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Tax Law Alert

January 2013

The "Fiscal Cliff" Tax Changes

On January 2, 2013, the Country was spared of the effects, but not the drama, of the "fiscal cliff" that would have automatically provided for draconian cuts in federal spending together with enormous tax increases. While many felt that the "fiscal cliff" presented an opportunity for significant tax and spending reform, they will have to wait at least two months for the coming battle over the temporarily tabled "sequester" on program cuts. The less than grand deal is encompassed in the American Taxpayer Relief Act of 2012 (the **"2012 Act"**), which should be reviewed in conjunction with the first installment of revenue raising provisions set forth in the Patient Protection and Affordable Care Act (the **"Health Act"**).

What follows is a brief summary of the fundamental deal that sprang from negotiations between the Obama administration and Senate Republican leaders and was grudgingly passed by the House as the <u>2012 Act</u>, as well as the initial rollout of the <u>Health Act</u>, both effective January 1, 2013.

Income Tax Provisions

First, the 39.6% tax bracket from the Clinton era has been reinstated for "higher income" taxpayers, defined under the 2012 Act as Individuals, Head of Households and Families (filing jointly) with taxable incomes above \$400,000, \$425,000 and \$450,000, respectively (the **"Income Tax Base Rates"**). In addition, all tax bracket ranges will be adjusted for inflation after 2013 based upon the standard formula of Section 1(f) of the Internal Revenue Code, as amended to date (the **"Code"**).

Second, there is a (i) personal exemption phaseout, and (ii) limitations on certain itemized deductions (the **"Pease Limitation"**).

- Personal Exemption Phaseout provides the total amount of exemptions that may be claimed is reduced by 2% for each \$2,500 (2% for each \$2,500 for married couples filing separately) that AGI exceeds the following **"Applicable Thresholds"**:

  \$300,000 for married couples and surviving spouses;
  \$275,000 for heads of households;
  \$250,000 for unmarried taxpayers; and
  \$150,000 for married taxpayers filing separately

- With respect to the limitations on certain itemized deductions, the amount of otherwise allowable deductions is reduced by 3% of the amount AGI exceeds the <u>Applicable Threshold</u>, but not to exceed 80% of the otherwise itemized deductions. Please note that certain itemized deductions are excluded from the <u>Pease Limitation</u>, including medical expenses, investment interest, and casualty, theft or wagering losses.

Finally, Congress has made "permanent" the Alternative Minimum Tax ("AMT") patch by using 2012 as a baseline (\$50,600 for unmarried individuals, \$78,750 for married couples filing jointly and surviving spouses, and $39,375 for married taxpayers filing separately), and then indexing these numbers for inflation. Indexing the baseline numbers will avoid future need for an annual AMT patch.

Long-Term Capital Gains and Qualified Dividends

The distinction between capital gains and ordinary income remain in the Code, as well as different tax rates for the two categories. The previous 15% rate for long-term capital gains survives if the taxpayer does not exceed the Income Tax Base Rates. For those who do exceed the Income Tax Base Rates, the rate for long-term capital gains is increased to 20%. Qualified dividends continue to be taxed at capital gains rates and not ordinary rates, and the same 15% and 20% rates are applicable. In addition, the 2012 Act created a new 18% capital gains rate (applicable to those who would otherwise be taxed at 20%) for assets acquired after December 31, 2000, and held for more than five years.

Federal Estate Tax

The 2012 Act provides for a maximum federal estate tax rate of 40%. This increase is tempered somewhat with an applicable exclusion amount of $5.25 million for estates of decedents dying after December 31, 2012. Moreover, the applicable exclusion amount (or unified estate and gift tax exemption) is adjusted annually for inflation. In addition, the 2012 Act provides for permanent "portability" between spouses that had expired on December 31, 2012, and the deduction for state estate taxes. Finally, a number of provisions were extended, including the installment payment of estate tax for closely-held businesses for purposes of the estate tax.

Gift and Generation-Skipping Tax

The $5 million unified estate and gift tax exemption remains available with the added benefit of inflation adjustment, which brings the 2013 exemption to $5.25 million. The gift tax annual exclusion amount, including split-gift elections, survived and equals $14,000 per donee in 2013. The generation skipping transfer (GST) tax rate has been increased to 40% with the $5.25 million exemption available. Finally, the 2012 Act also extends several expiring provisions, 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.

Business Tax Provisions

The 2012 Act provides many, albeit temporary, tax extenders. Included in the list are five very useful business-friendly initiatives that are contentious for the "fiscal cliff" debate because they are counted as "lost revenue":

- Section 179 of the Code – Small Business Expensing – through 2013: The dollar limit is $500,000 (including for 2012), with a $2 million investment limit.

- Bonus Depreciation – 2013: The 2012 Act generally extends the 50% bonus deprecation while some transportation and longer term production property enjoy the 50% bonus through 2014.

- Research Tax Credit – 2013: Section 41 of the Code provides for a research tax credit as an incentive to pursue "qualified" research activities.

- Work Opportunity Tax Credit – 2013: This tax credit rewards employers for hiring employees from certain selected groups.

- 15-year Recovery Period – 2013: The shortened recovery period covers the following: (1) qualified leasehold and retail improvements; and (2) qualified restaurant property.

There is an extensive list of additional 2013 tax extenders for business including New Market Tax Credits, 100% exclusion on sale of qualified small business stock, reduced recognition period for S corporations with built-in gains, treatment of dividends of RICs and RICs as investment vehicles, and expensing of brownfield remediation costs, to name a few.

Charitable Contributions

The 2012 Act reinstates the special rule for contributions of capital gain real property for conservation purposes. The special rule provides for the charitable contribution to be taken against 50% of the contribution base. In addition, the extension is for two years for contributions by certain corporate farmers and ranchers. The intent is that the special rule will allow for larger charitable contributions.

The provision allowing for tax-free distributions from individual retirement accounts to public charities of up to $100,000 per year, provided the donor has reached age 70-1/2, is extended through December 31, 2013. In addition, there is a special rule that allows distributions to be re-characterized in one of two ways: first, a January 2013 distribution to a charity can be treated as made on December 31, 2012; and second, all or part of an IRA distribution received by a donor in December 2012 can be treated as made to a charity on December 31, 2012, if the donor makes a transfer to the charity before February 1, 2013.

Energy Incentives

Certain energy tax incentives were extended, most notably the business-related credits. These incentives include:

- The production tax credit found in Section 45 of the Code for facilities that produce energy from wind fields has been extended. In addition, for trash to energy purposes, recycled paper is excluded from the definition of municipal solid waste.

- The non-business energy property credit found in Section 25C of the Code has been extended at $500 through December 31, 2013, for individuals who make their homes energy efficient.

The Health Act

On January 1, 2013, two changes took place as a result of the previously enacted Health Act. The first is rather simple and direct, the .9% Medicare Tax on “higher income” taxpayers. Presently, the Medicare tax on W-2 income is 2.9%, with the amount split equally by employer and employee. Self-employed individuals must pay the entire amount. On January 1st, that amount went to 3.8% for the following individuals:

- Wages or net self-employed income above $200,000 for unmarried individuals.

- Combined wages or net self-employed income above $250,000 for married filing jointly.

- Wages or net self-employed income above $125,000 for those who use married filing separate status.

It should be noted for the self-employed that the .9% increase will not qualify for the 50% deduction.

The second is a new tax that is referred to as the 3.8% Medicare Surtax (the **"3.8% Surtax"**). Unlike the .9% Medicare tax, the 3.8% Surtax attaches to "net investment income" for certain individuals, trust and estates that meet certain threshold amounts. Accordingly, this means that the highest individual income tax rate is not 39.6%; with the 3.8% Surtax the actual rate is 43.4%.

- Threshold Amounts

  $200,000 for single filers;
  $250,000 for married filing jointly; and
  $125,000 for married filing separately

- Net Investment Income

  Interest, dividends, royalties, annuities, rents;
  Income derived from passive activities;
  Trading financial instruments and commodities; and
  Net capital gains derived from the disposition of property (other than property held in an active trade or business).

For example, an individual would be subject to the 3.8% Surtax on the lesser of net investment income for the tax year, or the amount by which the modified adjusted gross income exceeds the threshold amount for that year.

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This issue of the Tax Law Alert was written by Christopher J. Rixon, Chair of the Tax Group at Reid and Riege, P.C. The Group works with business lawyers on issues of choices of entities, formation and operation, as well as taxable and/or tax-free transactions. The Group is involved with decisions involving capitalization, working with commercial and transactional lawyers in structuring and determining levels of equity, debt and various hybrids. The Tax Group is also called upon to work outside the Business Law Practice Area with respect to issues of pensions and profit sharing arrangements, trusts and estates, personal wealth planning, real estate transactions and financing, litigation and settlement agreements, health care and nonprofit law.

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