The Consequences of 2013 Tax Changes

Congress passed the American Taxpayer Relief Act (ATRA) of 2012 on New Year's Day. For most Americans, the law made prior tax cuts permanent with a few exceptions.

The federal estate tax exemption remains at $5,000,000 indexed for inflation. This year, the exemption is $5,250,000 due to indexing. For couples, each spouse has his or her own estate tax exemption and can use a predeceased spouse's unused estate tax exemption (known as "portability"). With portability, couples can now have assets of $10.5 million without owing any federal estate tax. There is a tax advantage to marrying a poor spouse!

For those "unfortunate" to die with more than the exemption amount, the federal estate tax rate on the amount over the exemption rose from 35% to 40%. Yet, that is much lower than the 55% that prevailed for most of the last 5 decades.

The federal gift tax now includes a permanent $5,250,000 lifetime exemption and a 40% tax rate just like the estate tax. In 2013, the gift tax annual exclusion also went up to $14,000 per person per year. Thus, federal gift taxes should no longer dissuade donors from making gifts to family members. The income tax consequences of gifting low-basis assets to family members, however, will continue to concern donors. Capital gains from selling property received as a gift can result in significant income taxes owed.

The generation-skipping transfer (GST) tax also has a $5,250,000 lifetime exemption and a 40% tax rate. This tax only applies if you transfer property to skip persons (grandchildren or non-descendants who are more than 37½ years younger than the donor) through either direct gifts to grandchildren or lifetime trusts for children. This tax is levied to assure that the federal government collects at least some transfer tax each generation. Portability does not apply to the GST tax.

Given the divisiveness in Congress, the permanent nature of these changes makes it unlikely that most taxpayers will ever have to pay federal estate and gift taxes. It is state estate & gift taxes that take center stage.

Connecticut has a $2,000,000 estate and gift tax exemption and no portability. The tax rate is 7% to 12% depending on the amount transferred. Connecticut does not have portability like the federal estate tax. Thus, for couples wishing to reduce state estate taxes for their children, tax-saving trusts can still prove wise.

For some, a change of domicile may make sense as an estate planning option. You would not want to move to New York ($1M exemption), New Jersey ($675,000 exemption), Rhode Island ($910,725 exemption) or Massachusetts ($1M exemption) for estate planning purposes. But you might want to move to Florida, Texas or New Hampshire (no estate tax at all) or North Carolina ($5,250,000 exemption). One unintended consequence of the new permanent federal estate tax law could be competition among the states to retain wealthy residents.

The exceptions in ATRA to making tax cuts permanent applies in the income tax arena. In 2013, taxpayers age 70½ or older can directly transfer to charity up to $100,000 of an IRA without incurring income taxes. An IRA transfer to charity by February 1, 2013, can apply to the 2012 tax year. This tax provision ends in 2013, so it is not permanent.

Some taxes did rise. For single filers with taxable income exceeding $400,000 and joint filers with taxable income exceeding $450,000, the top income tax rate rises to 39.6% and capital gains and dividends are now taxed at 20%, up from 15%. These minor changes in the tax rates allayed investor fears resulting in a rally in dividend-paying stocks this month.

The newest tax is the .9% Medicare surtax on earned income (i.e., wages) and 3.8% Medicare surtax on net investment income. The earned income surtax applies once earned income exceeds $200,000 for singles and $250,000 for couples. The investment income surtax applies if your adjusted gross income plus tax-free foreign income exceeds $125,000 for singles and $250,000 for couples. Investment income includes interest, dividends, capital gains, annuity payments, royalties and passive rental income. Retirement plan distributions and tax-free interest do not count.

Finally, everyone who receives a paycheck will take home a little less due to the payroll tax reduction which expired December 31, 2012. For 2 years, employees contributed only 4.2% of wages to payroll taxes. For 2013, it bumps back up to its previous level of 6.2% of wages. The tax increase will help restore our social security system if Congress can keep from raiding the social security fund.