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Dear Client:

The American Taxpayer Relief Act of 2012 was passed by both houses of Congress on New Year's Day and was signed into law by President Obama on January 2, 2013, in order to extend previously enacted tax cuts, known as the "Bush-era tax cuts" for certain taxpayers thereby avoiding the so called "fiscal cliff" as it related to tax increases. Not only does the new law make permanent reduced income tax rates for most taxpayers, it extends either permanently or temporarily a host of other tax incentives most of which were scheduled to expire after 2012. At the same time, the new law creates valuable tax planning opportunities. Not all provisions, however, are good for all taxpayers. Those individuals with income above $400,000 ($450,000 for families) are now subject to a new top income tax rate of 39.6 percent and a new capital gains maximum rate of 20 percent. And, all taxpayers will be taxed two percent more in 2013 than in 2012 on wages and self-employment income up to the Social Security employment tax wage base ($113,700). Our office can help you plan a tax strategy that reflects the important changes in the American Taxpayer Relief Act.

KEY PROVISIONS AFFECTING INDIVIDUALS

Changes for 2012

The following changes are effective retroactively to January 1, 2012:

- **AMT PATCH** – The Act permanently "patches" the Alternative Minimum Tax (AMT) for 2012 and subsequent years by increasing the exemption amounts and allowing nonrefundable personal credits to the full amount of the individual's regular tax and AMT. These amounts are to be inflation adjusted beginning in 2013. [1] The exemption amounts for 2012 will be:
  - $50,600 for unmarried individuals
  - $78,750 for married taxpayers filing jointly and surviving spouses
  - $39,375 for married taxpayers filing separately
- **Deduction for Qualified Tuition and Related Expenses** – The above-the-line deduction for qualified tuition and related expenses, which expired at the end of 2011, is extended retroactively for 2012 and is extended through 2013.
- **Teachers' Classroom Expense Deduction** – The above-the-line deduction for up to $250 of qualified out-of-pocket expenses, which expired after 2011, is extended through 2013.
- **Offset of nonrefundable personal credits against AMT** – For tax years after 2011, all nonrefundable personal tax credits are permanently allowed to the full extent of the taxpayer's regular tax and alternative minimum tax (AMT) liability. For this purpose, the taxpayer's regular tax liability is first reduced by any applicable foreign tax credit. Absent this Act, many of the credits would not be allowed to reduce tax below the AMT tax.[2]
- **Excluded Gain on Sale of Small Business Stock** – The 100 percent gain on Qualified Small Business Stock held for more than five years by non-corporate taxpayers has been extended two years and now applies to stock acquired after September 27, 2010, and before January 1, 2014. The portion of the gain included as an AMT adjustment will permanently be seven percent instead of increasing to up to 42 percent as was previously scheduled.
- **Mortgage Insurance Premiums** – The provision that treats mortgage insurance premiums as deductible qualified residence interest, which originally expired after 2011, is extended through 2013. The premiums must be paid or accrued in 2012 or 2013 and must not be properly allocable to a period after 2013.
- **Increased Transit Benefits** – The temporary increase to the limitation on the amount employees may exclude for transit passes and van pool benefits provided by an employer is extended to

2012 and 2013 to equal the limitation on the exclusion for qualified parking.

- **Contribution of Real Property for Conservation** – The enhanced deduction for charitable contributions of real property for conservation purposes, which otherwise would have expired after 2011, has been extended for two years, through December 31, 2013.[3]
- **IRA Contributions to Charity** – The provision allowing tax-free distributions from individual retirement accounts to public charities by individuals age 70½ or older is extended through 2013. A maximum of $100,000 of distributions to charity is allowed per taxpayer and the distribution must *generally* be made directly from the IRA to charity.

Under special transition rules in the Act, IRA distributions to the taxpayer made in December 2012 may be treated as a charitable deduction if transferred to the charity before February 1, 2013 and distributions made in January 2013 may be treated as made on December 31, 2012.

Changes for 2013

The following changes are effective January 1, 2013.

New 39.6% Tax Rate – Tax rate increases for all tax brackets previously scheduled to occur as a result of expiring tax cuts are eliminated by the Act, but individuals with taxable income over a threshold of $400,000 ($450,000 for married taxpayers) will be subject to a new tax 39.6% tax rate on income above the threshold. The act makes permanent the lower Bush-era income tax rates for taxpayers with taxable income below the threshold.[4] The threshold for the 39.6% bracket will be adjusted for inflation for tax years after 2013.

- **2012 Payroll Tax Holiday Not Extended** – Social Security (OASDI) payroll tax withholding for employees will increase 2% (from 4.2% to 6.2%) because the 2012 payroll tax holiday was not extended. There is no impact on employer payroll taxes as the payroll tax holiday did not apply to the employer portion.
- **Capital Gains Rates** – The top rate for capital gains will increase from 15% to 20% to the extent that a taxpayer's income exceeds the threshold set for the 39.6% income tax bracket ($400,000 in 2013 and $450,000 for married individuals).[5] The 20% capital gains rate will apply to the lesser of the excess of net capital gain or taxable income in excess of the income threshold for the 39.6% bracket. The capital gains rates for taxpayers with income below the threshold are permanently extended.

> - *Individuals subject to the higher capital gains and dividend rates will likely also be subject to the 3.8% additional Medicare tax on Net Investment Income that will be effective in 2013 as a result of the Affordable Care Act.*
> - *The Exclusion of gain from the sale of Small Business Stock was extended for two years as well, see discussion below.*

- **Dividend Tax Rates** – Qualified dividends[6] will continue to be taxed at capital gains rates instead of reverting to being taxed at ordinary income rates. The increase in the top capital gains rates from 15% to 20% will apply to qualified dividends as well.
- **Marriage Penalty Relief** – The Act permanently extends all existing marriage penalty relief. Absent this legislation, the standard deduction for married individuals would have dropped from 200% of the deduction for single individuals to 167%. Additionally, the Act maintains the 15 percent tax bracket for joint filers at twice the size of the corresponding income tax bracket for single filers. Without this Act, the bracket would have dropped to 167% of the size of the corresponding bracket for single individuals.
- **Limitation on Itemized Deductions** – The Act revives the "Pease" [7] limitation on itemized deductions but the limitations begin at higher income thresholds that otherwise would have applied when the Bush-era tax cuts expired. Under these limitations, itemized deductions are reduced by 3% of the amount by which the taxpayer's adjusted gross income exceeds an applicable threshold, up to a maximum reduction of 80 percent of the itemized deductions otherwise allowable. Certain deductions such as medical expenses, investment interest, and casualty, theft or wagering losses, are excluded. For 2013 the applicable thresholds, which will be adjusted for inflation in later years, are:
  - $250,000 for unmarried individuals
  - $300,000 for married taxpayers filing jointly and surviving spouses
  - $150,000 for married taxpayers filing separately
  - $275,000 for heads of households
- **Personal Exemption Phase-outs** – As with the limitations on itemized deductions, the Act

reinstates the personal exemption phase-outs rules that were in effect before the Bush-era tax cuts, but at higher income levels that would have applied due to the sunset of the Bush-era tax cuts. Under the phase-out, the total amount of exemptions that may be claimed by a taxpayer are reduced by 2% for each $2,500 ($1,250 for married filing separately), or portion thereof, by which the taxpayer's adjusted gross income (AGI) exceeds the threshold. The thresholds will be the same as those that apply for the "Pease" limitation on itemized deductions (*see above*).

- **State and Local Sales Tax Deduction** – The election to claim an itemized deduction for state and local sales taxes in lieu of state and local income taxes is extended through 2013.
- **Child Tax Credit** – The $1,000 child tax credit is extended permanently after 2012 instead of reverting back to $500. The credit is not inflation-adjusted. The provision that reduces the earnings threshold for the refundable portion of the credit was extended through 2017.[8]
- **Earned Income Credit** – Several enhancements to the earned income tax credit introduced in the Bush-era tax cuts and subsequent legislation were either extended through 2017 or made permanent.
- **Adoption Credit** – The Act extends permanently the Bush-era enhancements to the adoption credit and income exclusion for employer-paid or reimbursed expenses up to $10,000 (indexed for inflation) for both non-special needs adoptions and special needs adoptions.
- **Child and Dependent Care Credit** – The 35% credit rate is made permanent along with the $3,000 cap on expenses for one qualifying individual and the $6,000 cap for two or more qualifying individuals.
- **In-service Roth Conversions** – Employers may amend their 401(K), 403(b), or 457(b) plans to allow in-service employees to make rollovers a traditional account to a Roth account in the same plan, even if the distribution is not a result of the employee's severance from employment, death, disability, attainment of age 59½, or because of a hardship. The amount converted would be subject to regular income tax.
- **Cancellation of Indebtedness Income Exclusion on Principal Residence** – Cancellation of indebtedness on mortgage debt on a principal residence of up to $2 million is extended through 2013.
- **Education Incentives**
  - **American Opportunity Tax Credit** – This credit, a temporary enhanced version of the permanent HOPE credit, is extended through 2017.
  - **Student Loan Interest Deduction** – The 60-month rule for the $2,500 above-the-line student loan interest deduction is permanently suspended. This limitation on the number of months during which interest paid on the student loan is deductible was otherwise scheduled to be revived after 2012. Additionally, the modified adjusted gross income range for phase-out of the deduction is made permanent, as is the repeal of the disallowance of the deduction for voluntary payments of interest.
  - **Coverdell Education Savings Accounts** - The $2,000 limit on contributions is permanently extended as is the treatment of elementary and secondary school expenses as well as postsecondary expenses as qualified expenditures.[9]
  - **Employer-Provided Educational Assistance** – The Section 127 exclusion of up to $5,250 of employer-provided educational assistance from income and employment taxes was permanently extended.
  - **Federal Scholarships** – The exclusion from income for the National Health Services Corps Scholarship Program and the Armed Forces Scholarship Program is made permanent.
- **Estate, Gift and Generation-Skipping Transfer Taxes**
  - **Estate Tax rates and Exclusion** – The Act increases the maximum estate tax from 35% to 40% but makes permanent the $5 million exclusion for estates of decedents dying after December 31, 2012. The exclusion will be inflation-adjusted for years after 2012. Absent this legislation, the maximum estate tax rate would have been 55% with a $1 million exclusion which was not indexed for inflation. The 35% tax bracket for amounts subject to tax equal to or greater than $500,000 is replaced by a 37% rate, and additional tax brackets of 39% and 40% are created for amounts subject to tax equal to or greater than $750,000 and $1,000,000, respectively.

- **Portability Election** – The Act also makes permanent "portability" of the exclusion between spouses. If the act had not been passed, portability would not have been available for estates of decedents dying after December 31, 2012.[10]

- **Stepped-up basis is unchanged** – The rules providing for a step-up in basis at death for assets acquired from a decedent are not changed from the rules in effect for 2012 and are made permanent.[11]

- **Deduction for State Estate Taxes** – The Act makes permanent the estate tax deduction for estate taxes imposed by states.

- **Other Estate Tax Provisions** – The Act also makes permanent a number of other provisions affecting estate taxes including the repeal of distance requirements for qualified conservation easements [12]; the repeal of qualified family-owned business interest deductions; the installment payment of estate tax rules for closely-held businesses for purposes of the estate tax[13]; and repeal of the 5% surtax on estates larger than $10 million[14].

- **Gift Taxes** - As with the estate tax, the Act provides for a maximum 40% gift tax and a unified estate and gift tax exemption of $5 million to be adjusted annually after 2013 for inflation. (Note: The annual exclusion from gift tax is $14,000 in 2013, up from $13,000 in 2012.)
- **Generation Skipping Tax** – As with other transfer taxes, the maximum rate will be 40% with a $5 million exclusion. The Act makes permanent a number of GST tax-related provisions scheduled to expire after 2012, including: the GST deemed allocation and retroactive allocation provisions, clarification of valuation rules with respect to the determination of the inclusion ratio for GST tax purposes, provisions allowing for a qualified severance of a trust for purposes of the GST tax; and relief from late GST allocations and elections.

AMERICAN TAXPAYER RELIEF ACT OF 2012
KEY PROVISIONS AFFECTING BUSINESSES

The business tax incentives in the new law, while not receiving as much press as the individual tax provisions, are valuable. Two very popular incentives, bonus depreciation and small business expensing, are extended, as are many business tax "extenders." Many of these business tax incentives are only extended for a year or two, so taxpayers have a limited window in which to maximize their potential tax savings.

❖ **Section 179 Expensing** – The dollar limitation for expensing is extended through 2013 at $500,000 with a $2 million investment limit. The rule allowing section 179 expensing for off-the-shelf computer software is also extended. Without the extension, the dollar limit would have been $139,000 in 2012 and would have dropped to $25,000 (adjusted for inflation) in 2013.

- **Qualified Real Property** – Additionally the provisions allowing expensing qualified real property of up to $250,000 were extended through 2013. Qualified real property includes qualified leasehold improvements, qualified restaurant property, and qualified retail improvement property.

❖ **Bonus Depreciation**

- **Extended for 2013** – 50 percent bonus depreciation, previously scheduled to expire after December 31, 2012, is extended for property placed in service in 2013. Eligible property must be acquired before January 1, 2014, with the exception of certain non-commercial aircraft and longer period production property which is eligible through December 31, 2014.

- **Election to Claim Accelerated AMT Credit in lieu of Bonus Depreciation** – The Act allows corporations to elect to take additional AMT credits in 2013 if they agree to forego the use of bonus depreciation on qualified property placed in service in those years and depreciate such property using the straight-line method. The additional credit (which is refundable) is limited to 6% of the amount of such credits that had been generated before 2006 and had not been used in tax years ending before April 1, 2008. Also, the additional credit cannot exceed $30 million.

❖ **Research Tax Credit** – The federal Credit for Increasing Research Activities, which expired after 2011, is extended through 2013. The Act also includes provisions that treat qualified expenses incurred prior to the date of a change in ownership as expenses of the disposing taxpayer and may not be claimed by the acquiring taxpayer. Additionally, the allocation of credit among businesses in a controlled group is simplified by providing that the credit allowed to each member of the group is determined in proportion to its share of the aggregate of qualified expenses giving rise to the credit.

- **Work Opportunity Tax Credit** – The work opportunity tax credit is extended through 2013. The credit had expired in 2011 except for credits for hiring certain unemployed veterans, a newly created targeted group, which were allowed through 2012. Both the credits for prior targeted groups and the credits for qualified veterans were extended.

- **Qualified Leasehold/Retail Improvements & Restaurant Property** – The 15-year recovery period under the straight-line method for qualified leasehold improvements, qualified retail improvements and qualified restaurant property was extended through 2013.

- **Recognition Period for S Corporation Built-In Gains** - For tax years beginning in 2012 and 2013, for purposes of computing the built-in gains tax, the recognition period is the five-year period beginning with the first day of the first tax year for which the corporation was an S corporation. The Creating Small Business Jobs Act of 2010 had previously reduced the recognition period from ten years to five years, but only for tax years beginning in 2011.

- **Empowerment Zones** – The tax benefits available to certain businesses and employers operating in financially distressed empowerment zones, previously expiring after 2011, have been extended for two years through 2013.

OTHER TAX CREDITS AND INCENTIVES

- **Employer-Provided Care Credit** – The income tax credit for qualified expenses incurred by an employer in providing child care for employees has been made permanent for tax years beginning after December 31, 2012.

- **New Markets Tax Credit** – The new markets tax credit, which had expired after 2011, is extended for two years, through December 31, 2013. The carryover period for unused new markets tax credits is also extended for two years, through December 31, 2018.

- **Electricity produced from Renewable Resources** – The credit for electricity produced from renewable resources for facilities that produce energy from wind has been extended through 2013. The credit for Indian coal facilities has also been extended for an additional year through 2013. Other energy-producing renewable resource facilities will qualify for the production tax credit if construction has begun on the facility before January 1, 2014, rather than the facility being required to be placed in service by that date. Recycled paper has been excluded from the definition of municipal solid waste for purposes of the credit

- **Incentives for Biodiesel, Renewable Diesel and Alternative Fuels** - The per-gallon incentives for biodiesel, agri-biodiesel, and renewable diesel have been retroactively extended for two additional years, through December 31, 2013. The alternative fuel credit and the alternative fuel mixture credit have also been retroactively extended for two additional years, through December 31, 2013, for the following alternative fuels: liquefied petroleum gas; “P Series” Fuels; compressed or liquefied natural gas; liquid fuel derived from coal through the Fischer-Tropsch process (“coal-to-liquids”); compressed or liquefied gas derived from biomass; and liquefied fuel derived from biomass. The related outlay payment provision for alternative fuel has been extended as well. The outlay payment provision for alternative fuel mixtures, however, was not extended.

- **Cellulosic Biofuels Producer Credits** – The $1.01 per gallon income tax credit for the production of qualified cellulosic biofuel has been extended one year, and is now scheduled to expire after December 31, 2013. The credit, now called the “second generation biofuel producer credit,” has been expanded to include fuel derived from various algae. The other components of the alcohol fuels credit expired in 2011 and were not renewed.

[1] The AMT was originally put in place to ensure that very wealthy individuals did not escape taxation. Due partly to the fact that the AMT was not indexed for inflation, the AMT would have affected many middle class taxpayers without the temporary “patches” enacted by congress to provide relief to such taxpayers.

[2] The nonrefundable personal tax credits include: the dependent care credit, the credit for the elderly and disabled, the adoption credit (except in 2010 and 2011), the child tax credit, the credit for interest on certain home mortgages, the Hope Scholarship and Lifetime Learning credits (including the American Opportunity tax credit), the retirement savings contributions credit, the credit for certain nonbusiness energy property, the credit for residential energy efficient property, the plug-in electric drive motor vehicle credit, the new qualified plug-in electric drive motor vehicle credit, the alternative motor vehicle credit, and the District of Columbia first-time homebuyer credit.

[3] The deduction limitation for qualified conservation contributions will continue to be 50% of the donor’s contribution base through 2013 instead of dropping to a maximum of 30%. The 100 percent deduction for individuals who are qualified farmers or ranchers and the enhanced rules for corporations who are qualified farmers or ranchers are likewise extended through 2013.

[4] Prior to passage of this Act, the sunset of the Bush-era tax rates would have replaced the 10, 15, 25, 28 and 33 percent rates with the 15, 28, 31, 36 and 39.6 percent rates that were previously in place.

[5] Absent this Act, the maximum capital gains rate would have gone up to 20% for all taxpayers.

[6] Generally, dividends received from a domestic corporation or a qualified foreign corporation, on which the underlying stock is held for at least 61 days within a specified 121-day period, are qualified dividends for purposes of the reduced tax rate.

[7] The Pease limitation is named for the member of Congress who sponsored the original provision.

[8] The Act also extended permanently the provisions that the refundable portion of the child tax credit does not constitute income; that the credit is allowable against regular tax and AMT; that the AMT offset against the additional child tax credit is repealed for families with 3 or more children; and that the supplemental child tax credit is eliminated.

[9] The maximum contribution would have dropped to $500 absent this Act.

[10] Portability allows the estate of a decedent who is survived by a spouse to make a portability election to permit the surviving spouse to apply the decedent’s unused election to the surviving spouse’s own transfers during life and at death.

[11] Although EGTRRA temporarily did away with the concept of “stepped-up basis” at death for assets acquired from a decedent (Code Sec. 1014) and replaced it with “modified carryover basis” (Code Sec. 1022), the 2010 Tax Relief Act effectively limited the application of the carryover basis rules to the estates of decedents who died in 2010 and that elected to opt out of the estate tax regime (Act Sec. 301(c) of P.L. 111-312). This result was not altered by the 2012 Taxpayer Relief Act. Accordingly, the stepped-up basis rules are applicable to the estates of decedents dying in 2013 and later, just as they were to the estates of decedents dying in 2010 that did not elect out of the estate tax or to the estates of decedents who died in 2011 or 2012.

[12] Distance requirements on conservation easements were repealed by the Bush-era tax cuts and would have been revived in 2013. These requirements are permanently repealed. Additionally clarification that the date such a contribution was made is then used in determining the value of the exclusion is also made permanent.

[13] The rule under §6166(b)(1)(B)(ii), §6166(b)(1)(C)(ii), and §6166(b)(9)(B)(iii)(I) providing that a decedent’s estate may qualify for deferred payment of estate tax if the number of partners or shareholders in the decedent’s closely held business does not exceed 45 has been made permanent.

[14] A surtax of 5% was applied to estates and taxable gifts larger than $10 million and up to $17,184,000 prior to 2002 but was repealed as a result of the Bush-era tax cuts. This tax would have been revived in 2013 if the current legislation had not been passed.