



White Oaks

Wealth Management & Family Office Services

IDS Center
80 South 8th St
Suite 1725
Minneapolis MN 55402
www.whiteoakswealth.com

THE RETURN OF “PEASE”

By: [Nick Chimerakis](#), CPA, Sr. Planning & Tax Advisor

The passage of the American Taxpayer Relief Act of 2012 ushered in a variety of new and old tax provisions that impacted individuals and businesses. While most of the media attention centered on the tax rate compromise, forged between the Obama Administration and House Republicans, another provision of the bill went largely unnoticed by the American public – the permanent reinstatement of the personal exemption phase-out (PEP) and, perhaps more importantly, the limitation on itemized deductions (Pease). These “stealth taxes”, as they are commonly referred among tax practitioners, will effectively increase the marginal tax rate of certain taxpayers beginning in 2013. This article will provide an in-depth analysis of the Pease limitations, including an overview of the mechanics and its impact on other issues, such as charitable donations.



Legislative History and Mechanics

The Pease limitation was first implemented as part of the Omnibus Budget Reconciliation Act of 1990 and is named after former Congressman Donald Pease (D-OH), who introduced the legislation. The limitation reduces certain itemized deductions by 3% of the amount by which one’s adjusted gross income (AGI) exceeds a specified threshold. The law also states that itemized deductions cannot be reduced by more than 80% for any taxpayer. The itemized deductions subject to this limitation include taxes, mortgage interest expense, charitable contributions, and miscellaneous itemized deductions (investment advisory, attorney, and tax preparation fees). Investment interest expense, casualty losses, medical expenses, and gambling losses are not impacted.

The Pease limitations were phased out completely in 2010 under tax reform signed into law by President Bush, but beginning in 2013, will apply to married taxpayers earning AGI in excess of \$300,000 and unmarried taxpayers with AGI over \$250,000. These amounts will be indexed annually for inflation.

The impact of this new provision is designed to target high-income earners, and is perhaps best illustrated through an example. Let’s assume John and Jane Doe, who file a joint tax return, have AGI of \$750,000 in 2013. Their itemized deductions total \$50,000, broken down among the following categories:

- Taxes paid (income & real estate): \$30,000
- Mortgage interest: \$10,000
- Charitable donations: \$10,000

Using these facts, John and Jane Doe would only be able to deduct \$36,500 of their \$50,000 in itemized deductions, a 27% reduction ($\$750,000 - \$300,000 = \$450,000 \times 3\% = \$13,500$).

Many critics of the provision have argued that the law will reduce charitable donations since taxpayers will no longer receive full benefit for their contributions. The impact on John and Jane’s charitable donations is

calculated by multiplying the amount of the limitation (\$13,500) by the percentage that charitable contributions comprise of the total deductions ($\$10,000/\$50,000 = 20\%$) = \$2,700. Thus, the Pease limitation has reduced the charitable deduction to \$7,300, from \$10,000.

Planning for Pease

Although the planning strategies for coping with Pease are limited for high-income earners, there are a number of steps that taxpayers should take to mitigate the law's impact, including:

- Reducing AGI by maximizing deductible contributions to retirement plans or health savings accounts. The elective deferral limit for employees who participate in 401(k), 403(b), and most 457 plans is \$17,500 in 2013. Individuals aged 50 and over who participate in these plans can contribute an additional \$5,500.
- Lower mortgage debt by either refinancing your loan or paying it down. Also, if you are susceptible to alternative minimum tax (AMT) you should consider paying down home equity interest if the loan was not used to acquire or substantially improve your primary residence (this interest is not deductible for AMT purposes).
- Perform multi-year projections to optimize the value of your itemized deductions. For example, if your income was expected to be below the \$300,000 threshold in one year, you would be better served allocating your charitable donations to that year since the Pease limitations would not be present.

Looking Forward

Absent fundamental tax reform, the Pease limitations appear to be an entrenched component of the US tax code for the foreseeable future. Other proposals, including one to eliminate certain itemized deductions from the tax code altogether, continue to attract attention, but have not yet gained the widespread support necessary to move forward. If you would like White Oaks Wealth Advisors to help you assess and plan for the Pease limitations, please contact us at 612 455 6900.

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