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TAX PRACTICE ALERT

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The American Taxpayer Relief Act of 2012 and What It Means to You

By Jonathan R. Flora and James R. Olson

On Jan. 2, 2013, President Obama signed the "American Taxpayer Relief Act of 2012" (the "Act") which was passed by the House and Senate the previous day to avoid the so-called "fiscal cliff." The Act prevents many of the tax hikes that were scheduled to go into effect in 2013 and retains many favorable tax breaks that were scheduled to expire. However, it also increases income taxes for some high-income individuals and slightly increases transfer tax rates. This *Alert* provides an overview of the key income tax provisions of the Act.

Tax Rates

The income tax rates for most individuals will stay at 10 percent, 15 percent, 25 percent, 28 percent, 33 percent and 35 percent. However, a 39.6 percent rate will apply for income above the "applicable threshold." The applicable threshold is $450,000 for joint filers and surviving spouses; $425,000 for heads of household; $400,000 for single filers; and $225,000 (one-half of the otherwise applicable amount for joint filers) for married taxpayers filing separately. These dollar amounts are inflation-adjusted for tax years after 2013.

Capital Gain and Dividend Rates Rise for Higher-Income Taxpayers

The top rate for capital gains and dividends will permanently rise to 20 percent (up from 15 percent) for taxpayers with incomes exceeding $400,000 ($450,000 for married taxpayers). When taking into account the new 3.8 percent surtax on investment-type income and gains for tax years beginning after 2012 (See Schnader's December 2012 *Alert* "2013 Brings New Taxes to High Income Taxpayers"), the overall rate for higher-income taxpayers may be as high as 23.8 percent.

For taxpayers whose ordinary income is generally taxed at a rate below 25 percent, capital gains and dividends will permanently be subject to a 0 percent rate. Taxpayers who are subject to a 25 percent-or-greater rate on ordinary income, but whose income levels fall below the $400,000/$450,000 thresholds, will continue to be subject to a 15 percent rate on capital gains and qualified dividends. (The combined rate will be 18.8 percent for those individuals subject to the new 3.8 percent surtax.)

PEP and Pease Limitations to Apply to "High-Earners"

The Personal Exemption Phaseout ("PEP") reduces the value of an individual's personal exemption by 2 percent for every $2,500 that his or her adjusted gross income ("AGI") exceeds a certain threshold. The Pease limitation is a provision that reduces an individual's itemized deduction by 3 percent of the amount that his or her AGI exceeds a certain threshold. The PEP and Pease limitations had been phased out and eliminated by 2010.

The Act reinstates the PEP and Pease limitations beginning in 2013 with a starting threshold of $300,000 for joint filers and a surviving spouse; $275,000 for heads of household; $250,000 for single filers; and $150,000 for married taxpayers filing separately. Under PEP, the total amount of the personal exemptions that can be claimed by a taxpayer subject to the limitation is reduced by 2 percent for each $2,500 (or portion thereof) by which the taxpayer's AGI exceeds the applicable threshold. Under the Pease limitation, the total amount of their itemized deductions is reduced by 3 percent of the amount by which the taxpayer's AGI exceeds the threshold amount, with the reduc-

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tion not to exceed 80 percent of the otherwise allowable itemized deductions. The dollar amount thresholds listed above are inflation-adjusted for tax years after 2013.

Permanent AMT Relief

The Act provides permanent alternative minimum tax ("AMT") relief. The 2012 Taxpayer Relief Act permanently increases the exemption amounts to $50,600 for unmarried taxpayers, $78,750 for joint filers and $39,375 for married persons filing separately. In addition, it indexes these exemption amounts for inflation.

Recovery Act Extenders

The Act extends the following items that were slated to expire at the end of 2012:

- The American Opportunity tax credit, which permits eligible taxpayers to claim a credit equal to 100 percent of the first $2,000 of qualified tuition and related expenses, and 25 percent of the next $2,000 of qualified tuition and related expenses (for a maximum tax credit of $2,500 for the first four years of post-secondary education) (extended through 2017).
- Eased rules for qualifying for the refundable child credit (extended through 2017).
- Various earned income tax credit ("EITC") changes relating to higher EITC amounts for eligible taxpayers with three or more children, and increases in threshold phaseout amounts for singles, surviving spouses, and heads of households (through 2017).
- The option to deduct State and local general sales taxes is retroactively revived for 2012 and continued through 2013.
- The above-the-line deduction for qualified tuition and related expenses is retroactively revived for 2012 and continued through 2013.
- Tax-free distributions from individual retirement plans for charitable purposes is retroactively revived for 2012 and continued through 2013. Because 2012 has already passed, a special rule permits distributions taken in 2012 to be transferred to charities for a limited period in 2013. Another special rule permits certain distributions made in 2013 as being deemed made on Dec. 31, 2012.

Depreciation Provisions Modified and Extended

The following depreciation provision is retroactively extended through 2014:

- Increased expensing limitations and treatment of certain real property as Code Sec. 179 property.

The Act also extends and modifies the 50 percent bonus depreciation provisions for one year so that it applies to qualified property placed in service before 2014 (before Jan. 1, 2015 for certain aircraft and long-production-period property).

Business and Energy Tax Breaks Extended

The following business credits and special rules are also extended:

- The research credit is modified and retroactively extended for two years through 2013.
- The work opportunity tax credit is retroactively extended for two years through 2013.
- The basis adjustment to stock of S corporations making charitable contributions of property is extended to apply to tax years beginning in 2013.
- The reduction in S corporation recognition period for built-in gains tax is extended through 2013, with a 5-year period instead of a 10-year period.
- The nonbusiness energy property credit for energy-efficient existing homes is retroactively extended for two years through 2013. A taxpayer can claim a 10 percent credit on the cost of: (1) qualified energy efficiency improvements, and (2) residential energy property expenditures, with a lifetime credit limit of $500 ($200 for windows and skylights).

Pension Provision

For transfers after Dec. 31, 2012, in tax years ending after that date, plan provisions in an applicable

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retirement plan (which includes a qualified Roth contribution program) can allow participants to elect to transfer amounts to designated Roth accounts with the transfer being treated as a taxable qualified roll-over contribution. ◆

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