THE NEW YEAR'S DAY TAX BILL:

What Contractors Need to Know Right Now

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What is the Fiscal Cliff?

- The <u>combination</u> of sequestration cuts and tax increases that were scheduled to go into effect 1/1/13 absent an agreement by the President and Congress
- Furthermore, the debt ceiling must be raised again early in 2013 and FY13 Continuing Resolution expires in March 2013
- According to the Congressional Budget Office, the U.S. economy would slide into a "significant recession" as a result of the spending cuts and tax increases

The Fiscal Cliff:
How did we get here?

- Sunset of Bush-era tax policies
  - 2001 & 2003 tax cuts originally set to expire after 2010
  - President Obama & Lame Duck Congress extended for two years in 2010
- Sequestration cuts resulting from 2011 Debt Limit Deal
  - Bipartisan "Super Committee" charged with finding $1.2T in spending cuts over 10 years
  - Difference between cuts and $1.2T scheduled to apply equally to defense and non-defense spending
- Expiration of temporary "Great Recession" provisions
  - Extended Unemployment Insurance (UI) benefits
  - 2 percent individual payroll tax cut "holiday"
- Years of ad hoc budgetary policies and accounting gimmicks
  - Annual AMT "Patch" to prevent additional layer of taxation on tens of millions in middle class
  - Annual SGR "Doc Fix" to prevent massive cuts in Medicare provider payments
  - Annual "Extenders" package to maintain tax incentives and preferences for businesses

American Taxpayer Relief Act of 2012

- Passed by the Senate in the early hours of New Year's Day 2013
- Late that same Day the House passed the Bill
- On the January 2nd the President signed the Bill into law
- Technically, the country slipped over the "fiscal cliff" before the bill was passed and signed

American Taxpayer Relief Act of 2012

Overview

I. Individual Taxes

A. Rates: Income, Capital Gains, Dividends

B. Healthcare Provisions (PPACA)

C. Alternative Minimum Tax (AMT)

D. Exemptions & Deductions

E. Individual Credits / Education

American Taxpayer Relief Act of 2012

Overview

III. Estate / Transfer Taxes

IV. Business taxes

    A. Depreciation & Expensing

    B. Business Credits / Deductions

    C. Other Business Issues

IV. Planning and Other Considerations

Taxes Rates for 2013

with no Congressional Action

Est. 2013 Taxable Income Brackets	Marginal Rates		If Tax Cuts Expire...	
	Tax Cuts Extended	Tax Cuts Expire	Capital Gains*	Dividends Rate
< $17,400	10%	15%	0% to 10%	0% to 15%
$17,400-$70,700	15%	15%	0% to 10%	0% to 15%
$70,700-$142,700	25%	28%	15% to 20%	15% to 28%
$142,700-$217,450	28%	31%	15% to 20%	15% to 31%
$217,450-$388,350	33%	36%	15% to 20%	15% to 36%
> $388,350	35%	39.6%	15% to 20%	15% to 39.6%

** These rates do not reflect the additional 3.8% tax on unearned income after $250k required under 2010 healthcare reform.*

Source: Washington Analysis, PNC

I. Individual Taxes

New Income Tax Rate Brackets Effective 1/1/13

Rate		Joint	Single	HoH
10.0%	>	zero	zero	zero
15.0%	>	17,850	8,925	12,750
25.0%	>	72,500	36,250	48,600
28.0%	>	146,400	87,850	125,450
33.0%	>	223,050	183,250	230,150
35.0%	>	398,350	398,350	398,350
39.6%	***>***	***450,000+***	***400,000***	***425,000+***

I. Individual Taxes

Capital Gains / Dividend Rates						
Married Filing Joint				**Single Filers**		
From	**To**	**Rate**		**From**	**To**	**Rate**
zero	72,500	0.0%		zero	36,250	0.0%
72,500	450,000	15.0%		36,250	400,000	15.0%
450,000		20.0%		400,000		20.0%

I. Individual Taxes

Married Filing Joint Rates

From	To	Income Tax Rate	Dividends Cap Gains	Investment* Surtax	Medicare* Surtax**
-	17,850	10.0%	0.0%	-	1.45%
17,850	72,500	15.0%	0.0%	-	1.45%
72,500	146,400	25.0%	15.0%	-	1.45%
146,400	223,050	28.0%	15.0%	-	1.45%
223,050	398,350	33.0%	15.0%	3.8%	2.35%
398,350	450,000	35.0%	15.0%	3.8%	2.35%
450,000		39.6%	20.0%	3.8%	2.35%

* Impacts AGI over $250,000

** Employer matches 1.45% of all compensation

I. Individual Taxes

Single Rates					
From	To	Income Tax Rate	Dividends Cap Gains	Investment* Surtax	Medicare* Surtax**
-	8,925	10.0%	0.0%	-	1.45%
8,925	36,250	15.0%	0.0%	-	1.45%
36,250	87,850	25.0%	15.0%	-	1.45%
87,850	183,250	28.0%	15.0%	-	1.45%
183,250	398,350	33.0%	15.0%	3.8%	2.35%
398,350	400,000	35.0%	15.0%	3.8%	2.35%
400,000		39.6%	20.0%	3.8%	2.35%

* Impacts AGI over $200,000

** Employer matches 1.45% of all compensation

PPACA Revenue Raisers

Additional Medicare Tax

- Singles earning wages more than $200,000 and married couples earning wages more than $250,000 will be taxed an additional 0.9%.
- 2.35% in total (1.45% plus .9%)
- On amounts in excess over those thresholds
- Effective: 2013

PPACA Revenue Raisers

Additional Medicare Tax

- Example: In 2013, Tim earns wages of $195,000 and his spouse earns $105,000. Total wages is $300,000.
- Additional Medicare tax can be computed as follows:
  - $3,625 (1.45% times the base of total wages $250,000); plus
  - $2,700 (2.35% (.9% plus 1.45%) times $50,000 i.e. the wages in excess of joint filing threshold of $250,000).
- Total Medicare Tax is $4,800 ($450 increase for the .9%)
- Query: How much was withheld by each employer?

PPACA Revenue Raisers

Additional Medicare Tax

- Employers do not match the .9% surtax.
- Employers are required to withhold and pay over the .9% surtax on wages above the thresholds.
- The employer must disregard the wages, if known, received by the employee's spouse.

PPACA Revenue Raisers

Additional Medicare Tax

- Thresholds are not indexed for inflation
- Self-employed income:
  - Also subject to the surtax.
  - However, the income tax deduction for one-half of the self-employment taxes is computed without regard to the .9% surtax.

PPACA Revenue Raisers

Net Investment Income Tax

- New 3.8% surtax will be imposed on net investment income of single taxpayers with adjusted gross income (AGI) above $200,000 and joint filers over $250,000.
- Effective 2013

PPACA Revenue Raisers

Net Investment Income Tax

- Net investment income is interest, dividends, royalties, rents, gross income from a trade or business involving passive activities, and net gain from disposition of property (other than property held in a trade or business).
- Reduced by properly allocable deductions to such income.

PPACA Revenue Raisers

Net Investment Income Tax

- New 3.8% surtax is in addition to any regular tax or capital gains tax.
- Example
  - If a couple earns $200,000 in wages and $100,000 in capital gains, $50,000 will be subject to the new tax (i.e. the amount over $250,000 threshold).
  - The result: $1,900 tax increase.

PPACA Revenue Raisers

Net Investment Income Tax

- Consider increase in capital gains rates
- Consider the gain on sale of a principal residence in excess of the exclusion thresholds
- Tax exempt investments may gain favor because those earnings will not increase AGI

PPACA Revenue Raisers

- Taxpayers who have both:
  - High wages or self-employment income; and
  - High investment income

Could face **both** the Medicare surtax *and* net investment income tax

PPACA Revenue Raisers

- Example: For 2013 James, who is single has net investment income of $100,000, wages of $300,000 and AGI of $405,000.

- Results is $4,700 in new/additional taxes:
  - $3,800 Investment income tax ($100,000 times 3.8%);
  - $900 Medicare surtax ($300k wages less $200k threshold equals $100k times .9%).

PPACA Revenue Raisers

Reduced Itemized Deductions

- For tax years beginning after Dec. 31, 2012, unreimbursed medical expenses will be deductible by taxpayers under age 65 only to the extent they exceed 10% of adjusted gross income (AGI) for the tax year.

- If the taxpayer or his or her spouse has reached age 65 before the close of the tax year, a 7.5% floor applies through 2016 and a 10% floor applies for tax years ending after Dec. 31, 2016.

I. Individual Taxes

Alternative Minimum Tax

- Permanent Changes:
  - Patch put in place
  - AMT exemption indexed for inflation
  - Nonrefundable personal credits permitted against AMT
- Exemption for 2012:
  - $78,750 Joint
  - $50,600 Single

I. Individual Taxes

Alternative Minimum Tax

- Threshold at which phase-out begins is unchanged for 2012 (indexed for future years):
  - $150,000 Joint
  - $112,500 Single
- Complete phase out at:
  - $465,000 Joint
  - $314,900 Single

I. Individual Taxes

Limitation on Exemptions and Itemized Deductions are Back starting in 2013:

- **PEP:** Personal Exemption Phase-out
- **Pease:** Phase-out of Itemized Deductions

I. Individual Taxes

Limitation on Exemptions & Itemized Ded’ns

PEP: Personal Exemption Phase-out

- Cuts exemptions 2% for every $2,500 above the thresholds (basically phases them out over $125k)
- Permanent repeal for lower income levels
- AGI Thresholds to be adjusted for inflation
  - $300k for Joint
  - $250k Single

I. Individual Taxes

Limitation on Exemptions & Itemized Ded'ns

Pease: Phase-out of Itemized Deductions

- Cuts deduction 3% for every dollar above the threshold
- Cannot lose more than 80% of certain itemized deductions; but not medical, investment interest, casualty/theft, or gambling losses
- Permanent repeal for lower income levels
- AGI Thresholds to be adjusted for inflation:
  - $300k for Joint
  - $250k Single

I. Individual Taxes

Deductions

- Itemized deduction for state & local sales taxes reinstated and extended through 2013
- Standard deduction marriage penalty relief is made permanent
- Interest deduction for mortgage insurance premiums is extended to amounts paid or accrued before 2014
- Exclusion for debt discharge income from home mortgage forgiveness is extended for one year until the end of 2013
- Up-to-$250 above-the-line deduction for teachers' out-of-pocket classroom-related expenses is retroactively extended through 2013

I. Individual Taxes

- Rule allowing tax-free IRA distributions of up to $100,000 if donated to charity, is retroactively extended through 2013
- Provides opportunity to impact AGI

I. Individual Taxes

Individual Credits

- $1,000 per child amount and expanded refundability of child tax credit are permanently extended
- Increase in refundable portion of child tax credit is extended through 2017
- Expanded dependent care credit permanently extended
- Expanded adoption credit rules (but not refundability) made permanent
- Earned Income Credit simplification made permanent (and other changes to EIC temporarily extended)

I. Individual Taxes

Education

- American Opportunity Tax Credit (AOTC) for higher education expenses is extended five years, through 2017
- Qualified tuition deduction is retroactively extended through 2013
- Expired student loan deduction rules are made permanent

II. Estate / Transfer taxes

2012 vs. 2013 Transfer Tax Before New Year's Day Law

	2012	2013*
ESTATE TAX/GIFT TAX EXEMPTION	$5,120,000	$1,000,000
ESTATE TAX/GIFT TAX TOP RATE	35%	55% (+5% $10MM-$17+MM)
GST TAX EXEMPTION	$5,120,000	$1,400,000 est. (INDEXED SINCE 1999)
GST TAX TOP RATE	35%	55%

** Assumed EGTRRA sunsets in full for 2013.*

***Rounded. Assumes taxpayer made no taxable gifts during lifetime and there is no "clawback" of the 2012 gift.*

II. Estate Tax

- The highest estate tax (for taxable amounts over $1 million) increases from 35% to 40%.
- Exemption
  - 2012: $5,120,000
  - 2013: $5,250,000 projected inflation adjusted
- All rules put in place over past few years stays in place permanently; BUT rates change.
- Portability retained

III. Business Taxes

Depreciation & Expensing

- Expensing thresholds for tax years beginning in 1/1/12 & 1/1/13:
  - $500,000 Section 179 limit
  - Phase-out begins at $2 million
- Expensing for investments in “Qualified Real Property” extended
  - Increased for tax years beginning in 2012 & 2013.
  - $250,000

III. Business Taxes

Depreciation & Expensing

- Bonus depreciation extended
  - 50% Bonus extended for year
  - For property placed in service before 1/1/14 (one-year later for certain specific property)
- Reduced impact of bonus depreciation to tax percentage-of-completion reporting extended one year.

III. Business Taxes

Depreciation & Expensing

- Increase in first-year depreciation cap for cars that are "qualified property" is extended through 12/31/13
- 15-year MACRS depreciation for certain building improvements and restaurants is extended to apply to property placed in service before 1/1/14
- 7-year recovery period for motorsports entertainment complexes extended to facilities placed in service through 2013

III. Business Taxes

Business credits

- Research credit is retroactively extended, with modifications, to apply to amounts paid or incurred before 1/1/14
- Work opportunity credit is retroactively extended for all individuals who begin work for an employer through 12/31/13
- Employer-provided child care credit is extended permanently
- Partial credit for differential wage payment credit for compensation to active duty members of the uniformed services retroactively restored and extended to apply to payments made before 1/1/14

III. Business Taxes

Energy Credits

- Energy efficient appliance credit is extended for certain appliances manufactured in 2012 or 2013
- Energy efficient home credit for eligible home builders is retroactively restored and extended through 12/31/13
- Non-business energy property (i.e. water heaters, AC units etc) credit is retroactively reinstated and extended through 2013
- Credits with respect to facilities producing energy from certain renewable resources are extended and modified

III. Business Taxes

Energy Credits

- Income and excise tax credits/refunds for biodiesel and renewable diesel are extended retroactively through 2013
- Credit for 2- or 3-wheeled plug-in electric vehicles is retroactively extended two years to apply to vehicles acquired before 1/1/14
- Definition of qualified property for purposes of the election to take a 30% energy credit instead of the electricity production credit is retroactively clarified

III. Business Taxes

Other

- Shortened S Corp built-in gains holding period extended for 2012 and 2013

- 2% Payroll Tax Reduction for employees no longer applicable

IV. Other Consideration

Distribution Restrictions Eased for

"in-plan Roth Rollovers"

- Need to implement change to plan
- Issue/Opportunity:
  - Contribute Pre-tax dollars now and pay tax on earnings and contributions later; versus
  - Contribute after-tax dollars now and pay zero tax on earnings later

V. Tax Planning for 2012/2013

- Consider accelerating income into 2012 and shifting deductions to 2013
  - Review bad debt write-offs to determine whether receivables are uncollectible
  - Review depreciation opportunities
- Review estate plan and gifting opportunities in light of “permanent” high exemption for gift and generation skipping tax

V. Tax Planning for 2013

- Consider shifting dividend paying equities into growth equities
- Consider shifting investments into tax free bonds or tax deferred saving vehicles like life insurance policies or annuities
- Revisit your passive investments to see if you can become active
- If you are employed by a pass-through entity consider the level of your salary
- Be prepared to pay more

And the “Cliff” Remains…

- Sequestration still a possibility
- Debt Ceiling Looms: $16.4T national borrowing limit will be reached by February
  - Government Funding: Continuing resolution expires March 27th
  - Almost certain a resolution will be in place by February or March

Questions??
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