The Fiscal Cliff

Where are we and where can we go from here?

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Individual Tax Rates

- The American Taxpayer Relief Act of 2012 extends, once again, most of the Bush era tax cuts for more than 98% of taxpayers.
- Some extensions are now permanent for taxpayers with taxable income below $400,000 (single),$450,000 (MFJ), or $225,000 (MFS)
- Tax brackets remain the same (with indexing) for taxpayers below the thresholds.
- Above the threshold, the top marginal rate increases from 35% to 39.6%.

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Individual Rates (Continued)

- The 33% tax bracket ends at $398,350. This means that single taxpayers will only have $1,650 taxed at the 35% rate ($51,650 MFJ) before the new top rate comes into effect.
- The relaxed rates from the Bush Era will still benefit all taxpayers up to the income threshold amounts. This remains a savings of approximately $11,000 for single taxpayers and $13,000 for MJF, from where we could have been.

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Capital Gains and Qualified Dividends

- The Act retains the qualified dividend treatment for all taxpayers.
- Under the thresholds, LT Cap Gains and Qualified Dividends remain at 15%.
- Taxpayers over the thresholds have their LT Cap Gains and Qualified Dividends taxed at 20%.

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Capital Gains and Qualified Dividends (Continued)

- Taxpayers with a modest amount of capital gains that are in the lowest tax bracket could be taxed at 0%. This provision was carried over from the Bush Era Cuts.

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Capital Gains and Qualified Dividends (Continued)

- The 15% rate will apply to LT gains and Qualified dividends in an amount equal to the lesser of:
  - The actual LT capital gains plus qualified dividends; or
  - The amount by which the $400,000/$450,000 threshold amounts exceeds the taxpayer's taxable income, excluding the LT gains and qualified dividends.

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Capital Gains and Qualified Dividends (Continued)

- Example: Assume a married couple with taxable income from salary of $375,000, plus LT capital gain of $100,000.
- Under these facts, $75,000 of the LT Capital Gain is taxed at 15%, and the remaining $25,000 is taxed at 20%.
- In this were an individual, $25,000 would be taxed at 15%, and $75,000 at 20%

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Payroll Tax Holiday Ends

- The 2% reduction in the employee portion of Social Security tax (or self-employment tax) has been eliminated.
- Employee portion of Social Security Tax is back to 6.2%.
- The "Holiday is over"

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Alternative Minimum Tax

- For years, taxpayers have played a waiting game each year to see if Congress would approve an AMT "Patch"
- The Patch was necessary because the Code was written that the AMT exemption would reduce each year.
- This caused a great deal of uncertainty for taxpayers and professionals as often the "Patch" was approved very late in the year.

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Alternative Minimum Tax (Continued)

- The AMT exemption is now permanently increased to $78,750 (MFJ), $39,375 (MFS), and 50,600 (All other individuals).
- The AMT exemptions are now indexed annually for inflation.

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Itemized Deductions

- The Pease Limitation is back in play, but in a slightly relaxed way.
- Certain itemized deductions will be limited by an amount equal to 3% of the excess of AGI over a threshold amount, but not more than 80% of the itemized deductions
- Thresholds are AGI greater than $300,000 (MFJ), $150,000 (MFS), $275,000 (HOH), $250,000 (Single)

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Itemized Deductions (Continued)

- Itemized deductions effected include:
  - State and local taxes,
  - Property taxes,
  - Charitable contributions, and
  - Miscellaneous itemized deductions
- Deductions not subject to limitation include:
  - Medical expenses (discussed below),
  - Interest expense,
  - Casualty, theft or gambling losses

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Itemized Deductions (Continued)

- Medical expenses – The floor for deductible medical expenses has been raised from 7.5% of AGI to 10% of AGI starting in 2013. Certain taxpayers that are 65 years of age prior to 2013, will have a two year extension of the 7.5% floor.
- State Sales Tax Deduction – reinstated retroactively for 2012, and extended to 2013.

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Personal Exemption Limitation

- Personal exemptions will be reduced by 2% for each $2,500, or part thereof, that AGI exceeds the same thresholds as the Pease limitations on itemized deductions.

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Other Individual Provisions

- Direct IRA Charitable Contributions brought back for 2012 and 2013.
- Child Tax Credit
- Earned Income Credit
- American Opportunity Tax Credit (Education)
- Qualified Tuition Deduction
- Exclusion from income for employer-provided mass transit and parking benefits
- Special rule for charitable contributions of real estate conservation easements.

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Trusts and Estates

- 39.6% marginal rate threshold is much lower, at $11,950 of taxable income.
- The 20% tax rate on LT capital gain and qualified dividends applies beginning with taxable income of $11,950.
- The AMT exemption for trusts and estates is now “fixed” at $22,500, which will be adjusted for inflation.

Business Provisions

- 50% bonus depreciation is extended through the end of 2013 for qualifying additions.
- Increased Section 179 expense is extended through 2013. $500,000 expense for qualifying additions. Investment limitation phaseout begins, dollar for dollar, at $2,000,000 of qualified additions.
- R&D Credit has been extended through 12/31/2013.
- Temporary exclusion of 100% of gain on the sale of certain small business stock is extended.
- S-Corporation built-in gain recognition period reduction is extended.

Estate and Gift Taxes

- **Estate Taxes:**
    - **Exemption is now $5,250,000 for 2013, and will be adjusted for inflation,**
  - **Rates: 37% over 500,000 up to $750,000**
    39% over $750,000 up to $1,000,000
    40% on all amounts over $1,000,000
  - **Exemption is now $5,250,000 for 2013, and will be adjusted for inflation.**
  - **Portability was retained for unused portion of exemption of first spouse to die.**

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Estate and Gift Taxes (Continued)

- Gift Taxes – Exemption set at $5,120,000 for 2012 and goes up to $5,250,000 in 2013. Adjusted for inflation from there.
- The top gift rate in 2013 is 40% for taxable gifts greater than $1,000,000.

- GST – Similar exemption of $5,250,000 in 2013, and rate is top Estate Tax rate of 40%.

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Planning Opportunities

- Individuals: New installment sales in 2012 – consider electing out of installment treatment for 2012 sales for taxpayers that will be subject to the 20% LT capital gains rate in the future.
- Also consider the applicability of the Healthcare Law's 3.8% Medicare surtax on net investment income.
- Accelerating gains in 2012 may help to avoid both of these taxes in future years.
- This election can be made up until the due date of the individual's 2012 return, including extensions.

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Planning Opportunities

- Trusts: Trusts that have historically accumulated income and paid tax at the trust level should consider paying distributions to help avoid the 39.6% and 20% higher rates on ordinary income and LT capital gains and qualified dividends, respectively.

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Planning Opportunities (Continued)

- Businesses: Consider forgoing the 2012 bonus depreciation or Section 179 election if taxable income is projected to be higher in the future for flow through entities. This will allow for the deductions to be taken against income in future years that may be taxed at the higher 39.6% marginal rate.
- In addition, for owners of businesses, consider distributions from tax-free sources (basis or AAA, if positive) rather than salary or guaranteed payments due to the additional 0.9% FICA or SECA tax on higher earners.
- 2012 S-Corporations with Accumulated Earnings and Profits from C-Corporation years. Consider the election to change the ordering rules for distributions to make 2012 distributions come out of C-Corp AE&P. This is to take advantage of the 15% qualified dividend rate in 2012. This election can be made on the S-Corp return when filed, including extensions. However, once made, the election applies to all distributions for that tax year, to the extent of C-Corp AE&P.

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