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Dear Clients and Friends:

The American Taxpayer Relief Act of 2012 (better known as the fiscal cliff legislation) became law on 1/2/13. Due to the expiration of the so-called payroll tax holiday, all workers will pay higher federal taxes this year, but the Act cancels most other income tax increases that would have resulted in added misery for just about every individual taxpayer. In addition, many popular tax breaks for individuals were extended. The bad news is that, starting in 2013, higher-income folks will face higher taxes. The Act also extended lots of business tax breaks (some with modifications).

Here is a quick summary of most-important tax changes—starting with those that affect individuals.

Payroll Tax Holiday Is Dead (So Far)

For 2011 and 2012, the Social Security tax withholding rate on your salary was temporarily reduced by 2%, from the normal 6.2% to 4.2%. If you're self-employed, the Social Security tax component of the self-employment tax was reduced by 2%, from the normal 12.4% to 10.4%. Last year, this so-called payroll tax holiday could have saved one person up to $2,202 or a working couple up to $4,404. Somewhat surprisingly, the Act does not extend the holiday through 2013.

Note: For 2013, the Social Security tax can hit up to $113,700 of salary or self-employment income. Thus, loss of the 2% payroll tax holiday could cost one person up to $2,274 or a working couple up to $4,548.

Tax Increases for Higher-income Individuals

Rates on Ordinary Income. For most individuals, the federal income tax rates for 2013 will be the same as last year: 10%, 15%, 25%, 28%, 33%, and 35%. However, the Act increases the maximum rate for higher-income folks to 39.6% (up from 35%). For 2013, this change only affects singles with taxable income above $400,000, married joint-filing couples with taxable income above $450,000, heads of households with taxable income above $425,000, and married individuals who file separate returns with taxable income above $225,000. After 2013, these taxable income amounts will be adjusted for inflation. These changes are permanent (until further notice).

Note: Higher-income folks may also get hit by the new 0.9% Medicare tax on wages and self-employment income and the new 3.8% Medicare contribution tax on net investment income. If so, they can face combined tax rates in excess of the advertised rates.

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Rates on Long-term Gains and Dividends. The tax rates on long-term capital gains and dividends will also remain the same as last year for most individuals. However, the Act increases the maximum rate for higher-income folks to 20% (up from 15%). For 2013, this change only affects singles with taxable income above $400,000, married joint-filing couples with taxable income above $450,000, heads of households with taxable income above $425,000, and married individuals who file separate returns with taxable income above $225,000. After 2013, these taxable income amounts will be adjusted for inflation. These changes are permanent (until further notice).

Note: Higher-income folks may also get hit by the new 3.8% Medicare contribution tax on investment income, which can result in a maximum 23.8% federal tax rate on long-term gains and dividends instead of the advertised 20%.

Personal and Dependent Exemption Deduction Phase-out. The last time we saw a phase-out rule for personal and dependent exemption deductions was 2009. Sadly, the Act brings back the phase-out deal. As a result, your personal and dependent exemption write-offs can be reduced or even completely eliminated. For 2013, phase-out starts at the following Adjusted Gross Income (AGI) thresholds: $250,000 for singles, $300,000 for married joint-filing couples, $275,000 for heads of households, and $150,000 for married individuals who file separate returns. After 2013, these threshold amounts will be adjusted for inflation. This change is permanent (until further notice).

Itemized Deduction Phase-out. The last time we saw a phase-out rule for itemized deductions was also in 2009. Unfortunately, this phase-out provision is back too, thanks to the Act. As a result, you can potentially lose up to 80% of your mortgage interest, state and local taxes, charitable contributions, and miscellaneous itemized deductions if your AGI exceeds the applicable threshold. For 2013, the thresholds are $250,000 for singles, $300,000 for married joint-filing couples, $275,000 for heads of households, and $150,000 for married individuals who file separate returns. After 2013, these threshold amounts will be adjusted for inflation. This change is permanent (until further notice).

Alternative Minimum Tax Patch Made Permanent

It had become a tiresome annual ritual for Congress to “patch” the Alternative Minimum Tax (AMT) rules to prevent millions more households from getting socked with this add-on tax. The patch job consisted of allowing larger inflation-indexed AMT exemption amounts and allowing various personal tax credits to offset the AMT. The Act makes the patch permanent, starting with 2012. As a result, about 30 million households a year will be kept out of the dreaded AMT zone. For 2012, the AMT exemption amounts are $50,600 for unmarried individuals, $78,750 for married joint-filing couples, and $39,375 for married individuals who file separate returns. For 2013 and beyond, the AMT exemptions will be adjusted for inflation.

Tax Breaks for Families with Children

Larger Child Tax Credit Made Permanent. The $1,000 maximum credit for each eligible under-age-17 child was made permanent. Without the Act, the maximum credit would have dropped to only $500 for 2013 and beyond. In addition, provisions that allow the child credit to be refundable for more households were extended through 2017.

Favorable Child and Dependent Care Tax Credit Rules Made Permanent. Thanks to the Bush era tax cut legislation, most parents have been able to claim a credit of up to $600 for costs to care for one under-age-13 child, or up to $1,200 for costs to care for two or more under-age-13 kids, so the parents can work. Lower-income parents have been able to claim larger credits of up to $1,050 and $2,100, respectively. The Act makes these credit amounts permanent for 2013 and beyond (without the Act, they would have dropped to $480 and $960 for most parents; $720 and $1,440 for lower-income parents).

Favorable Earned Income Tax Credit Extended. Legislation enacted in previous years increased the earned income credit for families with three or more qualifying children and allowed married joint-filing couples to earn more without having their credits reduced. These changes, which help lower-income families, were extended by the Act through 2017.

Liberalized Tax Breaks for Adoptive Parents Made Permanent. The Bush tax cut package included a major liberalization of the adoption tax credit and also established tax-free employer adoption assistance payments. These taxpayer-friendly provisions were scheduled to expire at the end of 2012. The credit would have been halved and limited to special needs children only. Tax-free adoption assistance payments from employers would have disappeared. The Act permanently extends the more-favorable Bush era rules.

Tax Breaks for Education Expenses

American Opportunity Higher Education Tax Credit Extended. The American Opportunity Credit, which can be worth up to $2,500 and can be claimed for up to four years of undergraduate education, was extended by the Act through 2017.

College Tuition Deduction Extended. This write-off, which can be as much as $4,000 or $2,000 for higher-income folks, expired at the end of 2011. The Act retroactively restores it for 2012 and extends it through 2013.

Favorable Student Loan Interest Deduction Rules Made Permanent. This write-off, which can be as much as $2,500 (whether you itemize or not) was scheduled to fall under less-favorable rules in 2013 and beyond. There would have been a 60-month limit on deductible interest, and a stricter phase-out provision would have reduced or eliminated the deduction for many more middle-income taxpayers. The Act permanently extends the favorable rules that have applied in recent years.

Favorable Coverdell Education Savings Account Rules Made Permanent. For 2013 and beyond, the maximum annual contribution to these federal-income-tax-free college savings accounts was scheduled to drop from $2,000 to a paltry $500, and a stricter contribution phase-out rule would have applied. The Act makes permanent the favorable rules that have applied in recent years.

Tax Breaks for Your Residence

Tax-free Treatment for Forgiven Principal Residence Mortgage Debt Extended. For federal income tax purposes, a forgiven debt generally counts as taxable Cancellation of Debt (COD) income. However, a temporary exception applied to COD income from cancelled mortgage debt that was used to acquire a principal residence. Under the temporary rule, up to $2 million of COD income from principal residence acquisition debt that was cancelled in 2007–2012 was treated as a tax-free item. The Act extends this break to cover eligible debt cancellations that occur in 2013.

$500 Energy-efficient Home Improvement Credit Extended. In past years, taxpayers could claim a tax credit of up to $500 for certain energy-saving improvements to a principal residence. This break expired at the end of 2011, but the Act retroactively restores it for 2012 and extends it through 2013. The credit equals 10% of eligible costs for energy-efficient insulation, windows, doors, and roof, plus 100% of eligible costs for energy-efficient heating and cooling equipment, subject to the $500 cap. Note that the cap is reduced by any energy credits you claimed in prior years.

Mortgage Insurance Premium Write-off Extended. Premiums for qualified mortgage insurance on debt to acquire, construct, or improve a first or second residence can potentially be treated as deductible qualified residence interest. Before the Act, this break was only available for premiums paid through 2011. The Act retroactively restores the break for premiums paid in 2012 and extends it to cover premiums paid in 2013. However, the deduction is only available for premiums for qualifying policies issued after 12/31/06 and premium amounts allocable to periods before 2014 and it is phased out for higher-income taxpayers.

Other Individual Tax Breaks

Option to Deduct State and Local Sales Taxes Extended. In past years, individuals who paid little or no state income taxes were given the option of instead claiming an itemized deduction for state and local sales taxes. The option expired at the end of 2011, but the Act retroactively restores it for 2012 and extends it through 2013.

Charitable Donations from IRAs Extended. In past years, IRA owners who had reached age 70½ were allowed to make tax-free charitable donations of up to $100,000 directly out of their IRAs. The donations counted as IRA required minimum distributions. Thus, charitably inclined seniors with more IRA money than they need could reduce their income taxes by arranging for tax-free IRA donations to take the place of taxable IRA required minimum distributions. This break expired at the end of 2011, but the Act retroactively restores it for 2012 and extends it through 2013. To take advantage of the retroactive deal, you can treat donations from your IRA made in January of this year as having been made in 2012. You can also treat IRA distributions taken in December of last year as 2012 IRA donations if you transfer the money to qualifying charities by 1/31/13.

$250 Deduction for K-12 Educators' Expenses Extended. The $250 deduction for teachers and other K-12 educators for school-related expenses paid out of their own pockets was retroactively restored for 2012 and extended through 2013.

100% Gain Exclusion for Qualified Small Business Corporation Stock Extended. The Act retroactively restores the temporary 100% gain exclusion (within limits) for sales of Qualified Small Business Corporation (QSBC) stock issued in 2012 and extends the deal to cover eligible shares issued in 2013. Note that you must hold QSBC shares for more than five years to be eligible for the 100% gain exclusion privilege.

Relatively Favorable Gift and Estate Tax Rules Made Permanent

For 2013 and beyond, the Act permanently installs a unified federal estate and gift tax exemption of $5 million—adjusted annually for inflation—and a 40% maximum tax rate (up from last year's 35% rate). For 2013, the inflation-adjusted exemption amount is expected to be around $5.25 million. The Act also makes permanent the right to leave your unused federal estate and gift tax exemption to your surviving spouse (the so-called exemption portability deal).

Business Depreciation and Cost Recovery Provisions

50% Bonus Depreciation Extended. The Act extends 50% first-year bonus depreciation for an additional year to cover qualifying new (not used) assets that are placed in service in calendar-year 2013. However, the placed-in-service deadline is extended to 12/31/14 for certain assets that have longer production periods including transportation equipment and aircraft. Under the extended deadline privilege, only the portion of a qualifying asset's basis that is allocable to costs incurred before 1/1/14 is eligible for 50% bonus depreciation.

For a new passenger auto or light truck that is subject to the luxury auto depreciation limitations, the 50% bonus depreciation provision increases the maximum first-year depreciation deduction by $8,000.

Generous Section 179 Deduction Rules Extended and Qualifying Real Estate Expenditures Are Again Eligible. For qualifying assets placed in service in tax years beginning in 2012 and 2013, the Act restores the maximum Section 179 deduction to $500,000 (same as for tax years beginning in 2011). Without this change, the maximum deduction would have been only $139,000 for 2012 and only $25,000 for 2013. The Act also restores the Section 179 deduction phase-out threshold to $2 million for tax years beginning in 2012 and 2013 (same as for tax years beginning in 2011). Without this change, the phase-out threshold would have been only $560,000 for 2012 and only $200,000 for 2013.

Somewhat surprisingly, the temporary rule that allowed up to $250,000 of Section 179 deductions for qualifying real property placed in service in tax years beginning in 2010 and 2011 was retroactively restored for tax years beginning in 2012 and extended through tax years beginning in 2013.

Key Point: For tax years beginning in 2014, the maximum Section 179 deduction is scheduled to be only $25,000, the phase-out threshold is scheduled to fall to $200,000, and the Section 179 deduction privilege for real estate expenditures will be off the table.

15-year Depreciation for Leasehold Improvements, Restaurant Property, and Retail Space Improvements Extended. The Act retroactively restores the 15-year straight-line depreciation privilege for qualified leasehold improvements, qualified restaurant property, and qualified retail space improvements for property placed in service in 2012 and extends the deal to cover property placed in service in 2013.

Business Tax Credit Provisions

Research Credit Modified and Extended. The Act modifies and retroactively restores the research credit for 2012 and extends it through 2013 to cover qualifying expenses paid or incurred in those years.

Work Opportunity Credit Extended. The Act retroactively extends the general deadline for employing eligible individuals for purposes of claiming the Work Opportunity Tax Credit to cover qualifying hiring that occurred in 2012 and further extends the deadline to cover qualifying hiring that occurs in 2013.

Military Service Differential Pay Credit for Small Employers Extended. The Act retroactively restores the credit for eligible small employers that provide differential pay to employees while they serve in the military to cover payments made in 2012 and extends the deal to cover payments made in 2013. The credit equals 20% of differential pay of up to $20,000 paid to each qualifying employee during the year.

Credit for Building Energy-efficient Homes Extended. The Act retroactively restores the $2,000 per-home contractor tax credit for building new energy-efficient homes in the U.S. (including manufactured homes) for 2012 and extends it through 2013. The credit can also be claimed for substantially reconstructing and rehabilitating an existing home and making it more energy-efficient. Homes that don't fully meet the energy-efficiency standards may qualify for a reduced $1,000 credit.

Business Charitable Contribution Provisions

Enhanced Deduction for Food Donations Extended. The Act retroactively restores for 2012 and extends through 2013 the enhanced charitable contribution deduction for non-C-corporation businesses that donate food (it must be apparently wholesome when donated). This provision is intended for non-C-corporation businesses that have food inventories, such as restaurants. For non-C-corporation taxpayers, deductions for donated food are normally limited to the taxpayer's basis in the food or FMV, whichever is lower. In contrast, the enhanced deduction equals the lesser of: (1) basis plus one-half the value in excess of basis or (2) two times the basis (the same enhanced deduction rule has been available to C corporations for years).

Favorable Rule for S Corporation Donations of Appreciated Assets Extended. The Act retroactively restores for tax years beginning in 2012 and extends through tax years beginning in 2013 the favorable shareholder basis rule for stock in S corporations that make charitable donations of appreciated assets. For such donations, each shareholder's tax basis in the S corporation's stock is only reduced by the shareholder's prorata percentage of the company's tax basis in the donated assets. Without the extended provision, a shareholder's basis reduction would equal the passed-through write-off for the donation (a larger amount than the shareholder's prorata percentage of the company's tax basis in the donated asset). The extended provision is taxpayer-friendly because it leaves shareholders with higher tax basis in their S corporation shares, which is typically beneficial to shareholders.

Favorable Rules for C Corporation Farm and Ranch Conservation Contributions Extended. Liberalized deduction rules for qualified conservation contributions expired at the end of 2011. The Act retroactively restores them for tax years beginning in 2012 and extends them through tax years beginning in 2013. Qualified conservation contributions are charitable donations of real property interests, including remainder interests and easements that restrict the use of real property. For qualified C corporation farming and ranching operations, the maximum write-off for qualified conservation contributions is increased from the normal 10% of adjusted taxable income to 100% of adjusted taxable income. Qualified conservation contributions in excess of what can be written off in the year of the donation can be carried forward for 15 years.

Employee Benefit Provisions

Favorable Rules for Employer-paid Adoption Expenses Made Permanent. The Bush tax cut legislation increased the cap on tax-free employer adoption assistance payments and raised the income phase-out ranges to allow more employees to benefit. However, tax-free treatment for adoption assistance payments was scheduled to expire at the end of 2012. The Act makes the Bush tax cut provisions permanent.

Employer Educational Assistance Plans Made Permanent. Through 2012, an employer could provide up to $5,250 in annual federal-income-tax-free educational assistance to each eligible employee under an educational assistance plan. Both undergraduate and graduate school costs could be covered by the plan, and the education did not need be job-related. This taxpayer-friendly deal was scheduled to expire at the end of 2012, but the Act makes it permanent.

Parity for Employer-provided Parking and Transit Benefits. For 2012, employer-provided parking allowances are tax-free up to a monthly limit of $240. For 2013, the monthly limit is expected to be $245. Thanks to the Act, an employee can be given up to these same amounts last year and this year for tax-free transit passes or vanpooling. Without the Act, there would have been only a $125 monthly limit on employer-provided transit passes and vanpooling for both 2012 and 2013.

Qualified Retirement Plan Balances Can Be Transferred into Plan Designated Roth Accounts. Some qualified retirement plans [typically 401(k) plans] allow participants to make salary-reduction contributions to designated Roth accounts. These accounts are similar to Roth IRAs, but they are operated by the retirement plan rather than the individual. Previous legislation also gave plans the option of allowing a participant to roll over amounts eligible for distribution from the "regular" part of the plan into his or her designated Roth account. The Act extends the concept by giving plans the option of allowing participants to transfer amounts into designated Roth accounts without the requirement that such amounts be eligible for distribution. This favorable change is available for transfers after 12/31/12.

Key Point: For you, the federal income tax impact of transferring an amount into a designated Roth account is the same as receiving the amount as a plan distribution and then rolling it over into a Roth IRA. In other words, the taxable portion of the transferred amount must be included as income on your tax return—just like with a garden-variety Roth conversion transaction.

Break for S Corporation Built-in Gains Extended

When a C corporation converts to S corporation status, the corporate-level built-in gains tax generally applies when built-in gain assets (including receivables and inventories) are turned into cash or sold within the *recognition period*. The recognition period is normally the 10-year period that begins on the conversion date. Previous legislation established an exception for built-in gains recognized in S corporation tax years beginning in 2011 if the fifth year of the recognition period had gone by before the beginning of the tax year beginning in 2011. Gains that fall under this exception were not hit with the built-in gains tax. The Act retroactively restores the five-year exception for tax years beginning in 2012 and extends it for tax years beginning in 2013. In other words, for gains recognized in those years, the built-in gains tax won't apply if the fifth year of the recognition period has passed before the start of the year.

Conclusion

As you can see, the fiscal cliff legislation includes lots of tax changes. We did not cover them all here because we did not want this to turn into a book. If you have questions or want more complete information, please contact us.

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