THE AMERICAN TAXPAYER RELIEF ACT OF 2012

OPPENHEIMER

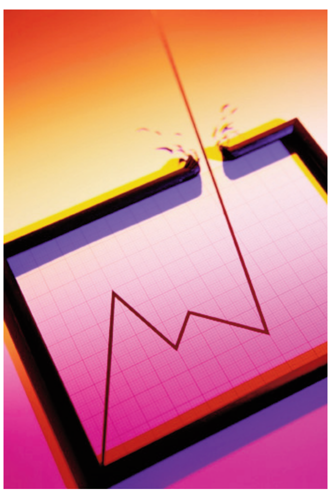
OPPENHEIMER

Ramifications of the American Taxpayer Relief Act of 2012 (ATRA)*

The American Taxpayer Relief Act of 2012 (ATRA), which was passed and signed into law early in January, has extended and made most of the Bush-era tax cuts permanent. Nevertheless, while solving some of the tax questions that have contributed to fierce political and public dialogue, ATRA has major ramifications for the U.S. economy. In addition, it only temporarily delays two major problems: the spending cuts, known as the "sequester," that are scheduled to take place across the board late in March; and lifting the U.S. debt ceiling to prevent default on the country's obligations.

**With the most recent changes made to the American Taxpayer Relief Act, this piece was created in early January 2013 to help provide some answers to questions that may arise regarding ATRA, as well as the fiscal cliff that may loom ahead for the next several months.*

Summary of Changes:



Income Tax Provisions

- **Tax Rates.** There will now be seven income tax rates: 10%, 15%, 25%, 28%, 33%, 35% plus the 39.6% rate, indexed for inflation, imposed at $400,000 for single filers, $425,000 for heads of households, $450,000 for joint filers and $225,000 for married taxpayers who file separately.
- **Capital Gains and Dividend Rates.** Taxpayers in the 39.6% bracket will see capital gains and qualified dividend rates increase to 20% from 15%. Taxpayers in the below-25% bracket will have zero tax, while those with tax rates of 25% to 35% will pay 15%. The 3.8% surtax on Net Investment Income (NII) applies only to taxpayers with net investment income and a modified adjusted gross income (MAGI) above $200,000 (filing singly), $250,000 (married filing jointly) and $125,000 (married filing separately).
- **Estate Tax:** Estate tax rates will increase to 40% from 35%. There is a unified estate and gift tax exemption of $5 million. It has no sunset provision and is expected to be permanent.
- **Phase-out of Itemized Deductions and Personal Exemptions.** These phaseouts take effect in 2013 at $300,000 for joint filers, $250,000 for single filers, $275,000 for heads of household and $150,000 for married filing separately.
- **Permanent Alternative Minimum Tax (AMT) Relief.** ATRA will permanently increase exemption amounts, indexed for inflation, to $50,600 for unmarried filers, $78,750 for joint filers and $39,375 for separate filers. Indexing the AMT prevents Congress from having annually to pass a "patch" on the AMT.
- **"Charitable IRA" Provisions.** The charitable IRA provisions for transfers of up to $100,000 tax-free to public charities have been reinstated for 2012 and 2013.
- **In-Plan Roth Conversions.** For tax years 2013 and later, an applicable retirement plan that includes a Roth contribution program can allow participants to elect to transfer amounts to their Roths as taxable qualified rollover contributions.
- **Business Tax Extenders.** For the years 2012 (just ended) and 2013, there will be an extension of certain expired and expiring business and individual tax provisions.

- **Payroll Tax Holiday.** The tax "holiday" in FICA (Social Security withholding) for 2010 to 2012 from 6.2% to 4.2% has expired. Wage earners have already seen an increase in their FICA withholding in 2013.

Transfer Tax Provisions

- **Exemption Amount.** The current $5,000,000 (indexed for inflation to $5,250,000 for 2013) applicable exclusion amount was scheduled to return to the pre-2001 level of $1,000,000. The $5,000,000 applicable exclusion is now permanent.
- **Transfer Tax Rate.** ATRA increased the top estate, gift, and generation skipping transfer tax rate from 35% to 40% for 2013 and later years, significantly below the scheduled increase to the pre-2001 level of 55%.
- **Spousal Portability.** Spousal portability provisions of TRA 2010, the "new" tax law passed in 2010, allow a surviving spouse to use the deceased spouse's exclusion, are permanent.
- **State Estate Tax Deduction.** The state estate tax deduction has been extended.

Other Provisions

- **Expiration of Social Security Tax "Holiday" Education Incentives.** The $2,000 Coverdell contribution limit has been made permanent. The above-the-line deduction for qualified tuition/ related expenses was extended for 2013.
- **Code Section 179 Small Business Expensing Deduction.** ATRA includes two years of extension (2012 and 2013) of certain provisions for business and individuals that have either expired or are expiring. These deductions, called "extenders," were covered by 2012 IRC §179 of the tax code.
- **Extension of Unemployment Benefits.** Unemployment benefits set to expire on December 31st have been extended into 2013.
- **Delay in "Sequestration" Spending Cuts Postponed Until March 1.** If such a bill fails to pass, the across-the-board funding cuts called the "sequester" or "sequestration" that ATRA postponed when it was passed will take effect on March 27.

Another Fiscal Cliff May Loom Ahead

ATRA has avoided the worst elements of the fiscal cliff. Nevertheless, we can expect turbulence in the political and economic environment for the next several months.

Below are listed the challenges that government funding faces in the coming month. Individually or separately, they pose different – and major – consequences to the operation of U.S. fiscal affairs.

Debt Limit Reached: According to outgoing Treasury Secretary Timothy Geithner, the federal government's $16.394 trillion statutory debt limit was reached on December 31, 2012. "Extraordinary measures" are now postponing the date by which the U.S. would otherwise default on its obligations. In his opinion, such measures can provide only about "two months of headroom" to meet the full faith and credit obligations of the government's debt service.

Sequestration Imposed: If the spending cuts issue is left unresolved, future discretionary spending – effective March 27 – will be cut by approximately $1 trillion over the next 10 years.

Government Funding Authorization: Preexisting law requires that the funding authority for federal departments and agencies will expire on March 27, 2013 (the same date that the sequestration, in the absence of a solution, will take effect). Unless policymakers pass additional government funding authorization before then, the U.S. faces the prospect that the government must shut down.

The chief problem with authorizing additional funding is that government spending is now up against the debt limit. The failure to reduce the deficit significantly during 2011 saw Standard & Poor's downgrade the U.S.'s sovereign credit rating for the first time ever. Although ATRA is likely to prevent the leading rating agencies from downgrading the U.S.'s full faith and credit rating, another contentious and unsatisfactory negotiation could very well cause the agencies to lower the U.S. rating by at least one notch or – if the government shuts down – declare a default.

Factional conflict is a major contributor to the risk of downgrade. Some congressional representatives might use the upcoming deadlines to attempt to impose cuts in Medicare and Social Security, or to use them as bargaining chips in securing other terms they want. Although these two entitlement programs were not included in the fiscal cliff bill, they are indeed core drivers of federal debt.

Another source of turbulence in funding authorization and/or reform is that concerns about the growth of debt and the state of the U.S. economy further down the road may motivate debate on overall tax reform. It is likely that the upcoming debates will be severe, with some congressional representatives arguing for a flat tax, while others demand dollar-for-dollar spending reductions at the very least for any rise in the debt ceiling. Conversely, President Obama is likely to attempt to gain additional revenues from higher-bracket taxpayers. At present, the Treasury Department calculates that it can make available funds last until around March 1.

Before ATRA was passed, some legislators and pundits spoke of allowing the economy to plunge over the fiscal cliff as a strategic move either to gain partisan objectives or to spur the previous congress into taking action. It is not unlikely that some voices may call for going over the March 27 fiscal "cliff," again in hopes of spurring massive change.

Should the government fall off the fiscal cliff this time, the threat of default could make consequences more severe than before ATRA passed. In this case, the rating agencies might see no recourse but to downgrade the U.S.'s sovereign rating, not just one notch but to C, the level for defaulted bonds. Then, even if the government could secure additional loans, interest rates would rise, consuming a greater proportion of these new loans, which would be used to pay debt service. The global aftershocks could be seismic, affecting economies and market psychology. Nations already in recession might remain so even longer, while recoveries would be postponed.

If, however, the debt ceiling is raised by approximately $1 trillion in return for a similar amount in expenditure cuts, the U.S. economy is likely to continue to grow slowly. Thus far, that has been favorable for the capital markets and hard goods. Housing prices have continued to rise, while foreclosures are decreasing. The U.S. auto industry is recovering, and unemployment – very slowly – is beginning to decline. Whether these trends continue, however, depends on a polarized and contentious government that very much needs to restore "compromise" to American political discourse.

Opportunities for Clients

With many questions unanswered regarding the U.S. economy, the most recent changes to ATRA; the increase in tax rates, makes tax-deferred products even more appealing. There are a number of products that can be used to help reduce the impact of increased taxes on individual income, dividends and capital gains. Annuities can be an important tool in offsetting tax burdens by providing tax deferred growth on the internal build up of annuity contact values. That build up would not be subject to taxes on capital gains or dividends until withdrawn.

Life insurance policies can also be utilized by creating assets to offset estate taxes, and the permanent extension of the estate tax exemption can provide piece of mind, knowing estate planning decisions will not be contingent on expiration dates. These solutions are just some of the numerous strategies that can be taken advantage of in order to lower the tax burden caused by ATRA.

Please contact us with questions:

Oppenheimer & Co. Inc.
85 Broad Street
New York, NY 10004
(212) 668-8000
(800) 221-5588

INS021913RM1