PUBLICATION

The American Taxpayer Relief Act of 2012: Some Tax Certainty in an Uncertain World

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On January 1, 2013, Congress averted the fiscal cliff with the passage of the American Taxpayer Relief Act of 2012 (Act), which was enacted when President Obama signed the Act on January 2, 2013. The Act provides a welcome degree of certainty about tax rates by eliminating the "sunset" provisions of the 2001 and 2003 tax cuts, though it includes tax increases on some higher income and net worth individuals.

For the past decade, uncertainty was ever present as to whether the lower tax rates included in the Economic Growth and Tax Relief Reconciliation Act of 2001 and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (together, known as EGTRRA) would sunset according to their terms at the end of 2010. Such uncertainty frustrated taxpayers and their advisors, creating an atmosphere which often paralyzed needed tax planning. Congress postponed the uncertain tax climate in late 2010, extending the EGTRRA lower rates for two additional years through 2012 in the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010.

Under the current Act, extension of lower tax rates are sometimes described as "permanent" because they are no longer subject to expire automatically after a period of time -- even though tax laws can, and almost certainly will, continue to change based on political pressures. The removal of the sunset provisions offers an increased degree of stability, however, and should bring some comfort to taxpayers and their advisors.

Following is a brief summary of many of the tax provisions within the Act. Stay tuned for more detailed analysis of specific provisions and planning opportunities under the Act in forthcoming Alerts.

Individual Income Taxes

Income Tax Rates: The Act permanently extends the reduced individual income tax rates under EGTRRA, so there will be no change to most individuals' tax rates under the Act. But the Act imposes a 39.6 percent tax rate bracket for "high-income taxpayers" that applies to income over a threshold amount, which will be adjusted for inflation in future years. The initial threshold amounts are:

- $400,000 for single individuals;
- $450,000 for married individuals filing joint returns
- $425,000 for heads of households; and
- half of the married filing jointly threshold amount for married individuals filing separate returns.

The Act also permanently extends the "marriage penalty" reduction provisions that set the 15 percent regular income tax rate bracket for a married couple filing a joint return at 200 percent the corresponding rate bracket for an unmarried (single) individual.

The following tables illustrate the projected 2013 tax brackets under the Act for single individuals and for married individuals filing joint returns.

Table 1. Projected 2013 Rates - Single Individuals

Taxable Income Over	But Not Over	Pay	% on Excess	Of the amount over
$0	$8,925	$0	10%	$0
$8,925	$36,250	$892.50	15%	$8,925
$36,250	$87,850	$4,991.25	25%	$36,250
$87,850	$183,250	$17,891.25	28%	$87,850
$183,250	$398,350	$44,603.25	33%	$183,250
$398,350	$400,000	$115,586.25	35%	$398,350
$400,000		$116,163.75	39.6%	$400,000

Table 2. Projected 2013 Rates - Married Filing Jointly

Taxable Income Over	But Not Over	Pay	% on Excess	Of the amount over-
$0	$17,850	$0	10%	$0
$17,850	$72,500	$1,785	15%	$17,850
$72,500	$146,400	$9,982.50	25%	$72,500
$146,400	$223,050	$28,457.50	28%	$146,400
$223,050	$398,350	$49,919.50	33%	$223,050
$398,350	$450,000	$107,768.50	35%	$398,350
$450,000		$125,846.00	39.6%	$450,000

Capital Gains and Qualified Dividend Rates: Since 2003, taxpayers have enjoyed a maximum tax rate of 15 percent on long-term capital gains. In addition, qualified dividends received by individuals have been taxed at the capital gain rate rather than being treated as ordinary income. The Act permanently extends the 15 percent capital gains and dividend rates for most taxpayers. But the Act adds 20 percent capital gains and dividend rates for taxpayers with annual income in excess of the income tax threshold amounts described above (currently $400,000 for individuals and $450,000 for married individuals filing joint returns).

Alternative Minimum Tax (AMT): The Act permanently increases the AMT exemptions retroactively beginning with the 2012 tax year, and provides that the AMT exemptions will be indexed for inflation starting in 2013. As a result, Congress will hopefully no longer have to pass annual "patches" to prevent the AMT from applying to lower income taxpayers. The 2012 AMT exemption amounts are:

- $50,600 for unmarried individuals;
- $78,750 for married individuals filing joint returns; and
- half of the married filing jointly exemption amount for married individuals filing separate returns.

Also, effective retroactively for tax years beginning with the 2012 tax year, the Act permanently allows nonrefundable personal credits to offset both regular tax liability and AMT liability.

Limitations on Itemized Deductions and Phase-Outs of Personal Exemptions: Beginning in 2013, itemized deductions of higher income taxpayers will be reduced by 3 percent of the amount by which the taxpayer's adjusted gross income exceeds an applicable amount, but the reduction is limited to 80 percent of the otherwise allowable itemized deductions. This limitation does not apply to deductions for medical and dental expenses, investment interest and casualty and theft losses.

Also beginning in 2013, personal exemptions of higher income taxpayers will be reduced by 2 percent for each $2,500 (or portion thereof) by which the taxpayer's adjusted gross income exceeds the applicable amount.

The same applicable amounts are used to determine both the reductions of itemized deductions and the phase-outs of personal exemptions. The applicable amounts are indexed for inflation for years after 2013. The 2013 applicable amounts are:

- $250,000 for single individuals;
- $300,000 for married individuals filing joint returns;
- $275,000 for heads of households; and
- half of the married filing jointly applicable amount for married individuals filing separate returns.

Other Changes and Extensions: The Act includes extensions of a number of individual tax provisions, some of which are permanent, and others of which are temporary. The following are some of the provisions extended or otherwise modified by the Act:

- <u>Permanent and Temporary Extensions of Child Tax Credit:</u> The maximum child tax credit is permanently continued at $1,000 and the credit remains refundable. The credit is generally refundable to the extent of 15 percent of the taxpayer's earned income above $10,000 (indexed for inflation). The Act also extends for five years (through 2017) the 2009 expansions of the credit allowing earnings above $3,000 to count toward refundability and including an alternative formula to calculate the credit for families with three or more qualifying children.
- <u>Permanent Extension of Expanded Credit for Dependent Care Expenses:</u> The Act permanently extends the 35 percent applicable percentage used to determine the amount of expenses that are allowed as a credit and dollar limitations for qualified expenses to $3,000 for one qualifying individual and $6,000 for two or more qualifying individuals.
- <u>Five Year Extension of Expanded Earned Income Tax Credit</u>: The Act extends for five years (through 2017) the 2009 increase of the earned income tax credit for families with three or more children and increased income thresholds for phase-out of the credit for married individuals filing joint returns.
- <u>Permanent Extension of Increased Adoption Credit and Adoption Assistance Programs</u>: The Act permanently extends the $10,000 adoption credit and $10,000 exclusion for adoption expenses paid by an employer.
- <u>Education Provisions</u>:

- *Interest on Education Loans:* The Act permanently extends EGTRRA's elimination of the 60-month limit for the above-the-line deduction of up to $2,500 of the interest on qualified education loans and the increased income thresholds for phase-outs of the deductions.
- *Qualified Tuition and Related Expense:* The Act extends through 2013 the above-the-line deduction for qualified tuition payments and certain related expenses.
- *Coverdell Educational Savings Accounts:* The Act permanently extends a number of favorable 2001 and 2004 changes to Coverdell education savings accounts (also known as Educational IRAs), including the increased maximum annual contributions of $2,000, an expanded definition of qualified education expenses that permits elementary and secondary education expenses to be paid from these accounts, and the allowance of current-year contributions until April 15 of the following year.
- *American Opportunity Tax Credit*: The Act extends for five years (through 2017) the 2009 modifications to the American Opportunity Tax Credit that provides a partially-refundable tax credit for 100 percent of the first $2,000 of tuition and related expenses and up to 25 percent of the next $2,000 of tuition and related expenses, subject to a phase-out for taxpayers with income over $80,000 ($160,000 for married individuals filing joint returns).
- *Employer-Provided Educational Assistance:* The Act permanently extends the exclusion by an employee of up to $5,250 per year of employer-provided educational assistance.
- *Exclusion of Scholarships:* The Act permanently extends the inclusion of scholarships under the National Health Service Corps Scholarship Program and the F. Edward Herbert Armed Forces Health Professions Scholarship and Financial Assistance Program within scope of qualified scholarships that can be excluded from income by the recipient.

- <u>Extensions Through 2013</u>: The Act extends through 2013 a number of temporary tax deductions, credits and incentives for individuals that expired at the end of 2011 or that would expire at the end of 2012. Following are some of the provisions that have been extended:

  - The above-the-line deduction for expenses up to $250 for educational materials purchased by elementary and secondary school teachers.
  - The exclusion from income of forgiven mortgage debt up to $2 million ($1 million if married filing separately).
  - The exclusion from income for employer-provided transit and vanpool benefits of up to $240 per month.
  - The deduction for qualified mortgage insurance premiums on a qualified personal residence, which is ratably phased-out for taxpayers with gross income between $100,000 and $105,000 (or between $50,000 and $55,000 for married taxpayers filing separate returns).
  - The permitted deduction of state and local sales taxes in lieu of deducting state and local income taxes.
  - The special rules increasing the limits on charitable deductions for contributions of capital gain real property for conservation purposes and for contributions by certain corporate farmers and ranchers.
  - The allowance of tax-free distributions of up to $100,000 per year to charities from an individual retirement account by taxpayers age 70 ½ or older. The Act also includes transition rules that allow taxpayers to treat distributions to charities made in January 2013 as having been made on December 31, 2012, and to treat distributions made in December 2012 that are paid to a charity in January 2013 as qualified charitable distributions.

<u>Business Income Taxes</u>

The following is a brief non-exhaustive summary of some of the Act's significant changes related to businesses.

R&D Credit: The Act reactivates the research and development tax credit which expired on December 31, 2011 retroactively for qualifying expenses incurred from January 1, 2012 through December 31, 2013. The rules for taxpayers under common control are modified under the Act for purposes of computing the R&D credit when a change of control occurs for a major portion of a trade or business.

Low-Income Tax Credit Rate for Non-Federally Subsidized Buildings: The Act reactivates the low-income tax credit of 9 percent for newly constructed non-federally subsidized buildings placed in service after July 30, 2008 for the housing credits allocated prior to January 1, 2014.

New Markets Tax Credits: The Act provides that the 2010 and 2011 new markets tax credits of $3.5 billion in qualified equity investments are to be carried forward and used in 2012 and 2013. Unused new market tax credits may be carried forward to 2018.

Work Opportunity Credit: The Act extends the work opportunity credit for individuals who were employed prior to January 1, 2014.

Qualified Zone Academy Bonds: The Act extends the $400 million in bond volume for 2012 and 2013. Qualified Zone Academy Bonds enable the holder a federal tax credit in lieu of interest.

15-Year Straight-Line Recovery for Qualified Leasehold Improvements: The Act extends the 15-year cost recovery period for certain leasehold improvements, restaurant buildings and improvements, and retail improvements placed in service before 2014.

Increased Expensing Limitation and Treatment of Qualified Property as Section 179 Property: The Act reinstates the special rules applying Section 179 to qualified real property and the allowance of $250,000 of the costs of the real property to be Section 179 through 2013.

Extension and Modification of Bonus Depreciation: The Act extends the Section 168(k) 50 percent bonus depreciation for qualified property acquired and placed in service prior to January 1, 2014. Additionally, the Act provides that corporate taxpayers may elect to accelerate the AMT and research credits instead of bonus depreciation.

Special Expensing Rules for Certain Film and Television Productions: The Act extends the special expensing rules allowing film and television producers to expense the initial $15 million of productions costs of qualified film and television productions incurred prior to January 1, 2014.

Exclusion of 100 Percent of Gain on Small Business Stock: The Act extends the exclusion of gains from the sale of qualifying small business stock acquired prior to January 1, 2014 that is held at least five years. Generally, qualifying small business stock is C-corporation stock where the corporation's aggregate gross receipts are not in excess of $50 million and the corporation satisfies the active business requirements. The total amount of gain eligible for the exclusion is the greater of 10 times the taxpayer's basis in the stock or $10 million of gain from the sale of the small business stock.

Extension of Reduction in S-Corporation Recognition Period for Built-In Gains Tax: The Act extends the recognition period of five years for purposes of computing the recognition period for the built-in gains tax. The recognition period begins with the first day of the first taxable year for which the entity elected S-corporation status.

30 Percent Exemption of Certain Dividends of Regulated Investment Companies: The Act extends the exemption from the 30 percent withholding tax for qualified interest related dividends and short term capital gain dividends under the Foreign Investment in Real Property Act.

Estate and Gift Taxes

Inflation-Indexed and Portable $5 Million Exemption is Now Permanent: The Act makes the $5 million unified exemption for gift, estate and generation-skipping transfer taxes permanent, and the exemption continues to be indexed for inflation. The unified exemption for 2013 is projected to be $5.25 million, up from the 2012 indexed unified exemption amount of $5.12 million. The Act also permanently extends portability of the unified exemption, which allows a surviving spouse to make use of a deceased spouse's unused unified exemption, and which was first introduced in the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010.

Increase in Tax Rate for High Wealth Individuals: The Act increases the maximum transfer tax rate to 40 percent in 2013, from the 35 percent maximum rate applicable to transfers made in 2011 and 2012.

Summary

This Alert is intended to be a general review of some of the tax provisions of the Act, and is not intended as advice under any specific facts and circumstances. Tax planning in these uncertain times starts with an understanding of your specific facts and circumstances. As a result, taxpayers should consider consulting with their tax advisors to discuss how the Act will impact them and strategies available to them now that the Act has passed.

If you have any questions regarding any of the Act's provisions summarized above, or questions relating to any other tax topics, please contact any of the attorneys in the Firm's Tax Department.