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Tax & Employee Benefits Focus

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Cliff Notes on Recent Tax Changes

Background

On January 2, President Obama signed into law the American Taxpayer Relief Act of 2012 (the Act), which permanently retains many provisions of the 2001 and 2003 Bush tax cuts with some modifications, but also allows some cuts to expire for higher-income taxpayers. The Act also extends or reinstates a number of expiring or expired energy credits and business tax credits and deductions. Most provisions of the Act are effective for tax years beginning in 2013, but some provisions retroactively apply to 2012 tax years. The Bush tax cut provisions are now “permanent” in that they are no longer subject to sunset provisions. The following is a brief summary of the key provisions of the Act and other new tax laws in effect for 2013.

Tax Rates

Ordinary Income Tax Rates. The Act permanently retains the 10%, 15%, 25%, 28%, 33%, and 35% brackets on ordinary income for individual taxpayers. However, the Act reinstates the 39.6% bracket for taxable income exceeding an inflation-adjusted threshold (for 2013, $450,000 if married filing jointly and $400,000 if unmarried). The 35% bracket will be relatively narrow compared to other brackets, especially for unmarried taxpayers. When the IRS releases the inflation adjustments for 2013, the tax brackets on ordinary income are projected to be as follows:

Tax Brackets				Rate
Unmarried Filers		Married Joint Filers		
Over	But Not Over	Over	But Not Over	
$ 0	$ 8,925	$ 0	$ 17,850	10%
8,925	36,250	17,850	72,500	15%
36,250	87,850	72,500	146,400	25%
87,850	183,250	146,400	223,050	28%
183,250	398,350	223,050	398,350	33%
398,350	400,000	398,350	450,000	35%
400,000	. . .	450,000	. . .	39.6%

As set forth below, the new 3.8% Medicare tax also applies to certain types of investment income, thereby increasing the effective tax rate on ordinary income for certain higher-income taxpayers who have investment income. In addition, the 0.9% additional Medicare tax on the wages and self-employment income of higher-income taxpayers also increases effective rates, as discussed below.

Long-Term Capital Gain Tax Rates. From 2003 through 2012, the maximum rate on long-term capital gain was 15%. Under the Act, the maximum rate for 2013 and beyond reverts to 20% for taxpayers whose income exceeds the threshold set forth above for the 39.6% ordinary income bracket. For taxpayers who do not exceed this threshold, the maximum long-term capital gain rate will continue to be 15%. Taxpayers in the 10% and

15% ordinary income tax brackets will continue to pay no tax on long-term capital gain. Additionally, the 3.8% Medicare tax discussed below increases the effective tax rates on long-term capital gain to 18.8% and 23.8% for certain higher-income taxpayers.

Planning Strategies. Individuals who sold a business in 2012 should consider electing out of the installment method if they will receive installment payments relating to the sale in 2013 and beyond. Electing out of the installment method will require the individual to recognize all of the gain in 2012, but will lock in lower 2012 tax rates. If an individual does not elect out of the installment method, he or she will recognize gain when installment payments are received, but the gain could be subject to higher capital gain tax rates and the new 3.8% Medicare tax, discussed below.

Qualified Dividend Income Tax Rates. Under the Act, dividend income from U.S. corporations and certain foreign corporations (qualified dividend income) will continue to be taxed at long-term capital gain rates (0%, 15%, or 20%, depending on the taxpayer's ordinary income bracket). Additionally, the 3.8% Medicare tax discussed below increases the effective tax rates on qualified dividend income to 18.8% and 23.8% for certain higher-income taxpayers.

Payroll and Self-Employment Tax Rates. Congress allowed the so-called payroll tax holiday to expire, such that an employee's share of the Social Security payroll tax reverts to 6.2% instead of 4.2% of wages. Similarly, the Social Security component of the self-employment tax rate reverts to 12.4% instead of 10.4% of self-employment income. The Social Security component of both the payroll tax and the self-employment tax applies to wages or self-employment income up to the inflation-adjusted wage base, which is $113,700 for 2013.

Furthermore, a new "additional Medicare tax" of 0.9% applies to a taxpayer's wages and self-employment income in excess of an inflation-adjusted threshold (for 2013, $250,000 if married filing jointly and $200,000 if unmarried). This provision was enacted as part of the 2010 Patient Protection and Affordable Care Act (PPACA). Employers are now required to withhold the additional Medicare tax on wages exceeding $200,000. Similarly, self-employed individuals are required to include the additional Medicare tax in their estimated tax payments.

New Medicare Tax on Net Investment Income. The Act does not affect the imposition of a new 3.8% Medicare tax on net investment income, which was also enacted as part of the PPACA. This tax now applies to the net investment income of certain individuals, trusts, and estates. For individuals, the tax is imposed on the lesser of the individual's net investment income or the amount by which the individual's modified adjusted gross income (AGI) exceeds certain thresholds (for 2013, $250,000 if married filing jointly and $200,000 if unmarried). For purposes of this tax, investment income includes capital gains, interest, dividends, income from trades or businesses that are passive activities or that trade in financial instruments and commodities, and net gains from the disposition of property held in a trade or business that is a passive activity or that trades in financial instruments and commodities. Investment income excludes tax-exempt interest, distributions from qualified retirement plans, and any items that are taken into account for self-employment tax purposes.

Planning Strategies. Proposed regulations, which are not yet effective but may be relied upon, allow taxpayers a "fresh start" to redetermine passive activity groupings in the first year that the Medicare tax is applicable to the taxpayer. Taxpayers who are subject to the tax should consider regrouping their activities to become active rather than passive in the activity if doing so would avoid the imposition of this tax. However, regrouping activities to make the taxpayer active may trigger other unintended consequences under other provisions of the tax code, such as causing a profitable activity to be active rather than passive for purposes of the passive loss rules. Taxpayers should consult with their tax adviser to discuss regrouping and other strategies to avoid the imposition of this tax.

Estate, Gift, and Generation-Skipping Transfer Tax Rates. The Act increases the maximum estate and gift tax rate from 35% to 40%. The tax applies to all cumulative gift transfers and taxable estates in excess of the exemption amount. The Act does not affect the gift and estate tax exemption amount, which remains an inflation-adjusted amount that was $5.12 million in 2012. The generation-skipping transfer (GST) tax exemption remains equal to the estate and gift tax exemption, to be adjusted by inflation, and the maximum GST tax rate has also increased from 35% to 40%.

Estate and Gift Tax Exemption Portability Election

The Act also preserves the portability election, which allows a surviving spouse to utilize any unused estate and gift tax exemption of the deceased spouse at death. To make the portability election, a United States Estate (and Generation-Skipping Transfer) Tax Return (Form 706) must be filed for the deceased spouse.

Phaseout in Itemized Deductions and Personal Exemptions

For 2010 through 2012 tax years, itemized deductions were not phased out if the taxpayer's AGI exceeded certain threshold amounts. The Act restores an overall limitation on itemized deductions for taxpayers whose AGI exceeds an inflation-adjusted threshold amount (for 2013, $300,000 if married filing jointly and $250,000 if unmarried). Most itemized deductions, except deductions for medical and dental expenses, investment interest, and casualty and theft losses, are reduced by the lesser of (i) 3% of AGI above the threshold, or (ii) 80% of the amount of itemized deductions otherwise allowable. Personal exemptions are also phased out for taxpayers whose AGI exceeds the thresholds described above for itemized deductions.

Alternative Minimum Tax Relief

The Act permanently "patches" the alternative minimum tax (AMT) for 2012 and subsequent tax years by retaining higher exemption amounts, eliminating the need for Congress to annually vote on an AMT patch. The Act establishes an increased inflation-adjusted exemption amount for all taxpayers, meaning that fewer taxpayers will be subject to AMT. In addition, the Act allows nonrefundable personal credits to be applied against a taxpayer's AMT liability.

Tax-Free Distributions from IRAs to Charities

Under prior law, a taxpayer age 70½ or older could make tax-free IRA distributions of up to $100,000 directly to an eligible charity (a qualified charitable distribution). This provision originally expired at the end of 2011, but the Act retroactively extends this provision to 2012 and through the end of 2013. Additionally, a taxpayer can make a qualified charitable distribution in January of 2013 and treat the distribution as having been made in 2012. Furthermore, the Act permits a taxpayer who received an IRA distribution in December of 2012 to treat all or part of that distribution, up to $100,000, as a qualified charitable distribution to the extent that the taxpayer makes a contribution to an eligible charity prior to February 1, 2013.

Planning Strategies. Action must be taken in January of 2013 to take advantage of the recharacterization options described above. Individuals who have reached the limit for deducting charitable contributions have an incentive to make qualified charitable distributions from their IRA, since these distributions are not subject to charitable contribution limits. In addition, because qualified charitable distributions are excluded from income, they do not increase an individual's AGI, which could benefit the individual under other tax code provisions, such as determining whether itemized deductions and personal exemptions are phased out, whether Social Security benefits are taxable, or whether the individual is subject to the 3.8% Medicare tax.

Expanded Opportunity for Roth Conversions

In the case of an employer that offers both traditional (pre-tax) and Roth (after-tax) 401(k) accounts under its retirement plan, the employer may now give employees the option to convert all or part of the employee's traditional 401(k) account into a Roth 401(k) account. The amount converted is taxed as ordinary income but is not subject to the 10% early distribution penalty.

Reduced Built-in Gains Tax Recognition Period for S Corporations

Businesses that have converted from a C corporation to an S corporation are potentially subject to a corporate-level 35% built-in gains tax (BIG tax) upon the disposition of their assets to the extent that the aggregate fair market value of the assets exceeded the aggregate basis of such assets on the conversion date. The BIG tax is applicable only during a limited recognition period that begins on the first day of the tax year in which the conversion occurred. The recognition period was five years for 2011 tax years and ten years for 2012 tax years. However, the Act retroactively continues the five-year recognition period for 2012 and 2013 tax years. For tax years after 2013, the recognition period reverts to ten years.

Planning Strategies. For S corporations, this retroactive change for 2012 tax years means that some sales that were apparently subject to the BIG tax last year may not actually be subject to the BIG tax, provided that the five-year recognition period has expired. Business owners who sold S corporation assets last year should redetermine whether the sale is subject to the BIG tax, taking into account this retroactive relief provision.

The parties to a 2012 S corporation stock sale may want to renegotiate whether to make a section 338(h)(10) election if the deemed asset sale would not be subject to the BIG tax due to this relief provision. The election generally must be made by the 15th day of the 9th month after the transaction. A section 338(h)(10) election allows the parties to treat the transaction as a deemed asset sale for tax purposes (even though the transaction is a stock sale for corporate law purposes), which provides the buyer with the benefit of a stepped-up tax basis in the purchased assets. Asset sale treatment could provide significant tax savings to the buyer, meaning that buyers may be willing to pay additional consideration to the seller if the seller agrees to elect section 338(h)(10) treatment.

Furthermore, business owners who are considering a sale of their S corporation's assets in the near future should take into consideration that a 2013 sale might not be subject to the BIG tax, while a sale after 2013 could once again be subject to BIG tax if the ten-year recognition period has not expired at that time.

Gain Exclusion for Qualified Small Business Stock

Taxpayers can exclude from their income all or part of the gain realized from selling stock of certain qualified C corporations that the taxpayer held for more than five years. The percentage of gain that may be excluded depends on when the stock was acquired. To qualify, the stock must be acquired at original issue and the business must meet certain requirements regarding the amount of its assets and must be active in certain specified lines of business. The Act retroactively extends the 100% gain exclusion for stock acquired after September 27, 2010 and before January 1, 2014. The amount of gain excluded under this provision is not treated as a preference item for AMT purposes.

Planning Strategies. Individuals who are forming a new entity should give additional consideration to structuring the new business as a C corporation to take advantage of the gain exclusion if the new business meets the statutory requirements. This gain exclusion, when coupled with the fact that the maximum corporate tax rate (currently 35%) is now lower than the maximum individual tax rate, may make C corporations more desirable than flow-through entities such as LLCs or S corporations in certain cases. However, individuals should consult with their tax adviser before forming a new entity, as no single factor such as this gain exclusion should control the choice of entity decision.

Section 179 Expensing and Bonus Depreciation

Taxpayers may elect to expense certain depreciable business assets such as machinery, equipment, computer software, and certain other tangible personal property (Section 179 assets) in the year the assets are placed into service rather than capitalize and depreciate the cost over time. The maximum amount that may be deducted cannot exceed a specified expense limitation, which is reduced dollar-for-dollar by the amount of Section 179 assets placed into service exceeding an "investment ceiling." The Act retroactively extends the $500,000 expense limitation to 2012 and 2013 tax years. For tax years beginning after 2013, the expense limitation will be reduced to $25,000. The investment ceiling is retroactively increased to $2 million for 2012 and 2013 tax years, after which it will be reduced to $200,000.

The Act also extends the 50% first-year bonus depreciation deduction applicable to qualified property placed into service before January 1, 2014. Qualified property includes, among other things, computer software, certain leasehold improvements, and property with recovery periods of 20 years or less.

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