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The Bottom Line

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Congress Rings In New Year with Fiscal Cliff Deal

With all the drama of a Hollywood thriller, Congressional leaders and President Obama finally agreed to a tax deal as the first step in averting the "fiscal cliff" – a combination of large tax increases and steep spending cuts that went into effect on January 1. The Senate overwhelmingly approved the American Taxpayer Relief Act of 2012 ("2012 Tax Relief Act" or the "Act") early in the morning of New Year's Day with an 89-8 vote. The House of Representatives approved the bill without amendments later that day with a 257-167 vote and President Obama signed before returning to Hawaii for vacation. Most of the Bush era tax cuts originally set to expire after 2012 were permanently extended, with some modifications for higher income taxpayers. Other tax relief provisions, many of which expired at the end of 2011, were extended through 2013 (or 2017 in a few instances). Notably absent from the fiscal cliff agreement was an extension of the 2% payroll tax holiday.

PROVISIONS AFFECTING INDIVIDUALS

Bush Era Tax Cuts Permanently Extended

Generally, all of the income tax provisions from the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") and the Jobs and Growth Tax Relief Reconciliation Act of 2003 ("JGTRRA") were permanently extended, including:

- The lower 10/15/25/28/33/35% tax rate structure for individuals (except for certain higher income individuals discussed below);
- The lower 15% tax rate on long-term capital gains and qualified dividends (except for certain higher income individuals discussed below);
- The marriage penalty relief that expanded the 15% bracket and standard deduction for married taxpayers filing jointly to twice that of single taxpayers;
- The increase in the child tax credit to \$1,000;
- The increase in the maximum dependent care credit and eligible expenses;
- The increase in the adoption credit to \$10,000 and related provisions;
- The \$5,250 income exclusion from employer-provided educational assistance;
- The increase in maximum annual Coverdell education savings account contributions to \$2,000 and related provisions; and
- The increase in Adjusted Gross Income ("AGI") phase-out limitation and waiver of 60 month limit on the above-the-line deduction for student loan interest.



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Limited Tax Benefits for Certain Higher Income Taxpayers

A cornerstone of President Obama's re-election campaign was to limit the extension of the Bush era tax cuts to couples with income below \$250,000 (\$200,000 for single taxpayers). While the President did secure tax increases on higher income taxpayers, the thresholds at which these tax increases kick in are at higher income levels than he sought originally.

Specifically, beginning in 2013 the highest marginal tax rate will increase to 39.6% and the long-term capital gains and qualified dividends tax rate will increase to 20% for couples with taxable income in excess of \$450,000 (\$400,000 for single filers). The tax increase on capital gains and qualified dividend income is in addition to the 3.8% Medicare tax on net investment income of higher income taxpayers that went into effect on January 1.

In addition to the tax rate increases, the overall limitation on itemized deductions and the phase-out of personal exemptions will be reinstated beginning in 2013 for couples with AGI in excess of \$300,000 (\$250,000 for single filers). These thresholds will be indexed for inflation beginning in 2014.

Still Time to Make Charitable Contributions for 2012

Under the new tax law, individuals age 70 ½ or older now have until January 31, 2013 to donate up to \$100,000 from Roth or traditional IRAs to charitable organizations without including the amount of their IRA withdrawals in gross income for 2012. These individuals can also make a rollover in January 2013 and have it treated as if made in 2012. Also, individuals age 70 ½ or older who took a distribution in December of 2012 may contribute that amount to a charity and treat it as an eligible charitable contribution provided the contribution to charity is made by January 31, 2013.

AMT Patch Permanently Extended

The 2012 Tax Relief Act saves millions of taxpayers from getting hit with the alternative minimum tax ("AMT") by permanently extending the AMT patch, retroactive to 2012. As a result, the AMT exemption for 2012 increases for married couples from \$45,000 to \$78,750 and for single filers from \$32,000 to \$50,600. These thresholds will be indexed for inflation beginning in 2013.

Estate Tax Relief Permanently Extended (with Modifications)

The 2010 tax relief act reinstated the estate tax, increased the lifetime gift and estate tax exemption to \$5,000,000 and lowered the top gift and estate tax rate to 35%. Without Congressional action, in 2013 the lifetime gift and estate tax exemption would have dropped to \$1 million and the top gift and estate tax rate would have increased to 55%. President Obama and many Congressional Democrats wanted to see the gift and estate tax provisions return to 2009 levels, specifically a \$3.5 million estate tax exemption, \$1 million gift tax exemption and a maximum gift and estate tax rate of 45%.

The 2012 Tax Relief Act permanently extends the \$5 million lifetime gift and estate tax exemption but raises the maximum gift and estate tax rate from 35% to 40%. The 2013 exemption is projected to be \$5.25 million, up from \$5.12 million in 2012. The exemption will continue to be indexed for inflation, and it is projected to increase to \$7.5 million by 2020. All of the other estate and gift tax provisions from the 2010 act are also permanently extended, most notably the ability to carryover any unused estate tax exemption to the surviving spouse.

Other Individual Tax Extenders

Several other tax benefits affecting individuals were extended through 2013. Unless otherwise noted, all of these provisions had expired at the end of 2011 and are retroactively reinstated:

- Deduction for state and local sales taxes;
- Above-the-line deduction for tuition and fees;
- \$250 above-the-line deduction for teacher classroom expenses;
- Exclusion of cancellation of indebtedness income from the discharge of qualified personal residence indebtedness (originally expired at end of 2012);
- Deduction for qualified mortgage insurance premiums;
- Exclusion for employer provided mass transit and parking benefits;
- Charitable deduction for contributions of real property for conservation purposes; and
- Tax-free distributions from IRAs for charitable purposes.

Certain tax benefits from the 2009 tax relief act that primarily benefit lower and middle-income taxpayers were extended through 2017, specifically:

- The more generous American Opportunity Tax Credit for higher education expenses;
- The expansion of the refundable child tax credit, and
- The expansion and modifications to the Earned Income Credit.

Payroll Tax Holiday Expires

One provision that the 2012 Tax Relief Act does not extend is the payroll tax holiday. In 2011 and 2012, the rate of the old age, survivors and disability insurance (OASDI) tax for employees was reduced from 6.2% to 4.2%. The rate on self-employment ("SE") income was reduced from 12.4% to 10.4%. Since this provision was not extended, the tax rates will increase to their pre-2011 levels in 2013. Employees and self-employed individuals with wages or SE income equal to or greater than the 2013 OASDI wage base limit of \$113,700 will realize a tax increase of \$2,274. This tax is in addition to the 0.9% Medicare tax on earned income of higher income taxpayers that went into effect on January 1.

PROVISIONS AFFECTING BUSINESSES

In addition to all of the Bush era tax cuts and other individual extenders, Congress extended several business tax breaks through 2013. Many of these provisions had expired at the end of 2011 and are retroactively reinstated. Unlike the Bush era tax cuts, however, these provisions were not extended permanently.

Research Tax Credit Reinstated and Extended

Expired for an entire year, the research and experimentation tax credit was reinstated by the Act for 2012 and extended through 2013. Many taxpayers proceeded with research activities in 2012 assuming that the credit would be reinstated, but the failure of Congress to permanently extend the credit means that businesses once again face uncertainty about the credit's future as they plan their long-term research activities. The Act also modifies how the credit is calculated when a business acquires another trade or business.

Cost Recovery Provisions Extended and Expanded

In an effort to encourage investment in capital equipment, the Section 179 immediate expensing election had been increased in recent years to as high as \$500,000 in 2010 and 2011. In 2012, the Section 179 deduction decreased to \$139,000 and was scheduled to drop to \$25,000 in 2013 without Congressional action.

The 2012 Tax Relief Act restores the Section 179 deduction to 2011 levels for the 2012 and 2013 tax years. As a result, businesses with adequate taxable income can immediately expense up to \$500,000 of qualified tangible personal property (including off-the-shelf computer software) in 2012 and 2013. The Section 179 deduction begins to phase out when total qualified purchases for the year exceeds \$2 million.

Traditionally, only tangible personal property was eligible for the Section 179 deduction. The Act reinstated the 2010/2011 provision that allows the immediate deduction of up to \$250,000 of qualified leasehold, restaurant and retail improvement property.

The 2012 Tax Relief Act also extends the 50% bonus depreciation provision to assets placed in service before January 1, 2014, as well as the corresponding election to accelerate AMT credits in lieu of bonus depreciation.

Other Business Tax Extenders

Several business tax provisions that had expired at the end of 2011 were extended through 2013, retroactive to the beginning of 2012, including, but not limited to the:

- Work opportunity tax credit;
- New markets tax credit;
- 15-year straight line cost recovery for qualified leasehold, restaurant and retail improvements;
- 100% exclusion of gain from the sale of qualified small business stock;
- 5-year recognition period for built-in gains of S corporations;
- Basis adjustment to stock of S corporations making charitable contributions of appreciated property;
- Subpart F exception for active financing income; and
- Enhanced charitable deduction for contributions of food inventory.

Energy Incentives Reinstated and Extended

Several energy incentives, most of which had expired at the end of 2011, were extended through 2013, including, but not limited to the:

- Residential energy property credit;
- Energy efficient new homes credit;
- Energy efficient appliances credit;
- Renewable electricity production credit; and
- Credit for biodiesel and renewable diesel used as fuel.

OTHER PROVISIONS OF 2012 TAX RELIEF ACT

Other notable provisions of the 2012 Tax Relief Act include:

- The automatic spending cuts scheduled to go into effect on January 1 were deferred until March 1, 2013, at a projected cost of \$24 billion.
- Taxpayers may now transfer amounts from a qualified retirement plan to a qualified Roth plan (e.g., Roth 401(k)) without paying an early withdrawal penalty. The income tax paid on the conversions is projected to offset half of the \$24 billion referenced above. The rest will be offset by future discretionary spending cuts, split equally between defense and non-defense spending.
- The provision that would have dramatically reduced the Medicare payments made to physicians has been deferred for one year.
- Federal long-term unemployment benefits have been extended for one year.
- The Federal milk subsidy has been extended for one year.

Congress may have temporarily averted the fiscal cliff, but considerable work remains. The automatic spending cuts will need to be addressed this spring, probably in conjunction with a negotiation on the debt ceiling. The 2012 Tax Relief Act also does nothing to address long-term tax reform or debt reduction.

If you have any specific questions, comments or concerns on the provisions of the 2012 Tax Relief Act and how they apply to you or your business, please contact your CBIZ Tofias & Mayer Hoffman McCann advisor, or you may reach us at TheBottomLine@cbiztofias.com and 888.761.8835.

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