Cracking the 2013 Tax Code

A guide to the changes wrought by the fiscal-cliff deal

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Early in the morning of January 1, Congress finally got around to dealing with the tax part of the fiscal cliff drama by passing what is inaccurately named the American Taxpayer Relief Act of 2012. Thanks to the demise of the so-called payroll tax holiday, all workers will pay higher taxes this year, but the new law cancels federal income tax increases that would have resulted in added misery for just about everyone. The bad news is that higher-income folks will face higher rates.

Here's a detailed summary of the most important changes for individual taxpayers.

Payroll Tax Holiday Is Dead

For 2010-2012, the Social Security tax withholding rate on your salary was temporarily reduced from the normal 6.2% to 4.2%. If you're self-employed, the Social Security tax component of the self-employment tax was reduced from the normal 12.4% to 10.4%. Last year, this so-called payroll tax holiday could have saved one person up to $2,202 or a working couple up to $4,404. Somewhat surprisingly, the new law does not extend the holiday through 2013. (For this year, the Social Security tax can hit up to $113,700 of salary or self-employment income.)

Rates on Ordinary Income: For most individuals, the federal income tax rates for 2013 will be the same as last year: 10%, 15%, 25%, 28%, 33%, and 35%. However, the maximum rate for higher-income folks increases to 39.6% (up from 35%). This change only affects singles with taxable income above $400,000, married joint-filing couples with income above $450,000, heads of households with income above $425,000, and married individuals who file separate returns with income above $225,000.

Rates on Long-Term Gains and Dividends: The tax rates on long-term capital gains and dividends will also remain the same as last year for most individuals. However, the maximum rate for higher-income folks increases to 20% (up from 15%). This change only affects singles with taxable income above $400,000, married joint-filing couples with income above $450,000, heads of households with income above $425,000, and married individuals who file separate returns with income above $225,000. Remember: these higher-income folks can also get socked with the new 3.8% Medicare surtax on investment income, which can result in a maximum 23.8% federal tax rate on long-term gains and dividends.

Personal and Dependent Exemption Deduction Phase-Out: The last time we saw a phase-out rule for personal and dependent exemption deductions was 2009. Sadly, the phase-out deal is back. As a result, your personal and dependent exemption write-offs can be reduced or even completely eliminated. Phase-out starts at the following adjusted gross income

(AGI) thresholds: $250,000 for single filers, $300,000 for married joint-filing couples, $275,000 for heads of households, and $150,000 for married individuals who file separate returns.

Itemized Deduction Phase-Out: The last time we saw a phase-out rule for itemized deductions was also in 2009. Unfortunately, this phase-our provision is back too. As a result, you can potentially lose up to 80% of your write-offs for mortgage interest, state and local income and property taxes, and charitable contributions if your AGI exceeds the applicable threshold. The thresholds are $250,000 for single filers, $300,000 for married joint-filing couples, $275,000 for heads of households, or $150,000 for married individuals who file separate returns. More specifically, the total amount of your affected itemized deductions is reduced by 3% of the amount by which your AGI exceeds the threshold. However, the reduction cannot exceed 80% of the total affected deductions that you started off with.

Key Point: All the aforementioned changes are permanent, so we at least have the illusion of tax-regime stability — until further notice.

Alternative Minimum Tax Patch Made Permanent

It had become an annual ritual for Congress to “patch” the AMT rules to prevent millions more households from getting socked with this add-on tax. The patch job consisted of allowing bigger AMT exemptions and allowing various personal tax credits to offset the AMT. Amazingly, the new law makes the patch permanent, starting with 2012. The change will keep about 30 million households out of the dreaded AMT zone.

Relatively Favorable Gift and Estate Tax Rules Made Permanent

For 2013 and beyond, the new law permanently installs a unified federal estate and gift tax exemption of $5 million (adjusted annually for inflation) and a 40% maximum tax rate (up from last year’s 35% rate). The right to leave your unused estate and gift tax exemption to your surviving spouse (the so-called exemption portability deal) was also made permanent.

Child Tax Credit Extended

The $1,000 maximum credit for each eligible under-age-17 child was extended through 2017.

Earned Income Tax Credit Extended

Legislation enacted in previous years increased the earned income credit for families with three or more qualifying children and allowed married joint-filing couples to earn more without having their credits reduced. These changes, which help lower-income families, were extended through 2017.

American Opportunity Higher Education Tax Credit Extended

The American Opportunity credit, which can be worth up to $2,500 and can be claimed for up to four years of undergraduate education, was extended through 2017.

Higher Education Tuition Deduction Extended

This write-off, which can amount to as much as $4,000 or $2,000 for higher-income folks, expired at the end of 2011. The new law retroactively restores it for 2012 and extends it through 2013.

Option to Deduct State and Local Sales Taxes Extended

In past years, individuals who paid little or no state income taxes were given the option of instead claiming an itemized deduction for state and local sales taxes. The option expired at the end of 2011, but the new law restoratively restores it for 2012 and extends it through 2013.

Charitable Donations from IRAs Extended

In past years, IRA owners who had reached age 70½ were allowed to make charitable donations of up to $100,000 directly out of their IRAs. The donations counted as IRA required minimum distributions. So charitably inclined seniors with more IRA money than they needed could reduce their taxes by arranging for IRA donations to take the place of taxable required minimum distributions. This break expired at the end of 2011, but the new law retroactively restores it for 2012 and extends it through 2013. To take advantage of the retroactive deal, you'll be given a window of time during the first part of this year to make donations that are treated as having been made in 2012. Stay tuned for details on that.

Tax-Free Treatment for Forgiven Principal Residence Mortgage Debt Extended

For federal income tax purposes, a forgiven debt generally counts as taxable cancellation of debt (COD) income. However a temporary exception applied to COD income from cancelled mortgage debt that was used to acquire a principal residence. Under the temporary rule, up to $2 million of COD income from principal residence acquisition debt that was cancelled in 2007-2012 was treated as a tax-free item. This generous break was extended through 2013.

$250 Deduction for K-12 Educators' Expenses Extended

The $250 deduction for teachers and other K-12 educators for school-related expenses paid out of their own pockets was retroactively restored for 2012 and extended through 2013.

$500 Energy-Efficient Home Improvement Credit Extended

In past years, taxpayers could claim a tax credit of up to $500 for certain energy-saving improvements to a principal residence. This break expired at the end of 2011, but the new law retroactively restores it for 2012 and extends it through 2013.