



## TAX ACT OVERVIEW

### American Taxpayer Relief Act saves taxes for many, boosts them for some

*On Jan. 1, Congress passed the American Taxpayer Relief Act of 2012 (ATRA) to address the “fiscal cliff” — a combination of higher taxes and forced spending cuts scheduled to go into effect in 2013. Regarding the spending cuts, ATRA does little more than extend the deadline. What the act focuses on, as its name implies, is providing tax relief: It prevents income tax rate increases for all but approximately the top 2% of taxpayers. It also extends or makes permanent other income tax breaks for individuals and businesses and addresses the alternative minimum tax (AMT) and the estate tax.*

But ATRA doesn’t provide as much relief to higher-income taxpayers. While they’ll enjoy the benefits of the extended lower rates on a portion of their income, they’ll also see rate hikes on income that exceeds certain thresholds. If you’re affected, these hikes, combined with additional Medicare taxes that go into effect this year under the 2010 health care act, could cause you to face significantly higher taxes.

Here’s a closer look at ATRA’s most important changes for individuals and businesses, along with the implications for your 2012 tax return and your tax and estate planning for 2013 and beyond. Many provisions are subject to a variety of rules and limitations, so it’s important to discuss them with your tax advisor to determine exactly how they’ll affect you or your business.

#### Individuals

Most of ATRA’s provisions benefit individual taxpayers through extensions of lower tax rates, certain deductions

and credits, and more. However, the act allows tax increases to go into effect for higher-income taxpayers.

#### Ordinary-income tax rates

Before ATRA, ordinary-income tax rates (except for the 15% rate) had been scheduled to increase for 2013. The act makes 2012 rates permanent for most taxpayers. (See Chart 1 below.) But, beginning in 2013, taxpayers with taxable income that exceeds \$400,000 (singles), \$425,000 (heads of households) or \$450,000 (married couples filing jointly) will be subject to a returning marginal tax rate of 39.6% on taxable income in



Frost  
Rittenberg &  
Rothblatt PC

CPAs & Business Advisors

111 S. Pfingsten Road • Suite 300 • Deerfield, IL 60015  
847.236.1111 • [www.frrCPAs.com](http://www.frrCPAs.com)

**CHART 1** Ordinary-income tax rates increase for some

2012	2013 <sup>1</sup>
10%	10%
15%	15%
25%	25%
28%	28%
33%	33%
35%	35% or 39.6% <sup>2</sup>

<sup>1</sup> Under the 2010 health care act, an additional 0.9% Medicare tax applies to FICA wages and self-employment income exceeding \$200,000 (singles and heads of households) or \$250,000 (married couples filing jointly).

<sup>2</sup> The 39.6% rate applies to taxable income exceeding \$400,000 (singles), \$425,000 (heads of households) or \$450,000 (married couples filing jointly).

excess of the applicable threshold. These thresholds will be indexed for inflation in future years.

Because the tax rates are permanent, for 2013 you can employ the traditional timing strategies of accelerating deductible expenses into the current year and deferring income to the next year, where possible, to defer tax (assuming you don't expect to be in a higher tax bracket in 2014). If you're facing the 39.6% rate, however, you may want to see if there are additional strategies you can employ to help minimize the impact of the higher rate.

Capital gains tax rates

The 15% long-term capital gains rate had been scheduled to increase to 20% in 2013. ATRA makes the 15% rate permanent. However, it brings back the 20% rate for higher-income taxpayers. As with the 39.6% ordinary-income tax rate, the 20% rate kicks in when taxable income exceeds \$400,000 (singles), \$425,000 (heads of households) or \$450,000



(married filing jointly) — indexed for inflation in future years.

ATRA also makes permanent the 0% long-term gains rate for taxpayers in the bottom two brackets. If you have children or other loved ones in these brackets, consider transferring appreciated assets to them. They can sell the assets and pay no tax on the capital gain. You may find this strategy particularly powerful if you'd pay tax at the 20% rate if you sold the assets. But

before gifting any assets, if the recipients are under age 24, make sure they won't be subject to the "kiddie tax." And regardless of their age, consider the gift tax consequences.

Finally, be aware that different income tax rates apply to capital gains in some situations. (See Chart 2.) And if you're subject to the 39.6% ordinary-income tax rate, you'll pay more tax on short-term gains.

Qualified dividend tax rates

ATRA makes permanent the long-term capital gains treatment of qualified dividends. So most taxpayers will continue to enjoy a 15% rate (0% for those in the bottom two brackets). But taxpayers with taxable incomes exceeding the applicable income thresholds will face a rate increase from 15% to 20% on qualified dividends. Nevertheless, without ATRA, they would have paid a much higher rate, because dividends would have gone back to being taxed at ordinary-income rates in 2013, with a top rate of 39.6%.

If you hold dividend-producing investments and will face the 20% rate, consider whether you should make adjustments to your portfolio in light of their potentially higher tax cost. Keep in mind, however, that the tax treatment of qualified dividends, even if taxed at 20%, will remain more attractive than the treatment of many other income investments. For example, interest from CDs, money market accounts and taxable bonds will continue to be taxed at ordinary-income rates.

Exclusion on small business stock gains

To make investing in certain small businesses more attractive, previous legislation increased the qualified small business (QSB) stock gain exclusion to 100% for stock acquired after Sept. 27, 2010, and before Jan. 1, 2012, that's held for at least five years. ATRA extends the acquisition deadline for 100% gain exclusion to Dec. 31, 2013.

CHART 2	What's the maximum income tax rate on capital gains?	
Assets held	2012	2013 <sup>1</sup>
12 months or less ( <i>short term</i> )	35%	39.6% <sup>2</sup>
More than 12 months ( <i>long term</i> )	15%	20% <sup>2</sup>
Some key exceptions		
Long-term gain on collectibles, such as artwork and antiques	28%	28%
Long-term gain attributable to certain recapture of prior depreciation on real property	25%	25%
Gain on qualified small business stock held more than 5 years	14% <sup>3</sup>	14% <sup>3</sup>
Long-term gain that would be taxed at 15% or less based on the taxpayer's ordinary-income rate	0%	0%
<sup>1</sup> Under the 2010 health care act, a new 3.8% Medicare tax applies to net investment income to the extent that modified adjusted gross income (MAGI) exceeds \$200,000 (singles and heads of households) or \$250,000 (married couples filing jointly).		
<sup>2</sup> Rate increase over 2012 applies only to those with taxable income exceeding \$400,000 (singles), \$425,000 (heads of households) or \$450,000 (married couples filing jointly).		
<sup>3</sup> Effective rate based on 50% exclusion from a 28% rate.		

QSB stock can help diversify your portfolio while providing additional potential tax benefits. So purchasing it by the end of 2013 may be worth considering. (To be a QSB, the company can't hold gross assets exceeding \$50 million at the time the stock is issued and must be engaged in an active trade or business.)

## AMT

The AMT is a separate tax system that limits some deductions and credits, doesn't permit others and treats certain income items differently. If your AMT liability is greater than your regular tax liability, you must pay the AMT.

Before ATRA, unlike the regular tax system, the AMT system wasn't regularly adjusted for inflation. Instead, Congress had to legislate any adjustments. Typically, it did so in the form of a "patch" — an increase in the AMT exemption. And the last patch had expired Dec. 31, 2011. So millions more taxpayers could have been subject to the AMT for 2012.

ATRA makes the patch permanent by increasing the exemptions for 2012 and indexing them for inflation for future years. (See Chart 3 at right.) The act also makes permanent the ability to offset your AMT liability with certain nonrefundable personal credits (such as the dependent care credit and certain energy-related credits) you're otherwise eligible for.

### CHART 3 Exemption "patch" provides permanent AMT relief

AMT exemption		
	Single or head of household	Married filing jointly
Without patch	\$33,750	\$45,000
2012 patch	\$50,600	\$78,750
2013 patch	\$51,900	\$80,800

**Note:** Consult your tax advisor for AMT exemptions for children subject to the "kiddie tax."

You may be able to time income and deductions to avoid the AMT or reduce its impact. Now that AMT relief is permanent, much of the uncertainty involved in AMT planning has been eliminated, making such planning a little easier. Nevertheless, it is still far from simple. Talk to your tax advisor to determine the best strategy for your situation.

### Deduction for state and local sales taxes

For the last several years, taxpayers have been allowed to take an itemized deduction for state and local *sales* taxes in lieu of state and local *income* taxes. This break can be valuable to those residing in states with no or low income tax rates or who purchase major items, such as a car or boat. But this break expired Dec. 31, 2011.

Now ATRA extends it for 2012 and 2013. If you're contemplating a major purchase, you may want to make it in 2013 to ensure the sales tax deduction is available.

### Breaks related to children and education

Many child- and education-related breaks that had expired (generally Dec. 31, 2012) have been made permanent by ATRA, while others have been temporarily extended:

- The \$1,000 child credit and other enhancements of the credit have been made permanent.
- The higher adoption credit and income exclusion for employer-provided adoption assistance have been made permanent.
- The higher dependent care credit has been made permanent.





### Expanded Medicare taxes will hit more taxpayers than ATRA's income tax hikes

Under the 2010 health care act, an additional 0.9% Medicare tax on earned income and a new 3.8% Medicare tax on net investment income go into effect in 2013. The employee portion of Medicare taxes is normally 1.45%, and, previously, investment income wasn't subject to Medicare tax. The expanded Medicare taxes apply when income exceeds certain levels.

Taxpayers hit with higher income tax rates under ATRA will generally also face expanded Medicare taxes. Factoring together both income and Medicare taxes, these taxpayers could see a 5.5 percentage point tax increase on a portion of their earned income and an 8.8 percentage point tax increase on some or all of their long-term capital gains and qualified dividend income (8.4 percentage points on short-term gains, nonqualified dividends and taxable interest).

But some taxpayers who escape an income tax hike will still face a Medicare tax increase. This is because the thresholds for expanded Medicare taxes are much lower than those for the 39.6% ordinary-income tax rate and the 20% long-term capital gains rate. (See "Ordinary-income tax rates" and "Capital gains tax rates" on pages 1 and 2.)

The additional 0.9% Medicare tax applies to FICA wages and self-employment income exceeding \$200,000 (singles and heads of households) or \$250,000 (married couples filing jointly). The new 3.8% Medicare tax applies to net investment income to the extent that modified adjusted gross income (MAGI) exceeds \$200,000 (singles and heads of households) or \$250,000 (married couples filing jointly). ATRA did nothing to change these thresholds.

Taxpayers who could be affected by the expanded Medicare taxes need to keep them in mind — along with the relevant tax law changes under ATRA — in their tax planning.



- The American Opportunity education credit has been extended through 2017.
- The above-the-line tuition and fees deduction (expired Dec. 31, 2011) has been extended through 2013.
- The enhancements to the student loan interest deduction have been made permanent.
- The income exclusion for employer-provided education assistance has been made permanent.
- The \$2,000 Coverdell Education Savings Account (ESA) annual contribution limit, the ability to use tax-free ESA distributions for elementary and secondary school expenses, and other ESA enhancements have been made permanent.

Be aware that the benefit of many of these breaks is phased out if a taxpayer's income exceeds certain limits. Your tax advisor can help you determine which breaks you or your children may qualify for.

### Charitable giving breaks

ATRA extends some valuable charitable giving breaks through 2013. The breaks had expired Dec. 31, 2011, and the extensions are retroactive to Jan. 1, 2012:

#### 1. Tax-free IRA distributions for charitable purposes.

If you're age 70½ or older, you can make a direct contribution from your IRA to a qualified charitable organization without owing any income tax on the distribution. The contribution can be used to satisfy a required minimum distribution. The maximum allowable distribution for charitable contribution purposes is \$100,000 per tax year.

#### 2. Contributions of capital gains real property for conservation purposes.

You can make such a contribution and take a larger deduction than is allowed for most other capital gains property contributions. Specifically, your deduction for a contribution of capital gains real property for conservation purposes generally



can be up to 50% of your adjusted gross income (AGI) rather than the 30% of AGI limit that normally applies to contributions of capital gains property.

## Businesses

Because their income flows through to the owners' tax returns, entities such as partnerships, limited liability companies (LLCs) and S corporations will in a sense be affected by ATRA's changes to ordinary-income tax rates for individuals. So, if you're the owner of such an entity and will face the 39.6% rate, traditional income and deduction timing strategies may help you minimize the impact, or at least defer taxes.

You also may want to consider converting your business to a C corporation, because the top corporate rate remains at 35%. But there are many other tax and nontax consequences of a conversion, so it's important to discuss the impact with your tax advisor as well as your attorney before implementing such a change.

On the plus side, ATRA extends and enhances many breaks for businesses. In particular, it provides incentives for businesses to invest in assets, research and people.

### Bonus depreciation

ATRA extends 50% bonus depreciation — an additional first-year depreciation allowance — generally through 2013. (See Chart 4 for an overview of bonus depreciation's rise and fall.)

Qualified assets include *new* tangible property with a recovery period of 20 years or less (such as office furniture and equipment), off-the-shelf computer software, water utility property and qualified leasehold improvement property.

ATRA also extends the provision allowing corporations to accelerate certain credits in lieu of claiming bonus depreciation for qualified assets placed in service through Dec. 31, 2013 (Dec. 31, 2014, for certain long-lived and transportation property).

If you made asset purchases that might qualify for 50% bonus depreciation on your 2012 tax return, be sure to discuss them with your tax advisor. And if you're anticipating major asset purchases in the next year or two, you may want to time them so you can benefit from 50% bonus depreciation. But also consider whether you qualify for Section 179 expensing, which may provide a greater tax benefit.

### Sec. 179 expensing

Section 179 is another tax law provision that encourages investment. It allows smaller businesses to immediately write off the full price of qualifying asset purchases rather than depreciating them over several years. The deduction is reduced by \$1 for every \$1 of expenses in excess of a phase-out threshold, which is why the break primarily benefits smaller businesses. The expensing election can be claimed only to offset net income, not to reduce net income below zero.

Before ATRA, the Sec. 179 expensing limit for 2012 was \$125,000, with a phaseout threshold of \$500,000 — and these amounts were scheduled to drop to \$25,000 and \$200,000, respectively, for 2013. The act increases these amounts for assets placed in service in both years to \$500,000 and \$2 million, respectively (the same amounts that applied in 2010 and 2011).

If you're eligible for full Sec. 179 expensing, it may provide a greater benefit than bonus depreciation because it can allow you to deduct 100% of an asset

**CHART 4** Bonus depreciation's rise and fall

Qualified assets placed in service	Bonus depreciation
Jan. 1, 2010, through Sept. 8, 2010	50%
Sept. 9, 2010, through Dec. 31, 2011	100%
Jan. 1, 2012, through Dec. 31, 2013	50%
After Dec. 31, 2013	none

**Note:** Later deadlines apply to certain long-lived and transportation property.

### Many energy-related breaks have been extended

ATRA extends certain energy-related incentives. While most are typically applicable to either home builders or manufacturers of energy-efficient appliances, there are some that are more generally applicable.

Nonbusiness energy credits that had expired at the end of 2011 have been retroactively extended through 2013. The credit can be taken for 10% of the cost of 1) qualified energy efficiency improvements, and 2) residential energy property expenditures, with a lifetime credit limit of \$500 (\$200 for windows and skylights). So, if, for example, you weren't able to install energy-efficient windows and doors by the Dec. 31, 2011, deadline you may still be able to get a tax credit.



acquisition's cost. Plus, only Sec. 179 expensing is available for *used* property. However, bonus depreciation may benefit more taxpayers than Sec. 179 expensing, because it isn't subject to any asset purchase limit or net income requirement. You'll also want to consider state tax consequences.

### Leasehold-improvement, restaurant and retail-improvement property

For 2009 through 2011, accelerated depreciation was available for qualified leasehold-improvement, restaurant and retail-improvement property. ATRA extends it to 2012 and 2013. Specifically, the provision allows a shortened recovery period of 15 years — rather than 39 years — for such property.

If you made asset purchases that might qualify for accelerated depreciation on your 2012 tax return, be sure to discuss them with your tax advisor. And if you're considering making such investments, you may want to do so in 2013 to ensure you can take advantage of this break if it's not extended again.

### Research credit

For many years, the research credit (also commonly referred to as the "research and development" or "research and experimentation" credit) has provided an incentive for businesses to increase their investments in research. But the credit expired at the end of 2011.

ATRA extends the credit to 2012 and 2013. The credit is generally equal to a portion of qualified research expenses. It's complicated to calculate, but the tax savings can be substantial. So consult your tax advisor.

### Work Opportunity credit

The Work Opportunity credit, designed to encourage hiring from certain disadvantaged groups, expired Dec. 31, 2011, for most groups. An expanded credit for qualifying veterans expired Dec. 31, 2012. ATRA extends the credit for most eligible groups through 2013.

Examples of disadvantaged groups for purposes of the credit include food stamp recipients, ex-felons and nondisabled veterans who've been unemployed for four weeks or more, but less than six months.

For these groups, the credit generally equals 40% of the first \$6,000 of wages paid to qualifying employees, for a maximum credit of \$2,400. A larger credit of up to \$4,800 is generally available for hiring disabled veterans. And, if you're hiring veterans who've been unemployed for six months or more in the preceding year, the maximum credits are even greater:

- \$5,600 for *nondisabled* veterans, and
- \$9,600 for disabled veterans.

If you're considering making new hires, and workers from one or more of these disadvantaged groups might meet your needs, making the hires before the end of 2013 may be beneficial from a tax perspective. And be sure to check with your tax advisor to see if you qualify for the credit on your 2012 tax return.

### Transit benefits

Some fringe benefits aren't included in an employee's wages for income and payroll tax purposes, yet the employer is still allowed to deduct them. Generally, the maximum transit benefit that could receive such treatment has been higher for parking than for van-pooling and mass transit.

Tax legislation in 2009, however, provided for the limits to be equal through 2010. Legislation in 2010 extended this parity through 2011. ATRA has extended it through 2013. For 2012 and 2013, the limits are both now \$240 per month, though there's been some discussion about increasing the 2013 amount. (Check with your tax advisor for the latest information.) If you offer transit benefits, keep parity in mind for your 2013 program.

### Other breaks

ATRA also extends many other business breaks that had expired Dec. 31, 2011. These breaks are too limited in applicability to cover here, but they can provide significant benefits to the taxpayers that qualify for them. Talk to your tax advisor to learn which breaks may apply to you.

## Estate planning

On the estate planning front, ATRA provides substantial relief compared to what would have occurred in 2013 without the act. However, it increases the estate tax rate compared to the 2012 estate tax law regime.

### Exemptions and rates

Without congressional action, gift, estate and generation-skipping transfer tax exemptions would have dropped precipitously (by more than \$4 million) and the top rates would have jumped significantly (by 20 percentage points) beginning in 2013. ATRA increases transfer taxes for some families, but much less dramatically. The act retains the 2012 exemptions (indexed for inflation) and increases the top rates by five percentage points. (See Chart 5 at right.)

The changes are permanent, which, despite the rate increases, will be welcome news to many taxpayers. The

CHART 5      Transfer taxes increase for some families		
	2012	2013
Gift tax exemption	\$5.12 million	\$5.25 million
Estate tax exemption <sup>1</sup>	\$5.12 million	\$5.25 million
Generation-skipping transfer (GST) tax exemption	\$5.12 million	\$5.25 million
Highest gift and estate tax rates and GST tax rate	35%	40%
<sup>1</sup> Less any gift tax exemption already used during life.		

exemptions remain at an all-time high level and will keep up with inflation for future years. This means that, even if you used up your exemptions in 2012 to lock them in, you'll still have some more exemption available in future years. In addition, the top rate, though higher than it was in 2012, is still quite low historically.

It's important to review your estate plan in light of these changes. Doing so will allow you to make the most of

available exemptions and ensure your assets will be distributed according to your wishes. Without a review, it's possible the exemption and rate changes could have unintended consequences on your estate plan.

### Exemption portability

Legislation in 2010 included a provision that — temporarily — provided significant estate planning flexibility to married couples. If one spouse died in 2011 or 2012 and part (or all) of his or her estate tax exemption was unused at his or her death, the estate could elect to permit the surviving spouse to use the deceased spouse's remaining estate tax exemption.

This relief was somewhat hollow in most cases, however, because it applied only if the surviving spouse made gifts using the exemption or died by the end of 2012. ATRA has made the portability provision permanent.

Making asset transfers between spouses during life and/or setting up certain trusts at death can produce similar results to portability. But making the portability election is much simpler and provides flexibility if sufficient planning hasn't been done before the first spouse's death.

Still, using lifetime asset transfers and trusts can provide benefits that exemption portability doesn't offer. For example, portability doesn't protect future growth on assets from estate tax as effectively as applying the exemption to a credit shelter trust does.

### Increased tax law certainty makes estate planning a little easier

One of the most beneficial aspects of ATRA's estate tax provisions is their permanence. For more than a decade, much uncertainty due to expiring exemptions and rates had made estate planning a challenge. The fact that rates, exemptions and other estate-tax-related breaks under the act won't expire will make it easier to determine how to make the most of your exemptions and keep taxes to a minimum while achieving your other estate planning goals.

Of course, just because the provisions don't expire doesn't mean legislation couldn't be signed into law in the future that would change exemptions, rates or breaks — or even repeal the estate tax. There are still many who support an estate tax repeal. But a repeal is probably unlikely for at least the next four years, given the current balance of power in Washington and concerns about deficit reduction. Nevertheless, it's always a good idea to build flexibility into an estate plan that will allow it to adapt to changing circumstances.

Also bear in mind that the state estate tax continues to be a consideration. If you live in a state with an estate tax, the exemption amount could be dramatically different from the federal exemption amount. Improper planning could lead to an unpleasant surprise in the form of significant state estate tax liability. Further complicating matters is that, even if your state doesn't have an estate tax, it's possible you may be subject to estate tax in other states in which you own property.



Also be aware that the provision doesn't allow the deceased spouse's remaining GST tax exemption to be used by the surviving spouse. In addition, some states don't recognize exemption portability.

### Other provisions

ATRA preserves several other provisions that affect estate planning, including:

- The federal estate tax deduction (rather than a credit) for state estate taxes paid,
- Deferral and installment payment of estate taxes attributable to qualified closely held business interests, and
- GST tax protections, including deemed and retroactive allocation of GST tax exemptions, relief for late allocations, and the ability to sever trusts for GST tax purposes.

Certain income tax provisions can also be beneficial for estate planning purposes. For example, ATRA makes it easier to convert an existing traditional 401(k), 403(b) or 457(b) account into a Roth account. Roth accounts can be attractive from an estate planning perspective because they don't require you to take distributions during your life, allowing you to let the entire balance grow tax-free over your lifetime for the benefit of your heirs.

## Tax planning must be ongoing

The changes under ATRA affect many areas of planning and will result in tax increases for higher-income taxpayers. Complicating matters is the fact that higher rates and limits on breaks go into effect at different income levels, depending on the type of tax or break.

There also are recently expired breaks that haven't been extended by ATRA — see "2 valuable breaks ATRA *doesn't* extend" at right. In addition, tax reform

is on the agenda for 2013. It may be unlikely that tax reform will change tax law for 2013, but even changes effective in future years can have a significant impact on what the best tax planning strategies are for the current year.

Changes in your personal situation may also require a change in tax planning strategies. Births, deaths, marriages

and divorces can all have an impact. So can changes in your personal finances or your business.

So to ensure that you minimize your tax liability, your tax planning needs to be an ongoing activity, not just a year end one. Consult your tax advisor about how ATRA and other changes affect your planning. ▀

### 2 valuable breaks ATRA *doesn't* extend

**1. Payroll tax relief.** For 2011 and 2012 the employee portion of the Social Security tax on earned income was temporarily reduced from 6.2% to 4.2% as a stimulus measure. Similarly, the rate for the self-employed was reduced from 12.4% to 10.4%. ATRA doesn't extend this relief, so taxpayers will see a two percentage point Social Security tax increase on earned income up to the Social Security wage base (\$113,700 in 2013) in 2013 and beyond.

**2. Elimination of the itemized deduction reduction and personal exemption phaseout.** Legislation in 2001 reduced the adjusted gross income (AGI)-based reduction on itemized deductions and phaseout of personal exemptions for 2006 through 2009 and eliminated them for 2010. Legislation in 2010 extended this elimination through 2012.

ATRA allows both limits to return in 2013, and sets thresholds for them of \$250,000 (singles), \$275,000 (heads of households) and \$300,000 (married filing jointly). This actually provides some tax savings over what would have occurred without the act, because the 2013 thresholds would have been significantly lower. For future years, the thresholds will be indexed for inflation.



The itemized deduction limitation reduces otherwise allowable deductions by 3% of the amount by which a taxpayer's AGI exceeds the applicable threshold (not to exceed 80% of otherwise allowable deductions). It doesn't apply, however, to deductions for medical expenses, investment interest, or casualty, theft or wagering losses.

The personal exemption phaseout reduces exemptions by 2% for each \$2,500 (or portion thereof) by which a taxpayer's AGI exceeds the applicable threshold (2% of each \$1,250 for married taxpayers filing separately).