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Fiscal cliff legislation offers many changes to private companies and their owners

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In brief

President Barack Obama on January 2 signed into law the *American Taxpayer Relief Act of 2012* (the Act). Much of the new law will affect privately held companies and their owners for 2012 and beyond.

The Act includes permanent extensions of certain 2001 and 2003 tax provisions for individuals with incomes below $400,000, and joint filers with incomes below $450,000. For individuals whose taxable income exceeds these thresholds, their top tax bracket will increase to 39.6% and their dividends and long-term capital gains will be taxed at 20%. The legislation also permanently extends the $5 million estate and gift tax exemption (indexed for inflation). In addition, the Act extends a 50% bonus depreciation provision for qualified property through the end of 2013.

The Act also provides permanent indexing of individual alternative minimum tax (AMT) exemption levels for 2012 and subsequent years. The Act includes retroactive extensions through 2013 of certain expired individual, business, and energy tax provisions. The renewed business tax provisions include the research credit (with modifications), controlled foreign corporation (CFC) look-through, 15-year straight-line cost recovery for qualified leasehold improvements, and certain other provisions that expired at the end of 2011.

In detail

Key individual tax provisions

Under the Act, the Bush-era tax rates are permanently extended for most taxpayers. In general, individuals with taxable income under $400,000 ($450,000 for joint filers) will continue to receive the benefit of these tax cuts. However, a top rate of 39.6% will be effective beginning after December 31, 2012 for individuals with taxable incomes above these amounts.

A top rate of 20% for long-term capital gains and qualified dividends will be effective beginning after December 31, 2012 for individuals with taxable incomes above $400,000, joint filers with taxable incomes above $450,000. Long-term capital gains and qualified dividends will continue to be taxed at 15% permanently for taxpayers with taxable incomes below these amounts.

Observations

While the increase in the top individual rates for higher income taxpayers has received the most attention, starting in 2013 trusts and estates are subject to the 39.6% rate on ordinary income and the 20% rate for long-term capital gains and qualified dividends at just $11,950 of taxable income.

The Affordable Care Act came with new taxes for higher income taxpayers beginning in 2013. The health care law increases the employee portion of Medicare taxes by an additional 0.9% on wages and self-employment income received in excess of $200,000 ($250,000 for joint filers). In addition, it imposes a separate 3.8% Medicare surtax on certain types of investment income for taxpayers with modified adjusted gross income above $200,000 (above $250,000 for joint filers and above $11,950 for trusts and estates). These new taxes are in addition to the rate increases discussed herein (see table below).

See PFS Planning Update: Planning for the Net Investment Income Tax, also known as the Medicare Contribution Tax.

Personal exemption phase-out and 'Pease' limitation

The personal exemption phase-out and 'Pease' limitation on itemized deductions will be reinstated permanently beginning after December 31, 2012 for single filers with adjustable gross incomes above $250,000 ($300,000 for joint filers). The Pease provision phases out itemized deductions by the lesser of 3% of adjusted gross income (AGI) or 80% of the otherwise allowable deductions. Not all deductions are affected by the phase-out of itemized deductions, but most of the common deductions like those for home mortgage interest, taxes and charitable contributions are subject to phase-out. The following deductions are not subject to phase-out: investment interest expenses, medical and dental expenses, gambling losses and non-business casualty and theft losses.

Observations

While the Act does not directly limit the value of a taxpayer's itemized deductions to a certain tax rate or place an overall cap on a taxpayer's itemized deductions reinstatement of the Pease provision limits the amount of certain itemized deductions if a taxpayer's income exceeds the applicable threshold. Because the limitation is impacted by both the level of income and deductions, whether this limitation will reduce the tax benefit of additional itemized deductions is not always clear.

Example: A married couple with $1 million of wages and interest income before itemized deductions, will have to reduce their itemized deductions by $21,000 (($1m less $300,000) x 3%). Assuming their itemized deductions such as home mortgage interest and taxes already exceed $21,000, additional charitable deductions should result in a full 39.6% tax benefit, with no further loss of deduction due to the phase-out.

While the increase in tax rates for the wealthiest individuals have received the most coverage, the failure to extend the payroll tax holiday, the reinstatement of the personal exemption phase-out, the Pease limitation on itemized deductions, and the 0.9% and/or 3.8 % Medicare taxes will cause taxpayers with lower incomes to face higher tax bills in 2013.

Permanent AMT relief

The Act increases the individual AMT exemption amount to $50,600 for single filers ($78,750 for joint filers) for 2012 and permanently indexes the AMT exemption amount for inflation beginning in 2013.

Observations

Higher income taxpayers with significant income taxed at the 20% rate or certain types of itemized deductions will continue to be subject to AMT without the benefit of the increased exemption due to phase-outs of the exemption amounts.

State and local sales tax deduction

The Act extends through 2013 the election to take an itemized deduction for state and local general sales taxes in lieu of the itemized deduction permitted for state and local income taxes.

2013 top individual tax rates for incomes above $400,000 single / $450,000 married filing joint

	Wage income	Interest income	Dividends	Long-term capital gains
2013 top rate	41.05%*	39.6%	20.0%	20.0%
2013 phase-out of itemized deductions	+1.2%	+1.2%	+1.2%	+1.2%
2013 HI surtax	+0.9%	+3.8%	+3.8%	+3.8%
2013 combined top rate	43.15%	44.6%	25.0%	25.0%

* Includes 1.45% employee share of Medicare HI tax (additional 1.45% applies for self-employed).

Note: Rates shown represent the equivalent marginal tax rate on each additional dollar of income earned in the top income tax bracket.

Individual retirement accounts and retirement plans

The Act extends through 2013 the provision allowing tax-free distributions from traditional or Roth individual retirement accounts (IRAs) directly to qualified charities, by individuals age 70-and-a-half or older, up to a maximum of $100,000 per taxpayer per year.

Observations

This provision expired after 2011 and has been extended for both 2012 and 2013. If a taxpayer took a required minimum distribution in December 2012, the taxpayer can elect to treat part or all of the distribution as a 2012 qualified charitable contribution for the amount contributed to a qualifying charity on or before February 1, 2013. In addition, taxpayers can treat distributions to charity from their IRAs and qualified plans in January 2013 as made on December 31, 2012.

In addition to the permanent extensions of the Bush-era tax rates, the Act permanently extends the following provisions:

- modifications to the child tax credit
- marriage penalty relief
- changes to Coverdell Education Savings Accounts
- expanded exclusion for employer-provided educational assistance
- expanded student loan interest deduction
- exclusion from income of amounts received under certain scholarship programs
- expanded dependent care credit
- increased adoption tax credit and adoption assistance programs
- credit for employer expenses for child care assistance.

In addition to temporary extensions of the deduction for state and local general sales taxes and tax-free distributions from IRAs for charitable purposes, the legislation temporarily extends individual tax provisions relating to:

- American Opportunity Tax Credit (through 2017)
- 2009 modifications to the child tax credit (through 2017)
- deductions for certain expenses of elementary and secondary school teachers (through 2013)
- mortgage debt relief (through 2013)
- premiums for mortgage insurance deductible as interest that is qualified residence interest (through 2013)
- special rules for contributions of capital gain real property made for conservation purposes (through 2013)
- above-the-line deduction for qualified tuition related expenses (through 2013).

The Act delays for two months automatic across-the-board 'sequestration' spending cuts that are a consequence of the Budget Control Act of 2011. This delay in scheduled spending cuts is offset in part by a provision relaxing conditions and age restrictions allowing participants in 401(k) plans with in-plan conversion features to makes transfers to a Roth IRA at anytime. The amount converted would be subject to regular income tax.

Action item

The changes to income tax rates on ordinary income and capital gains, the impact of the HI Surtax, and modifications to various other tax provisions discussed above make it important for taxpayers to review their withholdings or estimated tax payment requirements for 2013.

Key estate and gift tax provisions

In addition to addressing the expiration of 2001 and 2003 income tax rates, the Act provides for a 40% gift and estate tax rate and a unified estate and gift tax exemption of $5 million (indexed for inflation). While the exemption amount continues current policy, the new rate is a compromise between the 35% rate that has been in effect since 2010 and the Obama Administration's proposal to return to the 2009 top rate of 45%. Under prior law, the estate and gift tax was set to revert to pre-2001 levels, with a top rate of 55% and a $1 million estate and gift tax exemption amount.

Observations

Since the 2013 gift/estate tax exemption is projected to be $5.25 million, taxpayers that used their $5.12 million exemption during 2012 can transfer an additional $130,000 tax-free in 2013.

The amount that may be transferred without using a taxpayer's gift tax exemption is $14,000 per donee, up from 2012's annual exclusion amount of $13,000.

Current state of Transfer Tax

		Estate taxes	Gift taxes	GST taxes
2011	Exempt amounts	$5,000,000	$5,000,000	$5,000,000
	Maximum tax rate	35%	35%	35%
	Annual exclusion	N/A	$13,000	$13,000
2012	Exempt amounts*	$5,120,000	$5,120,000	$5,120,000
	Maximum tax rate	35%	35%	35%
	Annual exclusion	N/A	$13,000	$13,000
2013	Exempt amounts*	$5,250,000	$5,250,000	$5,250,000
	Maximum tax rate	40%	40%	40%
	Annual exclusion	N/A	$14,000	$14,000

* Indexed for inflation.

Portability

The Act makes permanent the 'portability' of unused exemptions between spouses introduced by the 2010 Tax Relief Act. Prior to the permanent extension, the executor of a deceased spouse's estate was able to transfer any unused exemption to the surviving spouse only for estates of decedents dying after December 31, 2010 and before January 1, 2013. This provision is effective for estates of decedents dying after December 31, 2012.

Other estate, gift, and generation-skipping transfer tax provisions

The Act also extends the deduction for state estate taxes and extends a number of generation-skipping transfer tax provisions that were set to expire after 2012.

Observations

The Act does not address broad wealth transfer tax reform proposals included in the Obama Administration's Fiscal 2013 Budget, including limitations on valuation discounts for family-held entities, the favorable tax treatment of irrevocable grantor trusts, short-term grantor retained annuity trusts, and the duration of long-term or dynastic type trusts.

Renewal of business and energy tax extenders

Business tax provisions

The Act includes retroactive extensions through 2013 of certain business tax provisions that had expired at the end of 2011. The renewed business tax provisions include the research credit (with modifications), controlled foreign corporation (CFC) look-through, the exception for active financing income, and certain other provisions. The extension of the research credit from January 1, 2012, through December 31, 2013, includes provisions that would modify rules for taxpayers under common control and rules for computing the credit when a portion of a trade or business changes hands.

In addition, the Act extends a 50% bonus depreciation provision for qualified property through the end of 2013, and decouples bonus depreciation from the Section 460 percentage of completion method of accounting for assets with a depreciable life of seven years or less that are placed in service in 2013. The Act also allows taxpayers to elect to accelerate some alternative minimum tax credits in lieu of bonus depreciation.

The Act extends the 100% exclusion of the gain from the sale of qualifying small business stock that is acquired before January 1, 2014 and held for more than five years. The Act also clarifies that, in the case of stock acquired after February 17, 2009 and before January 1, 2014, the date of acquisition for purposes of determining the percentage exclusion (i.e., 50, 75, or 100%) is the date the holding period for the stock begins.

The Act also extends many other business tax provisions through 2013, including:

- 15-year straight-line cost recovery for qualified leasehold improvements, qualified restaurant buildings and improvements, and qualified retail improvements
- increase in the maximum amount and phase-out threshold under Section 179
- new markets tax credit
- work opportunity tax credit
- empowerment zone tax incentives
- basis adjustment to stock of S corporations making charitable contributions of property
- reduction in S corporation recognition period for built-in gains to five years.

The Act does not extend several tax provisions that had been included in previous tax extender bills. For example, the Act does not include extension provisions related to the 100%-of-net-income limitation on percentage depletion for oil and gas from marginal wells, brownfields environmental remediation expensing, and augmented charitable deductions for corporate donations of computer and book inventory.

Observations

Taxpayers with fiscal years ending in 2012, 2013, and 2014 should consider opportunities to maximize cost recovery strategies using bonus depreciation and Section 179 expensing. Taxpayers who have not yet filed their fiscal year 2011 federal income tax returns should be mindful of the applicable dates to which the bonus depreciation and Section 179 expensing limitations apply. The 100% bonus depreciation allowance can generally be used only for qualified property that was placed into service before January 1, 2012. However, the increased Section 179 limitations ($500,000/$2,000,000) are applicable to tax years that began in 2011, 2012, and 2013. Therefore, these limitations still apply to qualified property that is placed into service after December 31, 2011, but within the taxpayer's fiscal year ending before 2015.

Energy tax provisions

The ACT extends and modifies the renewable electricity wind production tax credit and modifies other renewable energy credits. An investment tax credit is provided in lieu of the production tax credit for certain renewable energy facilities that began construction by the end of 2013.

The following is a list of some of the other energy provisions included in the Act:

- credit for certain nonbusiness energy property
- credit for alternative fuel vehicle refueling property
- incentives for biodiesel and renewable diesel
- credit for construction of new energy-efficient homes
- credit for energy-efficient appliances
- incentives for alternative fuels and alternative fuel mixtures.

Income tax accounting implications

While Congress approved a retroactive extension of certain business tax provisions that expired at the end of 2011 and 2012, this extension would be taken into account for financial reporting purposes in the quarter in which the legislation is signed into law by the President. Therefore, President Obama's signing of the Act on January 2 would be a financial statement event for the first quarter of calendar year 2013. Thus, regardless of the timing or retroactive nature of the legislation, calendar-year businesses would not be expected to reflect the financial statement benefits of these extensions in their 2012 calendar year-end financial statements. Nonetheless, financial statement disclosure in 2012 may be appropriate depending upon the potential impact of the Act.

The takeaway

Not only does the Act make permanent reduced income tax rates for most taxpayers, it extends either permanently or temporarily a host of other tax incentives. Accordingly, the Act opens tax planning opportunities not only for 2012 returns, but also 2013 returns and beyond.

Let's talk

For a deeper discussion of how these issues might affect you or your business, please contact your local PwC Private Company Services representative or one of the subject matter specialists shown on the next page:

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