has the last $1,000 of capital gains actually taxed at 23.8%, while the remainder is taxed at a blend of 0%, 15%, and 18.8% rates.

The Value Of Tax Deferral

Ultimately, the net result of these tax rate increases is to increase in turn the value of tax deferral, although notably even at a top 23.8% tax rate, the benefits of long-term capital gains deferral are still quite limited.

For instance, imagine an investment that was purchased for $300,000 and is now worth $400,000, representing a healthy (and probably multi-year) gain of $100,000, or 33% on the original investment. The reality is that the tax liability on $100,000 of capital gains will have to be paid someday (unless the value declines and the money is lost, or the client dies, neither of which is an improvement!). Thus, the value opportunity of tax deferral is to keep the current tax liability, which may be as high as $23,800 (at a top 23.8% rate), invested on the client's behalf.

At a moderate(?) 8%/year growth rate, this means keeping the last $23,800 of future-tax-dollars invested allows for an additional return of $23,800 x 8% = $1,904/year. That's the true economic value of tax deferral: an extra $1,904 of growth that could be earned and put in the client's pocket, on the $23,800 of tax dollars available to keep invested before they're turned over to Uncle Sam. However, the reality is that $1,904 isn't really a great deal of economic value on a $400,000 investment; the "benefit" of tax deferral is a mere 0.48%/year – which for many investments could be gained or lost in months, weeks, days, hours, minutes, or even mere seconds of market volatility!

Figure 2. Economic Value of 1 Year of Tax Deferral for Various Tax Rates & Gains

Embedded Gain	15% tax rate	18.8% tax rate	23.8% tax rate
10%	0.109%	0.137%	0.173%
20%	0.200%	0.251%	0.317%
30%	0.277%	0.347%	0.439%
40%	0.343%	0.430%	0.544%
50%	0.400%	0.501%	0.635%
60%	0.450%	0.564%	0.714%
70%	0.494%	0.619%	0.784%
80%	0.533%	0.668%	0.846%
90%	0.568%	0.712%	0.902%
100%	0.600%	0.752%	0.952%

Of course, the caveat is that this benefit compounds for each year that capital gains taxes are deferred; which means while just a year or two of deferral isn't very impactful (relative to market volatility), a decade or more of tax deferral certainly can be. On the other hand, the value of tax deferral is also not even this high for clients in lower tax brackets; Figure 2 (above) indicates the value of one year of tax deferral, assuming an 8% annual appreciation rate, varying levels of capital gains, and varying levels of already-embedded gains.

In terms of dividends, the primary impact of higher qualified dividend tax rates is simply to force investors to look a little more carefully at whether the after-tax yield of higher-dividend stocks is still worthwhile at those higher rates. On the other hand, the reality is that qualified dividends still represent a significant tax break relative to non-qualified dividends, or the taxation of ordinary income (e.g., bond interest); as a result, investors who found dividend-paying stocks appealing before will not likely be dissuaded by the change in the qualified dividend tax rate.

(Editor's Note: For further discussion of planning for the new 3.8% Medicare surtax on portfolio income, see the April 2010 issue of The Kitces Report, or contact feedback@kitces.com to request a copy.)

Alternative Minimum Tax Relief

Technical Rules

The Alternative Minimum Tax (AMT) represents an "alternative" secondary tax system to which all

individual taxpayers are subject. Technically, the process requires an individual's tax liability to be calculated twice - once under the "regular" tax system, and again under the (AMT) system, which has different tax rates and also fewer deductions - and the total amount of taxes actually owed is the *higher* of the two.

In exchange for a relatively limited number of deductions and exclusions from income, the AMT system does allow a large flat exemption amount to all taxpayers, which is phased out at higher income levels. The purpose of the exemption is to ensure that a large portion of lower and middle income taxpayers are not subject to the AMT (because the single large deduction is sufficient to ensure that their AMT liability will be lower than their regular tax liability, causing them to pay taxes under the "normal" regular system and not the AMT system).

However, if the AMT exemption is "too" small of an amount, it does not sufficiently limit exposure to the AMT, which has been especially problematic since 2001 as regular income tax brackets have declined with legislation and the tax bracket thresholds have continually adjusted for inflation, resulting in an ongoing "AMT creep" with more and more taxpayers becoming subjected to the tax each year. To try to mitigate this, Congress over the past decade has temporarily "patched" the AMT exemption to a higher amount several times to keep the AMT from affecting more and more taxpayers, with the latest AMT patch expiring back on December 31, 2011.

Fortunately, with ATRA the ongoing series of temporary AMT patches comes to an end. The provisions of ATRA retroactively patch the AMT exemption for 2012, at $78,750 for married couples and $50,600 for individuals (these are essentially the 2011 amounts adjusted for inflation). In addition, the legislation *permanently* adjusts the AMT exemption amount to these levels going forward, *with* an automatic inflation adjustment to the exemption each year in the future (which should reduce the risk of future 'AMT creep').

In a separate but related provision, the rules that allow nonrefundable tax credits to be used for both regular and AMT purposes (subject to some restrictions) is also retroactively patched for 2012 and made permanent going forward, which simply means the typical tax credits that clients claim will continue to apply, regardless of whether the client is subject to the AMT or not.

Planning Implications

In reality, the AMT "fix" was one of the most significant tax planning changes under ATRA. The new rules kept the scope of the AMT from widening to nearly 30 million taxpayers who would have been affected in 2012 without a patch (from only about 5 million impacted in 2011). In practice, the lapse of the AMT patch would have resulted in AMT becoming "the norm" and only clients whose income was very low (e.g., less than $60k) or very high (e.g., $600k+) would have escaped its grasp. In other words, for most financial planners, clients subject to AMT would have been the standard scenario, and the *exception* would have been clients who were actually subject to the normal tax system! Because of the wide scope of the AMT, though, the cost of this permanent patch to the AMT was significant; the Congressional Budget Office estimates indicate that nearly 45% of the *entire* $4T fiscal impact of the legislation over the next 10 years was attributable to this AMT resolution.

Notwithstanding the cost, though, the reality is that AMT is still not off the table for clients entirely; the ATRA "fix" merely patched the AMT with an inflation adjustment from the 2011 levels, and committed to keeping the AMT exemption at that level (plus future inflation adjustments) going forward. Thus, to the extent that approximately 5 million taxpayers were subject to the AMT in 2011, so too will a roughly comparable number continue to be exposed to the AMT going forward (although with the same ongoing inflation adjustments to the AMT exemption that apply to all the other tax brackets as well, the number or exposed taxpayers should no longer keep rising every year).

Evaluating AMT Exposure for Clients

So which clients are at greatest risk for AMT exposure? In general, individuals from $200,000 to $350,000 of income and married couples from $250,000 to $475,000 of income; the new 39.6% tax bracket will make it "easier" for clients to begin to escape the grasp of the AMT above $400,000 of income by racking up a regular tax liability at a faster rate. Common AMT triggers that typically increase exposure for clients in this category include:

- *Being married.* Both due to the fact that the AMT exemption for married couples is not twice the amount it is for single individuals, and also because of the two personal exemptions claimed for a husband and wife. On the other hand, the width of the lower tax brackets for married couples and the

fact that it requires more income for their AMT exemptions to phase out means the worst exposure for married couples begins at a higher income level than for single individuals (although it also extends to a higher level).

- *Having a family*. Because personal exemptions are not allowed under the AMT system, a larger family (dependent children, or even dependent {grand}parents!) means more personal exemption deductions lost for AMT purposes, and therefore a greater AMT exposure. Notably, though, this is primarily an issue for those with approximately $100,000 to $300,000 of AGI; income lower than this range is mostly covered by the new AMT exemption, and income higher than this range is less impacted due to the fact that the personal exemptions will be phasing out under the regular tax system, too.

- *High income tax states*. Since state and local income taxes paid are an AMT adjustment, the higher a state's income tax rate, the more taxes are paid, the greater the deduction for regular tax purposes, and the greater the AMT adjustment (and potential exposure) for AMT purposes. In states like California, New York, Hawaii, Iowa, Oregon, Vermont, Maryland, and DC – where the top combined state and local tax rate is about 9% or higher – it will be difficult to avoid the scope of the AMT. Even clients in "mid-taxation states" (where the rates are approximately 4% to 7%) may find it difficult to avoid the AMT if the client is exposed to several factors on this list simultaneously.

- *High property taxes*. As with state and local income taxes paid, any property taxes paid are a deduction for regular tax purposes, an AMT adjustment item, and therefore leads to greater exposure to the AMT. In some states and counties, a high property tax liability may be unavoidable due to a high local property tax rate (e.g., 2%+). In other states and counties, the property tax *rate* may be more modest, but if the real estate itself is very expensive (e.g., metropolitan areas on the east and west coasts), then a large property tax bill (and a large AMT adjustment) may be unavoidable even at "reasonable" rates.

- *Large miscellaneous itemized deductions*. Any type of deduction claimed as a "miscellaneous itemized deduction subject to the 2%-of-AGI floor" is not available for AMT purposes, and consequently large miscellaneous itemized deductions can end up being an AMT trigger. Notably, for many advisory firms, the investment advisory fees that clients pay (and seek to deduct) fall into this category, and consequently may trigger AMT exposure.

It's important to note that while the list of deductions above are AMT triggers, this is only true to the extent that the deductions are lost for AMT purposes. It never helps to deliberately avoid or not claim such deductions; to the extent not claiming the deduction would reduce AMT exposure, it happens only by increasing the client's tax liability under the regular tax system by an equivalent amount in the first place! Thus, the fundamental point is not that such deductions should be avoided, but simply that having a large amount of these deductions increase the likelihood that not all of them will be able to be utilized due to the AMT.

Figure 3 (below) can be used to estimate a client's AMT exposure in 2013. The column on the left indicates the client's *taxable income* (after all deductions). If the deductions the client claimed includes AMT adjustments (such as the ones just listed) that add up to

Figure 3. Estimating Potential AMT Exposure

Taxable Income	MFJ	Individual
$50,000	$56,154	$34,314
$75,000	$46,539	$33,352
$100,000	$45,576	$29,534
$125,000	$40,692	$26,072
$150,000	$35,255	$22,611
$175,000	$31,794	$19,149
$200,000	$28,332	$17,247
$225,000	$24,059	$15,819
$250,000	$22,630	$14,390
$275,000	$21,201	$12,961
$300,000	$19,773	$11,533
$325,000	$18,344	$13,855
$350,000	$16,916	$18,320
$375,000	$15,487	$22,784
$400,000	$14,153	$27,366
$425,000	$14,153	$37,723
$450,000	$14,153	$48,080
$475,000	$22,298	$58,438
$500,000	$32,655	$68,795

Note: Chart numbers assume inflation adjustment of approximately 2.5% for 2013 tax brackets and AMT exemption amounts.

at least the amount indicated in the chart (or any greater amount), the client will be subject to the AMT in 2013.

It's notable, though, that for many clients being subject to the AMT is not necessarily bad for tax planning at the margin. While being exposed to the AMT means, by definition, that the client will pay a higher total tax liability, the top tax bracket for the AMT is only 28%, compared to 39.6% under the regular tax system. As a result, clients subject to the AMT may actually wish to accelerate *more* income into an AMT year to take advantage of what is only a 28% marginal rate as long as the AMT continues to apply!

On the other hand, the phaseout of the AMT exemption causes the client's true marginal tax rate to rise from 26% - 28%, up to 32.5% - 35%, while the AMT exemption is being phased out. The impact ends when the exemption is fully phased out, which will occur at Alternative Minimum Taxable Income (AMTI) levels of approximately $323,000 of income for individuals, and $473,000 for married couples. As a result, planning for and around preserving the AMT exemption amount from year to year, in addition to avoiding the higher marginal tax rates as the AMT exemption phases out, becomes a significant AMT planning strategy.

(Editor's Note: For further discussion of AMT planning strategies, see the June 2011 issue of The Kitces Report, or contact feedback@kitces.com to request a copy.)

Miscellaneous Extensions – Temporary and Permanent

In addition to the preceding major changes to ordinary income tax brackets, long-term capital gains, qualified dividends, and the Alternative Minimum Tax, ATRA included a long list of minor and miscellaneous changes. In some cases, rules that had expired in 2011 were (retroactively) reinstated for 2012, and often extended into 2013 as well. In other cases, the extensions run for 5 years (through 2017) instead of just one year. In addition, a number of rules that were scheduled to lapse at the end of 2012 were not only extended, but actually made permanent (by entirely eliminating the sunset that would have lapsed them).

The guidance below is not an exhaustive list of every extension that occurred, but highlights the ones most likely to be relevant to planners and their clients.

5-year extensions

A number of the most popular "middle class" tax credits that were scheduled to lapse (either entirely, or back to lower limits) at the end of 2012 were extended for 5 years, through the end of 2017. These include more favorable refundability thresholds for the Child Tax Credit (which overall is also made permanent at the $1,000 per child level; see later section below), and the Earned Income Tax Credit for lower income individuals.

Most significant in the 5-year extension category is the American Opportunity Tax Credit for college expenses (which had replaced the Hope Scholarship credit in 2009 as the primary tax credit used for college education expenses).

1-year extensions

Most of the items in the "1-year extension" category are technically 2-year extensions – reinstated retroactively for 2012, and then extended again into the upcoming 2013 tax year. Most of these items will only have a limited impact on clients – who will either be eligible to claim them, or not – and don't necessarily require additional planning, although a few have additional planning implications, as noted.

The list of the most popular items, all of which will expire again at the end of 2013, include:

- Deduction for up to $250 expenses for elementary and secondary school teachers

- Exclusion from income of discharged mortgage debt (necessary to prevent a short sale from triggering income tax consequences for the amount of debt that was discharged)

- Deduction of mortgage insurance premiums as qualified residence interest

- Deduction for state and local *sales* taxes paid (in lieu of state and local *income* taxes paid, useful in states that have little or no income taxes)

- Above-the-line deduction for up to $4,000 of higher-education-related expenses (although in practice, this deduction is rarely used due to the

availability of the American Opportunity Tax Credit, which was also extended and provides far more favorable tax benefits for those eligible)

- Business provisions, including increased Section 179 expense deductions for small businesses (up to $500,000 expensing limit and phasing out at $2 million of eligible property purchased), and 50% bonus depreciation for all businesses.

- Exclusion from income for Qualified Charitable Distributions from an IRA to a charity (still with the age 70 1/2 requirement and the $100,000-per-taxpayer-per-year limitation). Notably, a special rule allows qualified charitable distributions made by February 1, 2013 to be counted retroactively for the 2012 tax year, for those who want to take advantage of the rule for 2012 and 2013. (See below for further discussion.)

Permanent Extensions

A number of tax rules were extended and made permanent under ATRA, due to the fact that they were previously scheduled to sunset at the end of 2012, but ATRA entirely removed the sunset provisions of President Bush's 2001 and 2003 tax acts.

As a result, the following provisions are now permanent law:

- The $2,000 contribution limit on Coverdell Education Savings Accounts, and the rules allowing qualified distributions to be used for eligible elementary and secondary school (i.e., K-12) expenses

- The higher credit amount and income phaseout limits for the adoption tax credit

Qualified Charitable Distributions (QCDs) from IRAs
A popular tax planning provision that has been enacted, lapsed, reinstated, and relapsed repeatedly for years, the rules for Qualified Charitable Distributions (QCDs) from IRAs allow retirement account owners to make a distribution *directly* from an IRA to a public charity (but not a private foundation, supporting organization, or donor-advised fund).

The donation is not eligible for a separate charitable deduction, but is not counted as a taxable distribution, either; the money simply goes directly, on a pre-tax basis, from the IRA to the charity. However, the maximum QCD for any individual in a single year is only $100,000 (a married couple can do $100,000 each from their own respective IRAs), and QCDs can only be done if the IRA owner is over the age of 70 ½. On the other hand, QCDs also satisfy an individual's Required Minimum Distribution (RMD) requirements, allowing the IRA owner to kill two birds with one stone (making a charitable contribution, and satisfy his/her RMD requirements), while not incurring taxes on the distribution.

Of course, reinstating QCDs for 2012 was of limited benefit, given that the law isn't even being enacted until 2013. To provide some flexibility, two special rules were added: the first allows QCDs from an IRA to charity made by February 1st, 2013, to be applied retroactively for the 2012 tax year; and the second allows any IRA withdrawals that occurred in December of 2012 to be treated as a QCD if the amounts are donated as cash to a charity by February 1st, 2013. In practice, though, these special rules for January 2013 will likely be of limited use.

Regarding the first provision, most individuals will (or should!) have already taken care of their 2012 RMDs, so having January 2013 QCDs treated as a 2012 QCD is only useful for those who anticipate contributing *more* than the $100,000 QCD limit in 2013 (who can use the rule to contribute an "extra" amount up to $100,000 retroactively for 2012, and then still do their 2013 QCCD).

The second provision is also of limited use, for the simple reason that in most cases, if the client planned to contribute IRA funds in 2012, both the withdrawal and donation have likely already happened. If funds were going to be contributed in 2013, most clients can/would simply do a QCD with his/her RMD in 2013.

Beyond the lookback provisions, the caveat to all QCDs remains that ultimately contributing appreciated securities directly to a charity is still more tax efficient than using QCDs. As a result, taking advantage of QCDs in 2013 (and the retroactive-to-2012 special rule) will primarily be useful for clients who either: 1) were going to make cash contributions anyway; 2) are expected to exceed the charitable deduction thresholds (and anticipate not being able to use the charitable deduction in a carryforward year, either); or 3) need a "get-out-of-trouble free" card for a missed 2012 RMD (which can now be made in January 2013 and counted retroactively for December 2012).

- Above-the-line deduction for student loan interest

- Exclusion for employer-provided education assistance

- Increased dependent care credit

- Increased/expanded child care tax credit

- Marriage penalty relief, which made the 10% and 15% tax brackets, and the standard deduction, twice the size for married couples as it is for single individuals

Notably, the existing phaseout thresholds that apply to many of the aforementioned deductions and credits are also made permanent.

Other Notable Provisions

Intra-Plan Roth conversions

An entirely new rule created under ATRA – intended to raise enough revenue to pay for half of the 2-month delay on certain spending cuts – will now allow individuals to convert their existing traditional 401(k) account to a Roth 401(k), if the employer offers designated Roth accounts under the plan, regardless of whether the individual is allowed to take a distribution out of the plan in the first place. The transaction will be taxed in a similar manner to any other Roth conversion. Notably, though, such conversions will *not* be eligible for recharacterization (e.g., if the client changes his/her mind, or the account has dropped in value), until/unless Congress further changes the rules to allow recharacterizations in the future. In addition, the client will still need available dollars to pay the tax liability associated with the conversion, especially since the money converted itself will not be available (as it's still inside the plan and only eligible for a loan, not a distribution!).

The reason this new intra-plan Roth conversion rule is notable is that, under current law, clients can only convert a 401(k) plan if you are eligible to take a distribution from the plan (whether it's going to a Roth 401(k) or Roth IRA), which generally means the clients has to be 59 1/2, deceased, disabled, or separated from service, unless the plan allows in-service withdrawals. The new ATRA provision will allow an intra-plan Roth conversion, regardless of whether the client is eligible for a distribution out of the plan (although being eligible for a distribution is still required to convert the money to a Roth IRA). Notably, the rules allow the new intra-plan Roth conversions for 401(k)'s, and also 403(b) and 457 plans.

The essence of the new rule simply means clients can now do intra-plan 401(k) (or 403(b) or 457 plan) conversions from traditional to Roth in the same manner they can do so for IRAs. But clients still can't go FROM a 401(k) (or other employer retirement plan) TO the IRA unless they are otherwise eligible for a distribution from the retirement plan. In theory, the increased flexibility for Roth conversions means more (current) workers will convert their existing 401(k) and other employer retirement plans, which provides a short-term revenue increase for the Federal government (thus, this new rule was actually scored as a "revenue raiser" in measuring the fiscal impact of the legislation).

Of course, whether completing a Roth conversion (inside a 401(k) or with an IRA) is a good deal or not depends on several individual-specific factors, most notably whether the client's tax rate is anticipated to be higher in the future than it is now.

(Editor's Note: For further discussion of the decisions whether "To Roth Or Not To Roth" see the May 2009 issue of The Kitces Report, or contact feedback@kitces.com to request a copy.)

National LTC Commission

The Community Living Assistance Services and Supports Act (the "CLASS Act") was created under the Patient Protection and Affordable Care Act (the so-called "Obamacare" legislation) in 2010, and was intended to establish a national, government-run long-term care insurance program. The coverage would be purchased directly by consumers and would be guaranteed issue (i.e., without underwriting). It was expected to offer modest but useful-sized policies, hopefully with premiums that could still be affordable to most consumers.

Unfortunately, though, the CLASS Act and its national LTC coverage program was determined to not be economically viable by the Department of Health and Human Services in 2011, which put the program on indefinite hold. Notably, the primary concern regarding the CLASS Act was that since coverage was optional, it was unclear whether the coverage could be priced reasonably given the likely adverse selection issues.

Under ATRA, the CLASS Act is formally repealed, but is replaced with the establishment of a new

"Commission on Long-Term Care" that is intended to provide a fresh look at national needs for long-term care, and try to come up with workable plan for "the establishment, implementation, and financing of a comprehensive, coordinated, and high-quality system" for long-term care services. The Commission will be bi-partisan, and has a relatively short timeline (6 months) to provide initial recommendations.

Although it remains to be seen whether the Commission's work will bear any fruit, expect to hear more discussion later in 2013 regarding potential options for a more nationally coordinated long-term care services system (in addition to a means to finance it). Proposals may even include an alternative to the CLASS Act for government-run long-term care insurance coverage, integrated with Medicare and/or another form of mandatory health coverage to reduce adverse selection.

Estate Taxes

After years of variability and uncertainty, another significant change under ATRA was that the estate tax laws now have permanence. The new rules continue the current $5 million (annually adjusted for inflation) gift and estate tax exemption, but make these amounts permanent going forward (including the annual inflation adjustments). This means the estate tax exemption for 2013 will rise to approximately $5.25 million (from $5.12 million in 2012).

The top estate (and gift, and GST) tax rate is increased to 40% (from the prior 35%), although this too is a permanent change and not subject to lapse or sunset.

In addition, the rules for portability of a deceased spouse's unused estate tax exemption amount are made permanent. This means the surviving spouse of any individuals who passed away since January 1st, 2011, have the deceased spouse's unused estate tax exemption available to use (assuming the required Form 706 estate tax return was timely filed!), and that portability is available going forward as well, both to use a deceased spouse's exemption, and for a currently living client to leave an unused exemption to a surviving spouse at the first death.

Ultimately, the permanence of portability will have a very significant impact on estate planning for most clients, as it reduces the need to use bypass trusts for all but the wealthiest of families or those with other non-tax-related reasons to use trusts. On the other hand, for many clients, bypass trusts may remain relevant for several more years to come, not to plan for Federal estate taxes, but to manage *state* estate taxes, as most states that do still have an estate tax do not allow portability. In fact, the reality is that planning for estate taxes may shift heavily from a Federal to state-by-state focus in the coming years.

The provisions in ATRA also make permanent the state estate tax deduction, which replaced the state estate tax credit last decade. This is significant, to the extent that states which did not "decouple" from the Federal system can no longer hope that a sunset law will reinstatement the old state estate tax credit system. Thus, to the extent that states want to generate their own estate or inheritance taxes, they will need to create and apply their own state-level taxes (for which the decedent's estate will receive a Federal estate tax deduction).

In the next issue of The Kitces Report, we'll take a deeper look at how the face of estate planning is going to change in 2013 and beyond in light of the now-permanent exemption, permanence of portability, and the ongoing challenge of state estate taxes.

What *Didn't* Get Extended?

Given all the discussion of what was extended under ATRA, it raises the question of what was *not* extended.

The most significant provision that was not extended was the 2% reduction in the payroll tax rate that has been in effect for the past two years. By allowing the payroll tax cut to lapse, all clients with earned income (whether as wages or via self employment) will see their payroll tax obligation rise by 2 percentage points in 2013 up to the $113,700 wage base. The net result will be a reduction in take-home pay of up to $2,274, which will be implemented for employees via an increase in withholdings and a smaller paycheck going forward from here. Given that the scope of the payroll tax system actually affects more Americans than the income tax system, this is the primary driver for the Tax Policy Center's estimate that the compromise agreement under ATRA would "still result in a tax increase on 77% of American households."

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Written and edited by Michael E. Kitces

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Beyond this, the primary parts of the fiscal cliff that were not extended are the unlimited 35% tax bracket (which lapsed back to 39.6%) and the 15% long-term capital gains rate (which lapsed back to 20%, and also applies to qualified dividends; both of these lapses, as noted earlier, only apply to taxpayers with taxable income in excess of $400,000 for individuals and $450,000 for married couples.

Bringing It All Together

Ultimately, there are two overriding themes to the planning implications of the fiscal cliff tax legislation.

The first is that the overwhelming majority of the significant changes to the law are *permanent* changes. The decade-long struggle of engaging in tax planning with clients, where it was difficult to know what to do each year because of the looming expiration of current tax brackets, or capital gains rates, or qualified dividend treatment, or the AMT exemption amount, is no longer an issue. Once again, planning can occur with some sense of permanence to the strategies.

Of course, the caveat to all of this is that even "permanent" tax laws are only permanent until Congress enacts a new law to change them again. Nonetheless, the reality is that Congress rarely enacts *adverse* tax changes retroactively, which means if ultimately there will be significant changes in the future that would materially alter the tax landscape, at least there's a high likelihood that we'll have advance notice and opportunity to plan for them. And with the extent of current Congress gridlock, it's not clear that much significant tax legislation will be forthcoming anytime soon (but who knows?). In the meantime, though, the fact remains that we have a permanent tax environment in which to plan for the foreseeable future.

The second theme of the fiscal cliff tax legislation is, as President Obama has advocated, the tax system is now more progressive – higher tax rates on higher income individuals – and this progressivity extends to not just ordinary income tax brackets, but also long-term capital gains and qualified dividends as well. In addition, the introduction in 2013 of the two new Medicare taxes on unearned income makes the system even more progressive for higher income individuals, with both the 0.9% Medicare surtax on earned income and the 3.8% Medicare tax on net investment income.

As a result of the interplay between the ordinary income tax rates, payroll taxes, and the new Medicare taxes, most clients are now effectively subject to far more incremental tax brackets than realized. Ordinary income is subject to 7 tax brackets now (or more for investment income subject to ordinary income rates); long-term capital gains and qualified dividends are subject to four brackets (0%, 15%, 18.8%, and 23.8%); earned income is subject to rising and falling payroll tax rates depending on whether the individual is below the Social Security wage base, above the 0.9% Medicare surtax threshold, or somewhere in between. Indirectly, additional brackets apply as itemized deductions and personal exemptions phase out as well.

The chart attached as an appendix to this newsletter (see final page) shows the key income thresholds for various marginal tax rates in 2013 and going forward, including the additional marginal tax rate impact of key high-income phaseouts. Note that the thresholds vary as to whether they're based on taxable income (after all deductions), Alternative Minimum Taxable Income (or AMTI, which is income after the limited number of deductions allowed under the AMT system but before deducting the AMT exemption), Adjusted Gross Income (AGI), or earned income (wages or self-employment income subject to FICA taxes). Tax rates from various columns can be added together as appropriate – depending on the type of client income – to determine the total marginal tax rate that would be in effect (in addition to any state/local income taxes that apply!).

Conclusion

In the end, the fiscal cliff legislation will likely be viewed positively by most advisors, at least to the extent that it provides the permanence necessary for productive income and estate tax planning, without sunsets and scheduled lapses of key foundational portions of the tax law. However, the American Taxpayer Relief Act of 2012 will not mark the end of ongoing fiscal deficit and spending debates, and additional tax law changes may also be on the table with further legislative battles. Fortunately, though, it will at least require a new, proactive piece of legislation from Congress to change the tax laws as they are now written, and the permanence of the new law arguably removes some of the pressure and impetus for additional significant individual income tax legislation in the near term.

At the same time, the increased progressivity of the tax system will likely make many clients more interested in proactive tax planning, especially at higher income levels where the combined impact of all the tax law changes can result in significantly higher tax rates than in the past. In addition, permanence of the estate tax system may finally provide some impetus – or at least, remove some hindrance – for clients to finally get underway with estate planning that they may have been putting off for years.

What did you think?

Hopefully you found this latest issue of The Kitces Report to be of value to you. However, since it is produced for you, the reader, we would like to hear from you about how the style, format, and content of the newsletter could be further improved to make it more valuable for you.

Please let us know what you think by emailing us at feedback@kitces.com! Thanks in advance for sharing your thoughts!

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Determining The Marginal Tax Rate For Various Types Of Income In 2013

<table>
<tr><th>Individual income above…</th><th>Couple's income above…</th><th>Income "type"</th><th>Ordinary Income</th><th>AMT rate</th><th>L/T gains & qual. dividends</th><th>Wage earned income</th><th>Self-employed earned income</th><th>Net inv. income</th><th>Itemized deduction phaseout (Pease)</th><th>Personal exemption phaseout (PEP)*</th><th>AMT exemption phaseout</th></tr>
<tr><td>$0</td><td>$0</td><td>Taxable</td><td>10%</td><td rowspan="8">26%</td><td rowspan="2">0%</td><td rowspan="3">7.65%</td><td rowspan="3">15.30%</td><td rowspan="11">0%</td><td rowspan="12">0%</td><td rowspan="12">0%</td><td rowspan="5">0%</td></tr>
<tr><td>$8,950</td><td>$17,900</td><td>Taxable</td><td>15%</td></tr>
<tr><td>$36,250</td><td>$72,500</td><td>Taxable</td><td rowspan="2">25%</td><td rowspan="15">15%</td></tr>
<tr><td>N/A</td><td>$113,700</td><td>Earned</td><td rowspan="3">0% / 1.45%</td><td rowspan="3">0% / 2.9%</td></tr>
<tr><td>$87,850</td><td>$146,400</td><td>Taxable</td><td rowspan="5">28%</td></tr>
<tr><td>$112,500</td><td>N/A</td><td>AMTI</td><td rowspan="2">6.5% / 0%</td></tr>
<tr><td>$113,700</td><td>N/A</td><td>Earned</td><td rowspan="4">1.45%</td><td rowspan="4">2.90%</td></tr>
<tr><td>N/A</td><td>$150,000</td><td>AMTI</td><td>6.5%</td></tr>
<tr><td>$175,000</td><td>$175,000</td><td>AMTI</td><td rowspan="11">28%</td><td rowspan="5">7%</td></tr>
<tr><td>$183,250</td><td>$223,050</td><td>Taxable</td><td rowspan="6">33%</td></tr>
<tr><td>$200,000</td><td>$250,000</td><td>Earned</td><td rowspan="9">2.35%</td><td rowspan="9">3.80%</td></tr>
<tr><td>$200,000</td><td>$250,000</td><td>AGI</td><td rowspan="8">3.80%</td></tr>
<tr><td>$250,000</td><td>$300,000</td><td>AGI</td><td rowspan="3">1%</td><td rowspan="2">1%</td></tr>
<tr><td>$323,000</td><td>N/A</td><td>AMTI</td><td rowspan="5">0% / 7%</td></tr>
<tr><td>$372,500</td><td>N/A</td><td>AGI</td><td>0% / 1%</td></tr>
<tr><td>$398,350</td><td>$398,350</td><td>Taxable</td><td rowspan="2">35%</td><td rowspan="2">1.05%</td><td>0% / 1.1%</td></tr>
<tr><td>N/A</td><td>$422,500</td><td>AGI</td><td rowspan="3">0%</td></tr>
<tr><td>$400,000</td><td>$450,000</td><td>Taxable</td><td rowspan="2">39.6%</td><td rowspan="2">20%</td><td rowspan="2">1.2%</td></tr>
<tr><td>N/A</td><td>$473,000</td><td>AMTI</td><td>0%</td></tr>
</table>

Income thresholds based on estimated 2013 inflation adjustments (where applicable).

Where two rates are shown, the first applies to individuals, the second to married couples

* Phaseout *per exemption*

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