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"Cliff" law reconfigures tax preparation and planning

BY PAUL BONNER
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With its scores of new and extended provisions, the American Taxpayer Relief Act of 2012 offers something for nearly all taxpayers and their preparers to assess and implement as they begin preparing 2012 returns and plan for the future.

Less than two hours into 2013 and the "fiscal cliff" expiration of the George W. Bush-era tax cuts and scheduled implementation of automatic federal spending cuts, the Senate passed the act (H.R. 8), and the House of Representatives quickly followed suit.

Most prominently, the law made permanent most of the cuts, including lower individual tax rates on ordinary income, capital gains, and dividends, although adding higher rates for the wealthiest taxpayers. Congress also extended many tax credits and other favorable provisions for individuals and businesses and clean-energy incentives. See earlier coverage, "Congress Passes Fiscal Cliff Act."

After weeks of second-guessing Congress's ability to find a compromise between members' seemingly adamant positions, taxpayers and the IRS are now adapting to the act's passage and its many details that had not had been proposed or debated publicly. On Dec. 31, with no agreement in sight, the IRS issued what may have been the shortest-lived income tax withholding tables ever, reflecting an assumption that with no cliff agreement, higher marginal rates across the board for 2013 would return. Three days later, the IRS issued revised withholding tables reflecting the act's provisions.

While tax filing season traditionally begins with the IRS's acceptance of electronically filed returns the beginning of the third week in January, on Tuesday the IRS announced that tax season would begin for most filers on Jan. 30. Some taxpayers, however, will have to wait until February or March to file returns (see "Start of Tax Season Delayed Until Jan. 30; Later for Some Taxpayers").

In December, the IRS had warned that Congress's failure to "patch" the alternative minimum tax (AMT) exemption for 2012, as in past years since its introduction in the 1960s, would delay return processing for most taxpayers into March this year or beyond. The act permanently indexes the AMT exemption beginning in 2012.

Implications for individual taxpayers

Beginning in 2013 tax years, the 39.6% income tax bracket begins at taxable incomes of $400,000 for single filers, $425,000 for head-of-household filers, and $450,000 for married taxpayers filing jointly. Those thresholds also apply for the higher 20% rate on capital gains and dividends.

But reinstatement of a limitation on itemized deductions and personal exemptions, beginning at taxable incomes of $250,000 for single taxpayers, $275,000 for head-of-household taxpayers, and $300,000 for joint filers, may in many instances increase effective tax rates on affected taxpayers and come as a surprise for many tax preparers' clients, said Jonathan Horn, a CPA in New York City who chairs the AICPA Individual Income Tax Technical Resource Panel.

On the other hand, high-income taxpayers with capital gains may be relieved to find that the 20% rate applies only to net capital gain exceeding the income thresholds for the new top ordinary-income bracket, and that a 15% rate still applies to gains (and dividends) below that amount.

"It's not a cliff tax, but graduated," Horn said.

One individual provision extension offering a current opportunity to adjust tax liability for 2012 is tax-free charitable distributions from individual retirement plans, which had expired at the end of 2011, he noted. A special rule (Section 208(b)(2) of the act) allows taxpayers to make such a distribution after Dec. 31, 2012, and before Feb. 1, 2013, which will be deemed to have been made on Dec. 31, 2012. A portion of a distribution from an IRA to the taxpayer made after Nov. 30, 2012, and before Jan. 1, 2013, may be transferred to the charity before Feb. 1 and recharacterized as a qualified charitable distribution.

"You can make a direct distribution in January and elect to have it count as a 2012 distribution, which reduces both your taxable income and your required minimum distribution," Horn said.

Another popular extender for 2013, but one whose retroactive application to 2012 remains unclear, is the parity for exclusion from income for employer-provided mass transit and parking benefits, he noted.

"How would it be implemented for 2012? The payroll's already done," Horn said. "The answer is, we don't know yet." Perhaps the IRS will provide a method similar to that for its refund in 2006 of prior-year telephone excise taxes, he said.

Fiduciary returns top bracket has lower threshold

Preparers of income tax returns for trusts and estates will notice that the act did not provide a 35% rate for these returns; the table under Sec. 1(e) after amendment provides rates of 15%, 25%, 28%, 33%, and 39.6%, the latter with a threshold for 2013 of about $11,950, which is the top bracket threshold for 2012 ($11,650) adjusted for inflation. The new net investment income tax of 3.8% enacted by the Health Care and Education Reconciliation Act of 2010, P.L. 111-152, also applies starting in 2013 to the lesser of (1) undistributed net investment income of the trust or estate, or (2) its adjusted gross income, above this top bracket threshold.

Businesses get help, but still a cliff to come

Of the act's extension of dozens of temporary business incentives, the most popular is likely the higher dollar limits and phaseout thresholds for expensing of business equipment under Sec. 179, said Chris Hesse, CPA, partner in the Federal Tax Resource Group of CliftonLarsonAllen LLP in Minneapolis and chair of the AICPA S Corporation Technical Resource Panel. The act extended through 2013 and retroactively to 2012 the $500,000 dollar limitation and phaseout threshold of $2 million in the cost of Sec. 179 property placed in service during the tax year that had been in effect in 2010 and 2011.

"It offers the most flexibility for small businesses to write off business assets they acquire and to choose how much to write off to achieve a favorable tax result," Hesse said. "I think it demonstrates Congress's continued desire to provide flexibility and simplicity in the Internal Revenue Code, if it can be called that, for small business, if they want to, to avoid depreciation calculations."

However, Hesse noted, in 2014, the expensing limit is scheduled to revert to $25,000, with a phaseout threshold of $200,000.

"There will still be a cliff, although taxpayers might expect Congress to continue to roll that ball forward," he said.

The act also continued a reduction of the 10-year recognition period for built-in gains of S corporations to five years, likewise leaving some uncertainty beyond 2013, when it again expires.

"But if an S election is appropriate for the business, it should be made, whether for a five- or a 10-year horizon for the built-in gain period," Hesse said. The act's higher individual rates, along with the 3.8% net investment income tax, new in 2013, need to be assessed as well in deciding whether to make an S election, he noted.

Other notable business extenders, he said, are those for 15-year depreciation of qualified leasehold improvements, the Sec. 41 research and development credit, and the ability of S corporations to adjust shareholder basis by a pro rata amount of the adjusted basis of appreciated property that the corporation donates as a charitable contribution.

Estate and gift planning on surer footing

In gift and estate planning, the act provides assurance that after two years of their being temporary, the enhanced provisions of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, P.L. 111-312, although modified, may now be relied upon by taxpayers permanently. The estate and gift tax exclusion amount is retained at $5 million indexed for inflation ($5.12 million in 2012) but the top tax rate increases from 35% to 40% for gifts made, decedents dying, and generation-skipping transfers made after Dec. 31, 2012. The deceased spousal unused exclusion, or "portability," provisions of Sec. 2010(c)(4) as amended by the Tax Relief Act, also remain.

"It takes the uncertainty in planning we've had in last 12 years out of the equation," said CPA Justin Ransome, partner in Ernst & Young's National Tax Department in Washington and past chair of the AICPA Trust, Estate & Gift Tax Technical Resource Panel. "In planning for contingencies, at least in terms of what the law may or may not do, I think we're on a better footing."

That is especially in contrast to analysis of what the future would otherwise have held under sunset of the Tax Relief Act's amendments to Sec. 2010 and higher exclusions and lower rates under the Economic Growth and Tax Relief Reconciliation Act of 2001, P.L. 107-16. It puts to rest, for example, speculation about a $1 million exclusion applying to prior taxable gifts in a "clawback."

Recognizing that Congress could still amend relevant sections of the Code, however, drafters of wills and transfer documents probably will continue to specify amounts by reference to those sections in lieu of their current dollar amounts, Ransome said.

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