LOWENSTEIN SANDLER LLP CLIENT ALERT

BUSINESS TAX COUNSELING & STRUCTURING

THE AMERICAN TAXPAYER RELIEF ACT OF 2012: KEY BUSINESS AND INDIVIDUAL INCOME TAX PROVISIONS

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On January 1, 2013, Congress passed the American Taxpayer Relief Act of 2012 (the "Act"), which halts tax increases scheduled to go into effect for most Americans as part of the so-called fiscal cliff. The Act generally allows tax rates to rise on higher-income individuals but extends certain favorable tax provisions for individuals and businesses. This alert briefly summarizes some of the key federal income tax provisions of the Act.

Individual Provisions

Extension of Certain Individual Ordinary Income Tax Rates and Introduction of New High-Income Bracket

The Act preserves the 25%, 28%, 33% and 35% brackets, which were set to rise at the beginning of 2013, and adds a new 39.6% bracket applicable to taxable income exceeding (i) $450,000 for married individuals filing jointly or (ii) $400,000 for individual filers. The income thresholds for each bracket will now be adjusted for inflation. Note that the Patient Protection and Affordable Care Act imposes additional Medicare taxes, also effective on January 1, 2013, of (i) 3.8% upon certain investment income and (ii) 0.9% on certain employee wages and self-employment income, each of which were previously subject to a 2.9% tax, including the employer portion of the Medicare tax on employee wages. Generally, the additional Medicare tax on investment income applies to the extent that modified adjusted gross income exceeds $250,000 for married individuals filing jointly and $200,000 for individual filers, and the additional Medicare tax on wages and self-employment income applies above a threshold of compensation income of $250,000 for joint filers and $200,000 for individual filers.

Increase in Dividend and Capital Gains Rates

Under the Act, the maximum rate of tax on long-term capital gains (generally, gains from the sale or exchange of capital assets held for more than one year) will rise to 20% for individuals whose taxable income exceeds the thresholds for the 39.6% bracket. Qualified dividends (generally, dividends from corporations formed in the United States or a foreign country with which the United States has entered into an income tax treaty) will continue to be taxed at the same rates as long-term capital gains. Note that the additional Medicare tax of 3.8% on investment income (discussed above) generally will apply in addition to the income tax on capital gains and dividends.

Extension of 100% Exclusion of Gain from Certain Dispositions of Qualified Small Business Stock

The Act extends the 100% exclusion from income (i.e., a 0% effective tax rate) on gain from the sale of qualified small business stock ("QSBS") acquired before January 1, 2014, and held for more than five years, thus retroactively applying the 100% exclusion to such stock acquired in 2012. QSBS generally includes stock of a corporation (other than one that has elected to be taxed as a pass-through entity) acquired by the holder at original issue, where the corporation's activities and assets satisfy certain tests. One of these tests is that the corporation must be engaged in a qualified trade or business, which includes providing services in the fields of health, law, engineering, and consulting, or any trade or business where the main asset of the trade or business is the reputation or skill of its employees. Therefore, many technology start-ups are qualified trades or businesses. Subject to certain limitations, the effective tax rate on QSBS had historically been 14%. For QSBS acquired after February 17, 2009 and before September 28, 2010, the effective rate was 7%. The 100% exclusion (and 0% effective rate) originally applied for stock acquired between September 28, 2010 and December 31, 2011.

Overall Limitation on Itemized Deductions and Phase-Out of Personal Exemptions

The Act reinstates an overall limitation on itemized deductions (the "Pease" limitations) and a phase-out of personal exemptions ("PEP"). Historically, the total amount of itemized deductions and the ability to utilize personal exemptions were limited for taxpayers with incomes over certain thresholds. Under the Act, these limitations, which had not applied to any taxpayers in 2012, will return in 2013 for individuals with adjusted gross incomes exceeding (i) $300,000 for married individuals filing jointly and (ii) $250,000 for individual filers.

End of Temporary Payroll Tax Cut for Employees and Self-Employed Persons

The Act does not extend the temporary payroll tax cut. For 2011 and 2012, the employee portion of the Social Security tax was reduced from 6.2% to 4.2% and the self-employment tax was reduced from 12.4% to 10.4%. For 2013 and thereafter, the rates return to 6.2% and 12.4%, respectively.

Permanent Alternative Minimum Tax Relief for Individuals

The Act permanently patches the Alternative Minimum Tax ("AMT"). The AMT, which generally prevents many higher-income taxpayers from benefiting from certain deductions and credits, exempts taxpayers with incomes below certain thresholds. The thresholds previously had not been indexed for inflation, prompting Congress to enact annual increases to the thresholds each year. The Act increases the thresholds to (i) $78,750 for married individuals filing jointly and (ii) $50,600 for individual filers, and it adjusts these thresholds for inflation.

Business Provisions

Extension of Bonus Depreciation and Small Business Expensing

Taxpayers that placed qualifying property in service during 2012 were allowed a special first-year depreciation deduction generally equal to 50% of the cost of the property (this was in addition to a deduction for depreciation on the tax basis of the property remaining after the special 50% deduction). The Act extends the special 50% first-year depreciation deduction for qualifying property placed in service before January 1, 2014 (and before January 1, 2015 for certain longer-lived and transportation property). The Act also permits taxpayers to accelerate certain AMT credits in lieu of taking the bonus depreciation.

Subject to certain limitations, taxpayers that invest in qualifying property may elect to deduct the cost of the property rather than recover the cost through depreciation deductions. The amount a taxpayer can deduct under this provision is limited, and the deduction is phased out based on the value of qualifying property placed in service by the taxpayer. For 2012, the maximum deduction was set to be $125,000, reduced by the amount of qualifying property placed in service by the taxpayer that exceeds $500,000. The Act increases the maximum deduction for 2012 (retroactively) and 2013 to $500,000, and increases the threshold value of property for phasing out the deduction to $2 million. This increase will expire at the end of 2013 and the amounts will revert to $25,000 and $200,000, respectively.

Extension of Research Credit

The Act extends the research credit for 2012 (retroactively) and 2013. The research credit generally allows taxpayers an income tax credit equal to 20% of the amount by which the taxpayer's qualified research expenses exceed a certain base amount. The credit had expired at the end of 2011.

Extension of 15-Year Cost Recovery for Certain Real Property Improvements

The Act (retroactively, in the case of 2012) extends the ability of taxpayers to depreciate qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property placed in service in 2012 and 2013. Without the extension, such improvements generally would have been depreciable over 39 years.

Extension of Special Expensing Rules for Film and Similar Property

Taxpayers previously were able to deduct the costs of qualifying film and television productions that commenced before January 1, 2012. The Act extends (retroactively, in the case of 2012) the special expensing rule to cover qualified film and television productions commencing before January 1, 2014.

Other Business Incentives

The Act also contains tax incentives for hiring certain individuals, including veterans, as well as tax incentives for engaging in certain energy-related activities.

Note on Transfer Tax Changes

The Act also contains significant provisions affecting the federal estate, gift, and generation-skipping taxes, which are described more fully in Lowenstein Sandler's Trusts and Estates Group Alert, dated January 3, 2013, available here.

This Alert is meant to be only a simple overview of tax provisions that are more complex and nuanced than can be described here. Also, given the fluid fiscal and legislative environment, there may be additional changes coming. To learn more about the Act and its implications for you or your business, please contact one of the Lowenstein Sandler attorneys listed at right.

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