


**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

Frederick J. Caspar, J.D.
Dinsmore & Shohl LLP
10 Courthouse Plaza, S.W., Suite 1100
Dayton, Ohio 45402
(937) 449-2818
fred.caspar@dinsmore.com

January 14, 2013

© 2013 Frederick J. Caspar

INCOME TAX (CON'T)

▣ BRIEF SUMMARY OF SELECT CHANGES

INCOME TAX (CON'T)

BUSINESS PROVISIONS

- Section 179 Deduction for Equipment
 - Annual limit for 2012 (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 or 2013, 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 earned 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 unearned (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)

<u>Is over</u>	<u>But not over</u>	<u>The tax is: *</u>
\$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

-
- * 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

	<u>2012</u>	<u>2013</u>
	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)

	<u>2012</u>	<u>2013</u>
	15%	20.0%*
with 3.8% surtax	15%	23.8%

* 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.
- Primary Disadvantages of Flow Through Structure
 - 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)
- More flexibility in structuring a tax deferred (reorganization) exit for S corporations.

Choice of Entity Decision Revisited (Con't)

TAKE AWAYS

- 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

<u>Year</u>	<u>Exemption</u>	<u>Top Rate</u>
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.