THE AMERICAN TAXPAYER RELIEF ACT OF 2012 ("ACT") A RESULT OF THE "FISCAL CLIFF" WHAT IT DID AND DID NOT DO

Presentation to the Dayton Association of Tax Professionals

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INCOME TAX (CON'T)

- BRIEF SUMMARY OF SELECT CHANGES

Income Tax (Con't)

<u>BUSINESS PROVISIONS</u>

- Section 179 Deduction for Equipment
  - Annual limit for <u>2012</u> (made retroactive) and 2013 is increased to $500,000, with a phase-out beginning at $2,000,000 of investment.
  - Previously for 2012 the limit was $139,000 (inflation adjusted), with a phase-out starting at $560,000 (inflation adjusted).
  - Annual limit decreased to $25,000 in 2014.
  - Phase-out starts at $200,000 in 2014.

INCOME TAX (CON'T)

INDIVIDUAL TAX PROVISIONS

- 50% Bonus Depreciation was to expire in 2013 (with an exception through 2013 for longer-produced property). This was extended to 2014.

- Collapsible corporation provisions (IRC §341) reinstated in 2013.
  - Essentially taxes sales of C corporation stock as ordinary income (vs. capital gain) if corporation formed for the principal purpose of packaging ordinary income assets for sale.

- Extends 15-year straight-line depreciation on qualified leasehold improvements through 2013.

Income Tax (Con't)

- Alters the taxation of S corporation "Built-in Gains" ("BIG"):
  - For 2012 and 2013 BIG, the recognition period is reduced from 10 years to 5 years.
  - If an installment sale of BIG assets occurs in 2012 or2013, the 5-year rule will apply even if the installment note is collected after 2013

- The smaller basis adjustment to S corporation stock for charitable contributions of appreciated property by such corporation is extended for contributions made in 2012 and 2013.

Income Tax (Con't)

- Extends the 9% low-income housing credit applicable percentage to all credit allocations made prior to 2014.
- Extends a number of other expiring provisions through 2013. E.g.:
  - 100% exclusion for gain on sale of "qualified/small business stock (§1202).
  - Research tax credit.
  - Work opportunity credit.
  - New Markets Tax Credit.
  - Subpart F exception for active financing income.
  - Various energy credits extended; "RIC," "CFC" extenders.

Income Tax (Con't)

INDIVIDUAL PROVISIONS

- Increased, and made permanent, the AMT patch
  - From $45,000 (married/$33,750 single) in 2012 previously, to $78,750/$50,600, indexed for inflation after 2012.
  - Allowing non-refundable personal credits to offset AMT.

- Reinstated the ability to deduct state and local sales taxes in lieu of income taxes from 2011 through 2013 (retroactive for 2012).

Income Tax (Con't)

- Extended, from 2011 through 2013 (retroactive for 2012) the ability of individuals 70½ or older to direct traditional IRA distributions to charities, up to $100,000 each year.
  - A distribution already received in December of 2012 can be so treated if equivalent cash is contributed to charity in January, 2013.
  - A January 2013 IRA distribution to charity can be treated as a 2012 rollover, effectively allowing a second $100,000 charitable distribution to be made in 2013.

Income Tax (Con't)

- Such distributions are treated as required minimum distributions (RMD).
- Distributions to donor advised funds do not qualify under this provision.
- Benefits to the donor include:
  - Effectively in charitable deduction with no AGI limitation.
  - Avoids the 2013 itemized deduction phase-out if it were to limit such deduction.
  - Effectively a state tax charitable deduction.

Income Tax (Con’t)

- Extends the exclusion from gross income of discharge of qualified principal residence indebtedness (up to $2,000,000) to December 31, 2013.
- Permanently extends “relief” from the “marriage penalty”
  - Allowing a standard deduction twice the single deduction.
  - Increases the 15% bracket, over time, to twice the corresponding single individual bracket.

Income Tax (Con't)

- Extends through 2013 certain other deductions
  - School teachers expenditures
  - Employer provided mass transit and parking as excludible working condition fringe.
  - Deduction of mortgage insurance premiums as qualified residence interest.
  - Extension of contribution of certain conservation easements.
  - Deduction of certain qualified tuition payments.

Income Tax (Con't)

Some Things the Act Did Not Extend

- Phase-out of itemized deductions reinstated in 2013; 3% of AGI over threshold (est. in 2013 $300,000 married filing joint, $250,000 single, adjusted for inflation after 2013) up to 80% of total deduction).
  - What is practical impact on discretionary (e.g., charitable) itemized deductions?
- Phase-out of personal exemptions reinstated in 2013; 2% for each $2,500 that AGI exceeds threshold amounts (est. $300,000 married filing joint, $250,000 single). Reduced to $0 if $125,000 over threshold.

SELECTIVE HEALTH REFORM ACT EMBEDDED TAXES

- Employee (including for self-employed) FICA ("payroll") tax rate allowed to increase from 4.2% to 6.2%.
- In 2013 forward:
  - Additional tax of 0.9% on <u>earned</u> income over $200,000/$250,000 for single/joint taxpayers, bringing total "surtax" from 2.9% to 3.8%.
  - Additional tax of 3.8% on <u>unearned</u> (passive/investment) income to the extent modified AGI exceeds $200,000/$250,000.
- In 2018 forward: 40% excise tax on health insurance premiums in excess of $10,800/$27,500 for individual/family coverage.
- AGI threshold for medical expense deduction increased from 7.5% of AGI in 2012 to 10% in 2013 (7.5% remains if age 65 or over).

INDIVIDUAL INCOME TAX RATE CHANGES

2012 Joint Tax Rates -- Ordinary

$0 to $17,400	10% of amount over $0
$17,400 to $70,700	$1,740 + 15% of amount over $17,400
$70,700 to $142,700	$9,735 + 25% of amount over $70,700
$142,700 to $217,450	$27,735 + 28% of amount over $142,700
$217,450 to $388,350	$48,665 + 33% of amount over $217,450
Over $388,350	$105,062 + 35% of amount over $388,350

EXPECTED 2013 INDIVIDUAL TAX RATES

If taxable income (married filing jointly)

Is over	But not over	The tax is:*
$0	$17,850	10% of taxable income
$17,850	$72,500	$1,785 plus 15% of the amount over $1,785
$72,500	$146,400	$9,982 plus 25% of the amount over $72,500
$146,400	$223,050	$28,458 plus 28% of the amount over $146,400
$223,050	$398,350	$49,920 plus 33% of the amount over $223,050
$398,350	$450,000	$107,769 plus 35% of the amount over $398,350
$450,000 and over		$125,846 plus 39.6% of the amount over $450,000

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* Plus 0.9% on earned income over $200,000/$250,000
Plus 3.8% on unearned income to extent AGI is over $200,000/$250,000

Other 2012/2013 Income Tax Rate Changes

- Long-term Capital Gain

	2012	2013
	15%	20.0%*
with 3.8% surtax	15%	23.8%

- Collectibles and Real Property Recapture Rates stay at 28%/25%, respectively.

- Qualified Dividends (Max. Rate)

	2012	2013
	15%	20.0%*
with 3.8% surtax	15%	23.8%

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* The extra 5% applies only to the extent taxable income exceeds $450,000 (married, joint)/$400,000 (single)).

Choice of Entity Decision Revisited

NON-CORPORATE FLOW THROUGH ENTITIES

- Sole Proprietorship
  - Can be 100% owned limited liability company (LLC), formed to limit liability but treated as disregarded entity for tax purposes.
- General Partnership
- Limited Liability Partnership
- Limited Partnership
- LLC taxed as Partnership

Choice of Entity Decision Revisited (Con’t)

CORPORATE FLOW THROUGH ENTITIES

- S Corporation
- “Check the Box” LLC that has made an S election

NON FLOW THROUGH ENTITIES

- C Corporation
- “Check the Box” LLC that has not made an S election.

Choice of Entity Decision Revisited (Con't)

SOME NON-TAX FACTORS TO CONSIDER

- Limited liability
- "Corporate" formalities
- Ease in accessing capital markets
  - Private money
  - Public markets
- Ownership restrictions (number and type)
  - Applicable to S corporation
- Flexibility in multiple classes of stock/equity
  - More limited for S corporations

Choice of Entity Decision Revisited (Con't)

TAX FACTORS TO CONSIDER

- Primary Advantages of Flow Through Structure
  - Avoidance of double tax
    - On stock sale (from increased basis attributable to retained earnings).
    - On asset sale, from retained earnings basis bump, and avoidance of double tax on unrealized appreciation in assets (subject to "BIG" tax for recently elected S corporations).
    - On current withdrawals of cash.

Choice of Entity Decision Revisited (Con't)

- Lower individual maximum capital gain rates.
  - 20% (23.8% if passive capital gain) vs. 35% corporate rate.
- Flexibility to withdraw cash
- Avoids unreasonable accumulation of earnings penalty tax.
- Avoids unreasonable compensation issues
- Possible ability to avoid "Medical surtax" of 3.8%
  - "Obamacare" surtax of 3.8% on S corporation pass-through income does not apply to materially participating shareholders.
  - This is a potential advantage of S corporations over other flow through structures.

Choice of Entity Decision Revisited (Con't)

- More flexibility in choosing method of accounting (cash vs. accrual) than C corporations.

- <u>Primary Disadvantages of Flow Through Structure</u>
  - Higher maximum immediate federal ordinary income tax rates.
    - 39.6%/43.4% if "passive" income vs. 35%
    - Bracket creep through C corporation brackets will result in lower rate than 35% if under $18,833,333 of taxable income.
  - Generally a calendar year is required.
  - Limited ability to implement deferred compensation plans for owners.

Choice of Entity Decision Revisited (Con't)

- Inability to use §1202 100% qualified sale exclusion of small business stock through 2013.
- Disability insurance premiums not deductible for owners/but benefits are not taxable.

- Primary Differences Between Corporations and other Flow Through Structures
  - Inability to add entity debt to S corporation stock basis
    - For loss flow through.
    - For tax deferred distributions.
  - Triggering of tax on appreciated assets if distributed from S corporations (§311).

Choice of Entity Decision Revisited (Con't)

- Less flexibility on contributing appreciated assets tax free to S corporations (§351 vs. §721).
- Less flexibility on structuring equity participation for key executives of S corporations (subject to carried interest proposals)
- <u>More </u>flexibility in structuring a tax deferred (reorganization) exit for S corporations.

Choice of Entity Decision Revisited (Con't)

<u>TAKE AWAYs</u>

- The choice of entity analysis has not fundamentally changed, and in most instances a flow through structure will still be preferred even in light of the increased spread in individual vs. corporate tax rates. However, for start-up companies
  - That want to minimize current taxes;
  - That have an exit plan that allows conversion from "C" to "S" status in sufficient time to avoid the "BIG" tax; and
  - For which S corporation status is an acceptable flow through structure (vs. partnership) the balance may shift to a C corporation structure initially.

Choice of Entity Decision Revisited (Con't)

- Note that if an S corporation converts to a C corporation, absent IRS consent it cannot return to S corporation status for five years.

Estate/Gift Tax

- ESTATE AND GIFT TAX RATE CHANGES

Year	Exemption	Top Rate
2012	$5,120,000	35%
2013	$5,250,000 (inflation adjusted)	40%

OTHER ESTATE/GIFT TAX PROVISIONS

- Spousal portability retained.
- All other sunset provisions of the 2001 and 2010 changes have been eliminated, and such otherwise sunsetted provisions made permanent (ACT §101(a)(1) and (2)). E.g.,
  - $250,000 home sale gain exclusion for qualified bypass trusts in §121(d)(ii)(C) retained.
  - Accommodative provision in IRC §6166 rules (installment payment of estate taxes for tax attributable to closely held business) retained.

OTHER ESTATE/GIFT TAX PROVISIONS (CON'T)

- Other possible future changes:
  - Elimination of discount planning.
  - Elimination of "defective" grantor trust planning.
  - Elimination of GRATs under 10 years in length.
  - Limitation of Dynasty Trusts to 90 years.