MADDOX THOMSON
& ASSOCIATES

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Dear Clients and Friends:

After months of starts and stops in negotiations between the White House and Congress, the brakes were applied before the country went over the tax side of the "Fiscal Cliff." Both the Senate and the House of Representatives rang in the New Year by voting on January 1, 2013, for The American Taxpayer Relief Act (the "Act") and the President followed by signing the Act into law on January 2, 2013.

The peculiar use of the word "Relief" in the Act reminded me of the late southern comedian and story-teller Jerry Clower and his coon hunting story. Jerry's friend John Eubanks, a "legendary" tree-climber would climb a tree to shake out the raccoon who had taken refuge from the dogs chasing it. On one particular coon hunt in southwestern Mississippi, John Eubanks climbed up the tree, and instead of a raccoon, he was staring in the face of a bobcat. As John attempted to ward off the bobcat, he implored Jerry and others to "shoot this thing." Jerry and his friends, of course, replied they could not see and were afraid to shoot. After several minutes of battling the bobcat in the tree, John yelled to his friends below, "Well, shoot up here amongst us; one of us needs relief!"

Let's look at the Act to see what "relief" was brought.

<u>2013 Ordinary Income Tax Rate</u>
First, the Bush-era income tax cuts were left in place for everyone except individuals with incomes over $400,000, and families with incomes over $450,000. The new increased income tax rate on these levels will now be at 39.6%. All of the other Bush-era graduated ordinary income tax rates (10%, 15%, 25%, 28%, 33 and 35%) were made permanent with the income thresholds indexed for inflation.

<u>2013 Long Term Capital Gains and Dividends</u>
If the Bush-era tax cuts had been allowed to expire on December 31, 2012, tax rates on dividends would have zoomed back to ordinary income tax rates as high as 39.6%. Similarly, long term capital gains tax rates would have been 20% for all taxpayers. The Act made permanent the tax treatment of qualified dividends and long term capital gains keeping the rate at 15% for taxpayers with income not subject to the top ordinary rate of 39.6%. For those taxpayers with income exceeding the thresholds ($400,000 for single filers and $450,000 for joint filers), the top rate for both qualifying dividends and long term capital gains is now at 20%.

2603 Augusta Drive
Suite 1400
Houston, Texas 77057
713.783.4242 main
713.783.4466 fax
maddoxthomson.com

Alternative Minimum Tax ("AMT")

As some of you may know and have experienced first-hand, the income tax laws impose a parallel tax known as AMT. First, one calculates his income tax under the "regular" method. Next, one calculates tax at almost a flat rate of 28% under the AMT rules and compares with the regular tax, and then pays the higher tax. While the AMT was originally passed in 1969 to apply to high income taxpayers employing tax strategies that eliminated or substantially reduced their income taxes, its tentacles had grown over the years. The AMT had exemptions and other variables that had not been permanently indexed for inflation requiring annual Congressional "patches." The Act now fixed the AMT exemption and other variables with permanent indexing. Without this action, Congress estimated that 34 million taxpayers (instead of 4 million) would have faced AMT in 2012.

Phase-Out of Itemized Deductions and Personal Exemptions

The Act revived limitations on deductions and exemptions that had previously been removed under the Bush-era tax cuts. Those taxpayers with incomes above certain thresholds ($300,000 for married couples and $250,000 for single unmarried filers) face the "Pease" Limitation and the Personal Exemption Phase-out ("PEP.") First, the Pease limitation, named after a Congressman who sponsored the original provision, operates to slash deductions by 3% of the excess of one's adjusted gross income ("AGI") over the appropriate threshold amounts up to 80%. In addition, PEP reduces the total amount of one's personal exemptions that he may claim by 2% for each $2,500 by which his AGI exceeds the appropriate threshold.

Payroll Taxes

For the years 2011 and 2012, Congress had lowered the Social Security tax rate for the employee share from 6.2% to 4.2%. The lowered rate was to expire at the end of 2012, and the Act did not extend the lower 4.2% rate to 2013. The result is an extra tax of $2,274 to each employee earning up to the Social Security wage base ($113,700 for 2013).

Cost Recovery

The Act extends increased expensing limitations through 2013 to $500,000. This ability to expense certain capital expenditures would have been $125,000 for 2012 and further reduced to $25,000 in 2013 without this provision of the Act.

Estate and Gift Tax and Generation Skipping Transfer Tax ("GSTT")

This area of the tax code could have seen drastic changes without the provisions of the Act. The current estate, and gift and GSTT exemption could have been reduced to $1,000,000 in 2013 from $5,120,000 in 2012. Instead the Act kept the exemption at inflation adjusted amounts of $5,250,000, but increased the estate, gift and GSTT tax rate to 40% from 35%. In 2013, the annual gift tax exclusion amounts per donee rises from $13,000 to $14,000.

<u>Other Considerations for 2013</u>

As discussed in an earlier letter, the Affordable Care Act ("ACA") will apply surtax rates in 2013. For Medicare, there will be a 0.9% Medicare surtax on wages and self-employment income over $200,000 for single filers and $250,000 for those married filing jointly. Also the ACA will exact a surtax of 3.8% on net investment income in 2013, for single taxpayers with modified AGI above $200,000 and married couples with modified AGI over $250,000. This surtax is levied on the smaller of one's net investment income or the excess of modified AGI over the applicable dollar threshold.

In watching recent Sunday morning news shows with White House officials and members of Congress, one realizes that further "fiscal cliff" issues may include further revenue discussion. Like Jerry Clower's friend John Eubanks, I think we can expect additional shots amongst us taxpayers to give "relief" as envisioned by the President and Congress.

All of us hope each of you has a healthy and prosperous 2013, and, as always if you have any questions, please call us.

Very truly yours,

Joseph W Thomson