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TAX AND BUSINESS Alert™

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American Taxpayer Relief Act of 2012

After a great deal of wrangling, Congress passed and the President signed the American Taxpayer Relief Act of 2012 (Act) in early 2013. The Act provides relief for most taxpayers, but will increase the tax bill for high-income folks. The Act includes, among other items, permanent extension of the Bush-era tax cuts for most taxpayers; revised tax rates on ordinary and capital gain income for high-income individuals; modification of the estate tax; permanent fix of the AMT for individual taxpayers; limits on deductions and exemptions of high-income individuals; and numerous retroactively reinstated and extended tax breaks for individuals and businesses. In this article we will discuss several of the Act's provisions impacting individual taxpayers. Business provisions are discussed on page 3.

Tax rates on ordinary income. For tax years beginning after 2012, the 10%, 15%, 25%, 28%, 33%, and 35% tax brackets from the Bush tax cuts will remain in place and are made permanent. This means that, for most Americans, the tax rates on ordinary income will stay the same. However, there will be a new 39.6% rate, which will begin at the following inflation-adjusted thresholds: $400,000 (single), $425,000 (head of household), $450,000 (joint filers and qualifying widows and widowers), and $225,000 (married filing separately).

Estate tax. The new law prevents steep increases in estate, gift, and generation-skipping transfer (GST) taxes that were slated to occur for individuals dying and gifts made after 2012 by permanently keeping the exemption level at $5,000,000 (as indexed for inflation; $5,250,000 in 2013). However, the new law also permanently increases the top estate, gift, and GST rate from 35% to 40%. It also continues the portability feature that allows the estate of the first spouse to die to transfer his or her unused exclusion to the surviving spouse.


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Capital gains and qualified dividends rates. The new law retains the 0% tax rate on long-term capital gains and qualified dividends, modifies the 15% rate, and establishes a new 20% rate. Beginning in 2013, the rate will be 0% if ordinary income falls below the 25% tax bracket; 15% if income falls at or above the 25% tax bracket but below the new 39.6% rate; and 20% if income falls in the 39.6% tax bracket. It should be noted that some taxpayers in the 15% and 20% tax brackets could also be required to pay the new 3.8% surtax on investment-type income and gains for tax years beginning after 2012, which applies on investment income

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2012 American Taxpayer Relief Act

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of taxpayers with modified adjusted gross income above $250,000 (joint filers), $125,000 (separate), and $200,000 (others).

Personal exemption phase-out. Beginning in 2013, personal exemptions will be phased out (i.e., reduced) for adjusted gross income over $250,000 (single), $275,000 (head of household), and $300,000 (joint filers). Taxpayers claim exemptions for themselves, their spouses and their dependents. For 2013, each exemption is worth $3,900.

Itemized deduction limitation. Beginning in 2013, itemized deductions will be limited for taxpayers with an adjusted gross income over $250,000 (single), $275,000 (head of household), and $300,000 (joint filers).

AMT relief. The new law provides permanent, inflation-adjusted alternative minimum tax (AMT) relief. Prior to the Act, the individual AMT exemption amounts for 2012 were to have been $33,750 for unmarried taxpayers, $45,000 for joint filers, and $22,500 for married persons filing separately. Retroactively effective for tax years beginning after 2011, the new law permanently increases these exemption amounts to $50,600 for unmarried taxpayers, $78,750 for joint filers, and $39,375 for married persons filing separately. In addition, for tax years beginning after 2012, it indexes these exemption amounts for inflation.

Tax credits for low- to middle-wage earners. The new law extends for five years the following items that were originally enacted as part of the 2009 stimulus package and were slated to expire at the end of 2012: (1) the American Opportunity tax credit, which provides up to $2,500 in tax credits for undergraduate college education; (2) eased rules for qualifying for the refundable child credit; and (3) various earned income tax credit (EITC) changes.

Tax break extenders. Many of the "traditional" tax extenders are extended for two years, retroactively to 2012 and through the end of 2013. Among many others, the extended provisions include the election to take an itemized deduction for state and local general sales taxes in lieu of the itemized deduction for state and local income taxes, $250 above-the-line deduction for certain expenses of elementary and secondary school teachers, special rule for contributions made for conservation purposes, above-the-line deduction for qualified tuition and related expenses, and limited tax-free distributions from individual retirement plans for charitable purposes (see page 4).

Payroll tax cut. The 2% payroll tax cut available in 2011 and 2012 was allowed to expire.

New Roth IRA Conversion Option

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A provision in the recently enacted 2012 American Taxpayer Relief Act permits an individual to convert any portion of their balance in an employer-sponsored tax-deferred retirement plan account into a Roth IRA account under that plan. This conversion option for retirement plans is only available if employer plan sponsors include this feature (i.e., in-plan Roth) in the plan. Prior to the Act, only eligible retirement plan distributions could be rolled over to an in-plan Roth IRA.

The catch under the new Roth conversion provision is that the conversion will be fully taxed, assuming the conversion is being made with pre-tax dollars (money that wasn't taxed to an employee when contributed to the qualified employer-sponsored retirement plan). The taxable amount will also include the earnings on those pre-tax dollars.

The provision is effective for post-2012 transfers, in tax years ending after December 31, 2012.

Business Provisions of the New Tax Act

The recently enacted 2012 American Taxpayer Relief Act includes a wide-ranging assortment of tax changes affecting both individuals and businesses. On the business side, two of the most significant changes provide incentives to invest in machinery and equipment by allowing for faster cost recovery of business property. Here are the details.

Enhanced small business expensing (Section 179 expensing). Generally, the cost of property placed in service in a trade or business can't be deducted in the year it's placed in service if the property will be useful beyond the year. Instead, the cost is "capitalized" and depreciation deductions are allowed for most property (other than land), but are spread out over a period of years. However, to help small businesses quickly recover the cost of capital outlays, small business taxpayers can elect to write off these expenditures in the year they are made instead of recovering them through depreciation. The expense election is made available, on a tax-year-by-tax-year basis, under Section 179 of the Internal Revenue Code, and is often referred to as the "Section 179 election" or the "Code Section 179 election." The new law makes three important changes to this expense election.

First, the new law provides that for tax years beginning in 2012 or 2013, a taxpayer will be allowed to write off up to $500,000 of capital expenditures subject to a phase-out (i.e., gradual reduction) once capital expenditures exceed $2 million. For tax years beginning after 2013, the maximum expensing amount will drop to $25,000 and the phase-out level will drop to $200,000.

Second, the new law extends the rule that treats off-the-shelf computer software as qualifying property through 2013.

Finally, the new law extends through 2013 the provision permitting a taxpayer to amend or irrevocably revoke an election for a tax year under IRC Sec. 179 without IRS consent.

Extension of additional first-year depreciation. Businesses are allowed to deduct the cost of capital expenditures over time according to depreciation schedules. In previous legislation, Congress allowed businesses to more rapidly deduct capital expenditures of most new tangible personal property, and certain other new property, by permitting an additional first-year write-off of the cost. For qualified property acquired and placed in service after December 31, 2011, and before January 1, 2013 (before January 1, 2014, for certain longer-lived and transportation property), the additional first-year depreciation was 50% of the cost. The new law extends this additional first-year depreciation for investments placed in service before January 1, 2014 (before January 1, 2015, for certain longer-lived and transportation property).

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The new law also extends for one year the election to accelerate the AMT credit instead of claiming additional first-year depreciation for certain corporate taxpayers.

The new law leaves in place the existing rules as to what kinds of property qualify for additional first-year depreciation. Generally, the property must be (1) depreciable property with a recovery period of 20 years or less, (2) water utility property, (3) computer software, or (4) qualified leasehold improvements. Also the original use of the property must commence with the taxpayer—used machinery doesn't qualify.

Please contact us if you would like more information about the new cost recovery provisions or any other aspect of the new legislation.

Direct IRA Contribution Provision Extended

The IRA distribution rules allow for the tax-free treatment of distributions from IRAs where the distributions are donated to charity. This provision is available to taxpayers age 70½ or older who have one or more IRAs and a desire to make charitable contributions.

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Specifically, a taxpayer may exclude from gross income so much of the aggregate amount of his or her qualified charitable distributions not exceeding $100,000 in a tax year. A qualified charitable distribution is any otherwise taxable distribution from a traditional IRA or a Roth IRA that is made directly to a qualified charitable organization.

For purposes of the required minimum distribution (RMD) rules as they apply to individual retirement accounts and individual retirement annuities, qualified charitable distributions may be taken into account to the same extent that the distribution would have been taken into account under the RMD rules had the distribution not been directly distributed under the IRA qualified charitable distribution rules. Thus, an IRA owner who makes an IRA-qualified charitable distribution in an amount equal to his or her RMD for the tax year is considered to have satisfied their minimum distribution requirement for that year, even though a charitable entity (and not the IRA owner) is the recipient of the distribution.

This favorable provision expired at the end of last year, but was recently extended for 2012 and 2013 by the American Taxpayer Relief Act of 2012. Please contact us if you have questions on this taxpayer-friendly provision or any other tax compliance or planning issue.

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