AMERICAN TAX RELIEF ACT OF 2012

Waiting until the last minute to avoid the so-called "fiscal cliff," Congress passed the ***American Tax Relief Act of 2012" ("ATRA")*** on January 1, 2013. This long-awaited tax legislation permanently retains the Bush-era tax rates for lower and moderate income individuals while raising the highest tax rates on regular income, dividends, and capital gains on those with higher income; provides a permanent lifetime gift and estate tax exemption amount of $5 million as adjusted for inflation ($5.12 million for 2012; $5.25 million for 2013); sets a top estate and gift tax rate of 40%; and locks in AMT relief on a permanent basis. In addition, the legislation retroactively extends (or makes permanent) ***a long list of tax breaks*** for both individuals and businesses that expired after 2011 (or, were scheduled to expire after 2012). ***Please note that*** our reference to "permanent" provisions simply means that the provision no longer has a sunset date. Of course, Congress could always change these provisions with future legislation. **Caution!** *ATRA* ***did not extend*** the temporary 2% Social Security tax holiday beyond 2012. Thus, those who receive W-2 compensation or self-employed income will experience an increase in Social Security taxes in 2013.

In addition to the recent changes under *ATRA,* the sweeping ***Health Care Act*** enacted in 2010 contains a 3.8% Medicare Tax on investment income, and a .9% Medicare Tax on earned income that will apply to higher-income individuals ***for the first time in 2013.*** In late November 2012, the IRS released extensive guidance on these new Medicare Taxes. These new taxes are ***in addition to*** the tax rate increases for higher-income taxpayers under ***ATRA*** (which also become effective in 2013).

We are sending you this letter to keep you abreast of the most important provisions under ***ATRA*** and the new ***Medicare Tax guidance.***

Planning Alert! In this letter, we suggest planning opportunities created by these new tax developments. However, you cannot properly evaluate a particular planning strategy without calculating your overall tax liability (including the alternative minimum tax) with and without the strategy. You should also consider any state income tax consequences of a particular planning strategy. We recommend you call our firm before implementing any tax planning technique discussed in this letter, or if you need more information. Also, we highlight only ***selected*** provisions of ***ATRA*** and the new ***Medicare Taxes.*** If you have heard or read about any related tax development not discussed in this letter, feel free to call our office.

TABLE OF CONTENTS

We have included a Table of Contents with this letter that will help you locate items of interest. The Table of Contents begins on the next page.

TABLE OF CONTENTS

AMERICAN TAX RELIEF ACT OF 2012 (ATRA)

The ***American Tax Relief Act of 2012*** *(*ATRA): **1)** permanently increases the highest tax rate on ordinary income, capital gains, and dividends of higher-income taxpayers; **2)** creates a permanent alternative minimum tax (AMT) "fix"; **3)** makes recent changes to the estate and gift tax rules permanent; **4)** temporarily extends various expiring tax breaks; and **5)** makes various tax breaks permanent that were previously scheduled to expire. **Planning Alert!** Our reference to ***"permanent"*** means that the provision ***has no sunset date*** after *ATRA* (Congress could always change these provisions with future legislation).

INCOME TAX RATES PERMANENTLY INCREASED FOR CERTAIN HIGHER-INCOME TAXPAYERS

Beginning in 2013, the ***American Tax Relief Act of 2012*** ("ATRA") generally increases the highest income tax rates on a permanent basis (i.e., no sunset date). **Planning Alert!** The tax increases discussed below ***do not include*** the ***new Medicare Taxes*** under the ***2010 Health Care Act*** on investment income and earned income of higher-income taxpayers beginning in 2013. These new Medicare Taxes are discussed in the last segment of this letter, and are ***in addition to*** the following *selected* provisions enacted under *ATRA*:

- **Highest "Ordinary" Income Tax Rate For Individuals Permanently Increased To 39.6%.** The Bush-era income tax rates were scheduled to expire for all individuals after 2012. *ATRA* permanently retains these rates (from 10% to 35%) for most lower and moderate income individuals. However, ***beginning in 2013,*** *ATRA* adds a new 39.6% bracket on ***taxable income*** of an individual that ***exceeds*** the following thresholds: ***$450,000*** for married couples ***filing joint returns*** ($225,000 if married filing separate); ***$400,000*** for ***single filers;*** and ***$425,000*** for ***heads of households***. These thresholds will be adjusted for inflation after 2013.

- **Highest "Income Tax" Rate For Estates And Trusts Permanently Increased To 39.6%.** ***Beginning in 2013***, *ATRA* permanently increases the highest income tax rate for income taxed to a trust or estate from 35% to 39.6%. For 2013, the 39.6% rate will apply to trust or estate taxable income that ***exceeds $11,950.*** **Please note** that the 10% *income* tax bracket applicable to individual taxpayers has never applied to estates and trusts. The lowest income tax rate for estates and trusts remains at 15%. **Planning Alert!** The income threshold for taxing an individual at 39.6% (e.g., $400,000 if single) is substantially higher than the income level for taxing a trust or estate at 39.6% (i.e., $11,950 for 2013). Therefore, *ATRA* has created an additional tax incentive for distributing trust or estate income to an individual beneficiary where the beneficiary's income is taxed in a lower tax bracket.

- **Highest Long-Term Capital Gain And Qualified Dividend Rates Permanently Increased To 20%.** *ATRA* permanently retains the maximum long-term capital gain and qualified dividend rates at 15% for lower and moderate income individuals. *ATRA* also permanently retains the zero percent tax rate for long-term capital gains and qualified dividends where the capital gain or dividend income would otherwise be taxed in the 15% or 10% brackets (for 2013, taxable income up to $36,250 for single individuals and $72,500 for joint filers is taxed in the 15% bracket or below). However, ***beginning in 2013***, for long-term capital gains or qualified dividends that would otherwise be taxed in the 39.6% bracket, *ATRA* increases the rate to 20%. For example, to the extent long-term capital gains of a single individual cause his or her taxable income to exceed $400,000 in 2013 (i.e., the income threshold for the 39.6% bracket), the capital gains will be taxed at 20%. **Caution!** The current maximum rates of 28% on the sale of collectibles and 25% on the gain attributable to straight-line depreciation taken on depreciable realty were not changed and continue to apply for 2013 and subsequent years. **Trust And Estates.** For long-term capital gains and/or qualified dividends that would otherwise be taxed in the 39.6% bracket of a trust or estate (i.e., for 2013, where taxable income exceeds $11,950), *ATRA* permanently increases the rate to 20%.

  Tax Tips! The retention of the zero percent rate for long-term capital gains and qualified dividends is particularly important to lower-income retirees who rely largely on investment portfolios that generate dividends and long-term capital gains. Furthermore, gifts of appreciated securities to lower-income donees who then sell the securities could reduce the tax on all or part of the gain from 15% or 20% to zero percent **(Caution!** If the donee is subject to the so-called *kiddie tax*, this planning technique will generally not work). Moreover, if you sell capital gain property using seller financing, you generally recognize the

gain in the years you receive payments on the installment note. Thus, spreading the capital gain over multiple years by taking an installment note upon the sale, may allow you to keep your taxable income below the 39.6% threshold, causing your capital gain to be taxed at a maximum rate of 15% (or possibly 0%), rather than 20%.

- **Personal Exemption And Itemized Deduction Phase-Outs Permanently Reinstated.** During most of the past two decades, higher-income individuals were subject to an income phase-out provision that reduced their ***personal exemptions*** and ***itemized deductions*** as their income exceeded certain thresholds. All individuals were given a three-year reprieve from these phase-outs ***from 2010 through 2012.*** Under *ATRA*, ***beginning in 2013***, these phase-out provisions are permanently reinstated for individuals with ***adjusted gross incomes*** exceeding the following threshold amounts: ***$300,000*** for married couples ***filing joint returns*** ($150,000 if married filing separately); ***$250,000*** for ***single filers;*** and ***$275,000*** for ***heads of households.*** These thresholds will be adjusted for inflation after 2013. **Tax Tip.** The phase-out provisions ***do not apply*** to the following itemized deductions: medical expenses, investment interest, gambling losses, casualty losses, and theft losses. **Practice Alert!** Individuals whose itemized deductions and/or personal exemptions are reduced by these phase-out provisions will have higher "effective" tax rates than listed in the published statutory-rate schedules.

- **Marriage Penalty Relief Permanently Extended – But Not Eliminated.** Several Bush-era tax provisions reduced (but did not completely eliminate) the so-called "marriage penalty" (i.e., provisions in the tax law causing married individuals filing jointly to pay more tax than if they were single filing separate returns). *ATRA* makes these marriage penalty relief provisions permanent (e.g., by providing a larger standard deduction and larger 10% and 15% brackets for married taxpayers filing jointly). **Planning Alert!** Although these Bush-era marriage penalty relief provisions were made permanent, *ATRA* has created new marriage tax penalties by virtue of its income thresholds for the new 39.6% tax bracket and the personal exemption and dependancy phase-outs. For example, if a married couple files a 2013 joint return and each spouse has taxable income of $400,000, their joint taxable income of $800,000 will generally be taxed at 39.6% to the extent it exceeds the $450,000 income threshold for married individuals filing joint returns (i.e., $350,000 will be taxed at 39.6%). By contrast, if the individuals were not married and each filed as single, neither would be subject to the 39.6% tax rate because neither would have exceeded the $400,000 income threshold that triggers the 39.6% rate for single individuals.

ALTERNATIVE MINIMUM TAX (AMT) "FIX" MADE PERMANENT

For the past several years, Congress has routinely enacted a series of so-called AMT "patches" that temporarily increased the alternative minimum tax (AMT) exemption amounts by indexing these amounts. These AMT patches temporarily ensured that most lower and middle income taxpayers were not subject to AMT. ***Beginning in 2012, ATRA provides for the permanent indexing*** of the AMT exemption amounts. *ATRA* also allows non-refundable personal income tax credits to offset the AMT permanently. Moreover, the 0%, 15%, and 20% tax rates on long-term capital gains and qualified dividends for regular income tax purposes also ***apply permanently*** in calculating the AMT. **Planning Alert!** Although these permanent AMT "fixes" do not eliminate AMT, they ensure that most middle and low income taxpayers will be exempt from the AMT on an ongoing basis. The changes will also provide more certainty in planning to reduce the AMT.

FAVORABLE ESTATE, GENERATION SKIPPING, AND GIFT TAX CHANGES MADE PERMANENT

Over the years, gift and estate taxes have generally been imposed only on estates and aggregate lifetime gifts exceeding a certain dollar amount (the "exclusion amount"). The *Tax Relief Act of 2010* temporarily set the lifetime estate and gift tax *exclusion amount* at $5 million (as indexed for inflation) through 2012: for 2010 and 2011 the *exclusion amount* was $5 million, and $5.12 million for 2012. The *Tax Relief Act of 2010* also temporarily set the maximum estate and gift tax rate at 35% through 2012. ***ATRA*** **extends the inflation-adjusted $5 million** *exclusion amount* ***permanently*** to years beginning after 2012 (e.g., $5.25 million for 2013). However, *ATRA* ***permanently*** increases the maximum **estate and gift tax rate** from 35% ***to 40%*** for years beginning after 2012.

- ***ATRA* Permanently Unifies The Gift And Estate Tax "Exclusion Amount."** For several years before 2011, the gift tax *exclusion amount* for aggregate lifetime gifts was set at $1 million, while the estate tax *exclusion amount* was higher (e.g., $5 million for decedents dying in 2010).The *Tax Relief Act of 2010* temporarily unified the "gift" and "estate" *exclusion amount* by providing a single unified *exclusion amount* of $5 million (as adjusted for inflation) for 2011 and 2012. *ATRA* makes the single ***unified gift and estate exclusion amount permanent.***

- **"Portability" Of Deceased Spouse's Unused Exclusion Amount Made Permanent.** Historically, each spouse's estate has been entitled to a full estate tax *exclusion amount*. Traditionally, technical estate tax planning structures and strategies (e.g. credit shelter trusts) were often necessary to ensure that the estate tax *exclusion amount* of the first spouse to die was not partially or completely wasted. For individuals dying in ***2011 or 2012,*** the *Tax Relief Act of 2010* temporarily allowed a personal representative of the estate of the first spouse to die to "elect" (by timely filing a completed estate tax return) to transfer the deceased spouse's unused portion of the estate tax *exclusion amount* to the surviving spouse. ***ATRA* makes this so-called *"portability" provision permanent.***

  - **Example.** Assume that Husband dies in 2013 when the maximum *exclusion amount* is $5.25 million, but Husband's taxable estate is only $3.25 million. Under this *portability rule*, the personal representative for Husband's estate is allowed to elect to have Husband's unused $2 million *exclusion amount* added to the surviving Wife's unused $5.25 million *exclusion amount*. Wife could then use her $7.25 million *exclusion amount* to shelter her lifetime gifts from gift taxes. And, to the extent not used to shelter gifts from the gift tax, any remaining *exclusion amount* could be used to shelter amounts in her estate from estate taxes.

  - **Planning Alert!** To make the "portability" election, IRS says that the deceased spouse's estate ***must timely file a properly-completed estate tax return.*** An estate tax return generally must be filed ***within 9 months*** of a decedent's death, unless the estate timely obtains a 6-month filing extension. If you need additional information regarding the technical requirements for making this *portability election,* or the advisability of making this election, please call our firm.

- **Generation-Skipping Tax.** In addition to the estate and gift taxes, there is also imposed a generation-skipping tax (GST) on transfers that skip a generation (e.g., gifts to grandchildren). ***ATRA* permanently sets the GST *exemption amount* at an inflation-adjusted amount of $5 million** ($5.25 million for 2013), and the **maximum GST rate at 40%. Planning Alert!** Unlike the estate and gift tax *exclusion amount* discussed above, the GST *exemption amount* is ***not portable*** between spouses.

***SELECTED* "EXPIRED" TAX BREAKS THAT WERE EXTENDED WITH NEW "SUNSET DATES"**

In addition to making permanent changes to income tax rates, the alternative minimum tax, and the estate and gift tax provisions, *ATRA* temporarily extends a host of targeted tax breaks for both businesses and individuals that expired either at the close of 2011 or 2012. *ATRA* extends (through 2013 or 2017) these expired tax breaks ***retroactively*** (i.e., as though the provision had never expired). The following summaries highlight popular tax breaks that *ATRA* retroactively extended ***with new sunset dates:***

Selected* "Individual" Tax Breaks Extended Through 2013.** *ATRA* ***retroactively extends ***through 2013*** the following tax breaks for ***individual* taxpayers** (that had expired or had been reduced after 2011 or 2012): **1)** school teachers' deduction (up to $250) for certain school supplies; **2)** election to deduct state and local sales tax; **3)** deduction (up to $4,000) for qualified higher education expenses; **4)** expanded deduction and carryover limits for charitable contributions of conservation easements; and **5)** deduction for mortgage insurance premiums as qualified residence interest. ***In addition,*** the following individual tax breaks were extended ***through 2013:***

- **Qualifying IRA Transfers To Charities.** For the past several years, we have had a popular (but temporary) rule that allowed an individual, who is at least age 70½, to make a qualifying transfer of up to $100,000 from his or her IRA ***directly to a qualified charity,*** and exclude the distribution from income. The IRA transfer to the charity also counted toward the owner's "required minimum distributions" (RMDs)

for the year. Although this provision expired after 2011, *ATRA* retroactively extends it ***through 2013.*** **Planning Alert!** *ATRA* contains a ***transition rule*** allowing individuals (who are at least age 70½) to elect: **1)** to treat any IRA transfer ***directly to a charity*** during ***January of 2013*** as ***if made during 2012*****;** and **2)** to generally treat any portion of a distribution from an IRA ***during December, 2012*** that ***was not made directly to a charity*** as a *"qualified charitable distribution"* for 2012 – to the extent cash is transferred to a charity ***before February 1, 2013.***

- **Income Exclusion For Discharge Of Qualified Principal Residence Indebtedness.** The provision allowing you to exclude the income from the discharge of all or a portion of a mortgage (not exceeding $2 million) that you incurred to purchase, construct, or substantially improve your principal residence, expired after 2012. *ATRA* extends this exclusion to discharges that occur ***by the end of 2013.*** **Tax Tip.** This exclusion could potentially apply to debt forgiveness involving the "short sale" or foreclosure of your principal residence.

- **Credit For Energy-Efficient Improvements To Principal Residence.** The temporary 10% credit (with a life-time cap of $500) for qualified energy-efficient home improvements expired after 2011. *ATRA* retroactively extends this credit for qualifying installations ***made through December 31, 2013.*** **Planning Alert!** The current 30% credit for installing a qualifying solar water heater, solar electric generating property, a geothermal heat pump, or a small wind energy property in or on your residential property is not ***currently scheduled to expire until after 2016.***

Expanded "American Opportunity Tax Credit" Extended For Individuals Through 2017. Before 2009, individuals were allowed a HOPE tuition tax credit (HOPE Credit) for qualifying tuition costs generally for the first two years of college (e.g., freshman and sophomore years). For 2009 through 2012, Congress changed the name of the HOPE credit to the ***"American Opportunity Tax Credit,"*** and enhanced and expanded it by: **1)** increasing the maximum credit from $1,800 to $2,500 (100% of the 1st $2,000 of qualifying education expenses plus 25% of the next $2,000 of qualifying expenses); **2)** increasing the total number of years that a student may qualify from two years to four years (i.e., generally, freshman through senior years); **3)** increasing the income phase-out levels (the credit is phased out as your modified adjusted gross income increases from $160,000 to $180,000 for those filing joint returns, and from $80,000 to $90,000 for single filers); **4)** making 40% of the credit refundable (unless the person claiming the credit is subject to the so-called kiddie tax rules); and **5)** adding course materials to the expenses (in addition to tuition and fees) that qualify for the credit. *ATRA* retroactively extends these expanded provisions of the American Opportunity Tax Credit ***through 2017.***

Selected **"Business" Tax Breaks Extended Through 2013.** *ATRA* ***retroactively*** extends ***through 2013*** the following tax breaks for ***businesses*** that had expired or had been reduced after 2011 or 2012**: 1)** 15-year (instead of 39-year) depreciation period for "qualified" leasehold improvements, restaurant property, and retail improvement property; **2)** 7-year depreciation period for certain motor sports racetrack property; **3)** research and development credit; **4)** employer differential wage credit for payments to military personnel; **5)** favorable S corporation charitable contribution provisions involving capital gain property; **6)** temporary exclusion of 100% of gain on the sale of certain small business stock for both regular tax and AMT purposes; **7)** a host of tax benefits for qualified energy-efficient expenditures, and for qualifying investments in empowerment zones; **8)** 5-year (instead of 10-year) *recognition period* for S corporation built-in gains tax; **9)** election for C corporations to exchange bonus depreciation for refundable AMT credits; **10)** parity between employer-provided parking and transportation tax-free fringe benefits; and **11)** enhanced charitable contribution rules for qualifying business entities contributing food inventory **(Caution!** Enhanced contribution rules for businesses contributing computer equipment and books ***expired after 2011 and were not extended). In addition,*** the following business tax breaks were extended ***through 2013:***

- **Work Opportunity Tax Credit Extended Retroactively Through 2013.** Many employers that have taken advantage of the popular Work Opportunity Tax Credit (WOTC) for hiring workers from certain disadvantaged groups were disappointed that the WOTC expired for individuals, other than *qualified veterans*, hired after 2011. In addition, the WOTC expired for *qualified veterans* hired after 2012. ***ATRA*** **reinstates the WOTC retroactively for all qualifying individuals** ***hired after 2011 and through 2013 (both for qualified veterans as well as for members of other targeted groups).***

Tax Tip. To encourage employers to hire more military veterans, in late 2011, Congress added an expanded ***"qualified veteran"*** category to the types of employees that qualify for WOTC. Depending on the "tax" classification of the *"qualified veteran,"* the maximum credit runs from $2,400 to $9,600, provided the *qualified veteran* is hired ***after November 21, 2011*** and ***before 2014.*** In addition, unlike previous credits under the WOTC, tax-exempt employers (other than government agencies) that hire *"qualified veterans"* ***after November 21, 2011*** and ***before 2014,*** may receive a *"refundable"* credit of 65% of the credit allowed for taxable employers.

Planning Alert! To qualify for the WOTC, all employers (including tax-exempt employers who hire "qualified veterans") must have the new worker complete IRS **Form 8850** ("Pre-Screening Notice and Certification Request for the Work Opportunity Credit"), and submit that form to the state employment security agency ***no later than 28 days*** after the employee begins work. You can locate Form 8850 at www.irs.gov. The instructions to the form provide detailed information on the categories of workers who qualify for the WOTC (including the definition of a *"qualified veteran*").

- **First-Year 168(k) 50% Bonus Depreciation Extended Through 2013.** For *qualifying* "new" business property placed-in-service during 2012 (through December 31, 2013 for certain long-production-period property and qualifying noncommercial aircraft), businesses were allowed a 50% first-year 168(k) bonus depreciation deduction. The 50% bonus depreciation generally expired for property placed-in-service after 2012. *ATRA* extends the 50% bonus for qualifying property placed-in-service ***through December 31, 2013*** (through December 31, 2014 for certain long-production-period property and qualifying noncommercial aircraft).

  - **Qualifying 50% 168(k) Bonus Depreciation Property.** Generally, property qualifies for the 50% 168(k) bonus depreciation deduction if it is purchased *new* and it is either a "qualified leasehold improvement," or it has a depreciable life for tax purposes of *20 years or less* (e.g., machinery and equipment, furniture and fixtures, cars and light general purpose trucks, sidewalks, roads, landscaping, depreciable computer software, farm buildings, and qualified motor fuels facilities). **Planning Alert!** These are only examples of qualifying property. If you have a question about property that we did not mention, call us and we will help you determine if it qualifies. **Caution!** "Qualified restaurant property" and "qualified retail improvement property" (described in the section 179 discussion below) do not qualify for the §168(k) deduction unless the property also constitutes a "qualified leasehold improvement."

  - **168(k) Bonus Depreciation For Passenger Automobiles, Trucks, And SUVs.** The maximum annual depreciation deduction (including the section 179 deduction) for most *business automobiles* is capped at certain dollar amounts. For a business auto first placed-in-service in **calendar year 2012,** the maximum first-year depreciation deduction is generally capped at $3,160 ($3,360 for trucks and vans not weighing over 6,000 lbs). However, Congress increased the first-year depreciation cap by $8,000 for 2008 through 2012 for qualifying new vehicles otherwise qualifying for the 168(k) bonus depreciation deduction. *ATRA* extends this $8,000 increase in the first-year depreciation deduction limitation to qualifying new vehicles placed-in-service ***through December 31, 2013.***

- **Expanded Section 179 Deduction Extended Through 2013.** For the last several years, Congress has increased the maximum section 179 up-front deduction for the cost of qualifying new or used depreciable business property (e.g., business equipment, computers, etc.). For property placed-in-service in tax years beginning in 2010 and 2011, the section 179 cap was increased from $250,000 to $500,000, and the beginning of the deduction phase-out threshold was also increased from $800,000 to $2,000,000. In addition, for 2010 and 2011 purchases, a taxpayer could elect for up to $250,000 of "qualified real property" (discussed below) to be section 179 property. ***ATRA retroactively extends all of these enhanced section 179 provisions*** (i.e., $500,000 section 179 cap; up to $250,000 section 179 deduction for "qualified real property;" and the $2,000,000 phase-out threshold) for qualifying property placed-in-service in ***tax years beginning in 2012 or 2013.***

  - **"Electing" To Treat Up To $250,000 Of *"Qualified Real Property"* As Section 179 Property.** Traditionally, the up-front section 179 deduction was only allowed for depreciable, tangible, "personal"

property, such as equipment, computers, vehicles, etc. However, taxpayers may "elect" to treat up to $250,000 of "qualified *real* property" as §179 property, provided the property is **placed-in-service in tax years beginning in 2010, 2011, 2012, or 2013.** "Qualified Real Property" includes property within any of the following three categories: **1) Qualified Leasehold Improvement Property** (generally capital improvements to the interior portion of certain leased buildings that are used for nonresidential commercial purposes); **2) Qualified Retail Improvement Property** (generally capital improvements made to certain buildings which are open to the general public for the sale of tangible personal property); and **3) Qualified Restaurant Property** (generally capital expenditures for the improvement, purchase, or construction of a building, if more than 50% of the building's square footage is devoted to the preparation of, and seating for, the on-premises consumption of prepared meals). **Planning Alert!** The $500,000 overall section 179 deduction limitation is reduced by any section 179 deduction taken for *qualified real property*.

SELECTED "EXPIRED" TAX BREAKS THAT WERE EXTENDED "PERMANENTLY"

Selected* "Individual" Tax Breaks Made Permanent (No Sunset Date).** *ATRA* retroactively extends ***permanently the following tax breaks for individual taxpayers (that had expired or had been reduced after 2011 or 2012): **1)** enhanced rules for Coverdell education savings accounts (e.g., $2,000 instead of $500 annual contribution limit; ability to use for elementary and secondary school expenses); **2)** enhanced student loan interest deduction (e.g., higher income phase-out thresholds; elimination of 60-month limit); **3)** enhanced earned income tax credit (e.g., higher income phase-out level for married individuals); **4)** expanded and enhanced $1,000 child credit (e.g., maintaining the credit at $1,000 rather than $500) ; **5)** expanded child and dependent care credit (e.g., maintaining the increased credit percentages and income phase-out thresholds); and **6)** tax-free treatment of scholarships under the NHSC Scholarship Program and the Armed Forces Scholarship Program. ***In addition,*** the following individual tax breaks are retroactively ***made permanent:***

- **Adoption Credit.** For 2012, the maximum adoption credit was $12,650, and the credit was phased-out for taxpayers with modified adjusted gross income (MAGI) between $189,710 and $229,710. After 2012, the adoption tax credit was to be cut back (e.g., reduced to $6,000 and available only for special needs adoptions). *ATRA* retroactively reinstates the pre-2013 adoption credit provisions ***with no sunset.*** **Tax Tip.** ***For 2013***, the maximum adoption credit is $12,970, and will be reduced as an individual's MAGI increases from $194,580 to $234,580. **Practice Alert!** Although the adoption credit was temporarily refundable for 2010 and 2011, ***it is not refundable after 2011.***

- **Employer-Provided Educational Assistance Tax-Free Fringe Benefit.** An employer may pay up to $5,250 of an employee's qualified education expenses as a tax-free fringe benefit, provided the payments are pursuant to an employer-sponsored, nondiscriminatory qualified education assistance program. The employer may also deduct the education expenses up to $5,250. This provision expired after 2012, however ***ATRA*** retroactively reinstates it ***with no sunset.***

Selected* "Business" Tax Provisions Made Permanent (No Sunset Date).** *ATRA* ***permanently changes the following business tax provisions: **1)** retroactively reinstates the credit for employer-provided child-care facilities (with no sunset); **2)** for ***tax years beginning after 2012,*** permanently increases the *accumulated earnings* and *personal holding company* tax rates ***from 15% to 20%;*** and **3)** repeals the "collapsible corporation" rules.

MISCELLANEOUS TAX CHANGES UNDER ATRA

ATRA contained several miscellaneous tax changes including:

Expanded In-Plan Roth Conversions. Effective for ***transfers after 2012,*** *ATRA* provides that an employer-sponsored qualified retirement plan (e.g., 401(k) plan, 403(b) annuity plan, or 457 plan) that includes a qualified Roth contribution program may allow a participant to transfer an amount to a designated Roth account maintained under the same plan, ***even though the transferred amount is not otherwise distributable under the plan.*** The conversion of the otherwise taxable amounts into a Roth account is fully taxable.

Special Rule For Long-Term Contractors. Generally, taxpayers that report taxable income on long-term contracts using the "percentage of completion method" of accounting must recognize (on an annual basis) a percentage of the estimated revenue from the contract based on a completion percentage. The *completion percentage* is determined by comparing the costs allocated to the contract through the end of the current tax year, as a percentage of the estimated total costs under the contract. Thus, a taxpayer who deducts 168(k) bonus depreciation on property used in long-term contract projects that are reporting income using the *percentage of completion* method, would normally be required to report more income from the contract for the year the bonus depreciation deduction is taken. *ATRA* provides that, ***for property placed-in-service in 2013 that has a depreciable life of 7 years or less,*** income reported under the "percentage of completion" method is determined ***without taking into account the bonus depreciation deduction.***

IRS PROVIDES NEW GUIDANCE ON NEW .9% AND 3.8% MEDICARE TAXES

Starting in 2013, the ***Health Care Act*** (enacted in 2010) imposes an *additional* ***Medicare Tax of .9%*** on the wages and self-employment income of higher-income individuals, as well as a *new* ***3.8% Medicare Tax*** on their *net investment income*. These taxes are ***in addition to*** the tax rate increases under *ATRA* that also begin in 2013. Thus, ***beginning in 2013,*** the Federal tax rates for individuals taxed in the ***highest income tax brackets*** who are also subject to these new Medicare Taxes could be as high as: ***40.5%*** (39.6% plus .9%) for wages and self-employment income; **23.8%** (20% plus 3.8%) for long-term capital gains and dividend income; and ***43.4%*** (39.6% plus 3.8%) for interest income. In late November 2012, the IRS released extensive guidance on these new Medicare Taxes. The following highlights how these new Medicare Taxes operate, and summarizes key aspects of the recent IRS guidance.

.9% MEDICARE TAX ON "EARNED INCOME" OF HIGHER-INCOME INDIVIDUALS

Payroll taxes imposed on your W-2 earnings include both a Social Security tax and a separate Medicare tax. Prior to 2013, the overall Medicare tax rate was 2.9% (1.45% imposed on the employee and an additional 1.45% imposed on the employer). If you are self-employed, you must pay the entire 2.9% Medicare tax on your income from self-employment. Generally, ***effective for wages and self-employed earnings received after 2012*** that exceed certain thresholds, the *2010 Health Care Act* imposes an *additional* ***.9% Medicare Tax*** on individuals with higher W-2 wages and self-employed income. This .9% Medicare tax applies to the amount by which the ***sum of*** your ***W-2 wages*** and your ***self-employed earnings*** exceeds the following thresholds: ***$250,000*** if you are ***married filing jointly; $200,000*** if you are ***single***, or ***$125,000*** if you are ***married filing separately.*** For married individuals filing a joint return, the .9% Medicare tax will apply to the extent *the sum of* both spouses' W-2 earnings and the self-employed earnings exceeds the $250,000 threshold. **Planning Alert!** These income thresholds are fixed and are ***not indexed*** for future inflation. Also, you are not allowed an "income" tax deduction for any portion of the .9% tax, whether or not you are self-employed.

- **Recent IRS Guidance.** Recently-released IRS regulations on the .9% Medicare tax clarify that: **1)** An employer is required to withhold the .9% Medicare tax on an employee's W-2 earnings in excess of $200,000, but there is no match of the .9% tax by the employer; **2)** An employer is required to withhold the .9% Medicare tax once the employer pays an employee more than $200,000 whether the employee is single or married and without regard to the employee's spouse's earnings; **3)** Wages are subject to the .9% Medicare tax if the wages are otherwise subject to Medicare taxes generally (e.g., elective deferrals under a 401(k) plan are subject to Medicare tax generally and, therefore, are subject to the .9% Medicare tax – provided the employee's earned income exceeds the .9% Medicare tax earned-income threshold); **4)** Amounts deferred in a non-qualified deferred compensation arrangement are subject to the .9% Medicare tax when taken into account as wages for FICA purposes; and **5)** Individuals are required to report their .9% Medicare tax on Form 1040 (starting in 2013), and must also pay the .9% Medicare tax with their Form 1040 to the extent it was not paid through employer withholding or estimated tax payments. Feel free to call our firm if you need additional information on this *new* .9% Medicare tax.

3.8% MEDICARE TAX ON "NET INVESTMENT INCOME" OF HIGHER-INCOME TAXPAYERS

Beginning in 2013, the *2010 Health Care Act* imposes a new 3.8% Medicare tax on the ***net investment income*** of ***higher-income*** *taxpayers*. With limited exceptions, ***"net Investment Income"*** generally includes the following types of income (less applicable expenses): interest, dividends, annuities, royalties, rents, "passive" income (as defined under the traditional "passive activity" loss rules), long-term and short-term capital gains, and income from the business of trading in financial securities and commodities. **Planning Alert!** Income, including "passive" income, ***is not*** *"net investment income"* (and is therefore exempt from this new 3.8% Medicare tax), ***if the income is "self-employment income"*** subject to the 2.9% Medicare tax. The 3.8% Medicare tax applies to individuals with modified adjusted gross income (MAGI) exceeding the following ***"thresholds"*** (which are ***not indexed*** for future inflation): ***$250,000*** for ***married filing jointly***; ***$200,000*** if ***single***; and ***$125,000*** if ***married filing separately.*** The 3.8% Medicare tax is imposed upon ***the lesser of*** an individual's **1)** modified adjusted gross income (MAGI) in excess of the ***threshold,*** or **2)** net investment income. Moreover, ***trusts and estates*** that have *net investment income* and *adjusted gross income* (AGI) in excess of a certain ***"threshold"*** (for 2013, the threshold is $11,950) must pay the 3.8% Medicare tax, unless the income is timely distributed to beneficiaries. **Planning Alert!** Timely distributions of *net investment income* from an estate or trust may cause the beneficiary to be subject to the 3.8% Medicare tax on the distributed income.

Any income that is otherwise exempt from taxable income is likewise exempt from the 3.8% Medicare tax. For example, the following types of income are generally tax exempt, and are therefore exempt from the 3.8% Medicare tax: municipal bond interest; gain on the sale of a principal residence *otherwise excluded* under the ***home-sale exclusion*** rules (i.e., up to $250,000 on a single return, up to $500,000 on a joint return); and life insurance proceeds. Also, the 3.8% Medicare tax ***does not apply*** to distributions from qualified plans (e.g., IRAs, §403(b) annuities, etc.), whether or not the distributions are otherwise taxable. Moreover as mentioned above, any income that constitutes *self-employment income* subject to the 2.9% Medicare tax is excluded from *net investment income*.

- **Recent IRS Guidance.** Recently-released IRS regulations on the 3.8% Medicare tax clarify that: **1)** Deductions that are allowed in computing *"net investment income"* for a particular tax year depend upon detailed expense allocation rules contained in the new IRS regulations, and may include the following: investment interest expense to the extent allowed as an itemized deduction for the year; investment expenses directly connected to the production of investment income (e.g., deductible investment advisor fees allocable to investment income); state and local income taxes allocable to investment income; capital losses and capital loss carryforwards (including capital loss carryforwards from pre-2013 tax years) may offset capital gains; passive losses and passive loss carryforwards (including passive loss carryforwards from pre-2013 tax years) may offset passive income – as determined under the traditional "passive activity" loss rules; **2)** Net operating losses (NOLs) carryovers/carrybacks ***do not*** reduce *net investment income;* **3)** Payments from non-qualified deferred compensation plans ***are not included*** in *net investment income;* **4)** The 3.8% Medicare tax does not apply to tax-exempt trusts (e.g., charitable remainder trusts, health savings accounts, section 529 plans); however, charitable remainder trust "distributions" of *net investment income* to the grantor may trigger the 3.8% Medicare tax to the grantor; **5)** Although *net investment income* generally includes taxable distributions from commercial annuity contracts, it ***does not include*** Social Security benefits or taxable alimony payments; and **6)** A child's *net investment income* presumably will not be included in the parents' *net investment income* for purposes of the 3.8% Medicare tax unless the parents qualify to file (and do file) Form 8814 ("Parents' Election To Report Child's Interest and Dividends").

- **Planning Alert!** In certain situations, the rules for determining whether you have *net investment income* subject to the 3.8% Medicare Tax can be complicated. For instance, *net investment income* generally includes net income that you report from a business activity if you are a "passive" owner (unless the income constitutes *self-employment* income that is subject to the 2.9% Medicare tax). You will be deemed a "passive" owner if you do not "materially participate" in the business as determined under the traditional "passive activity loss" rules. For example, under the *passive activity loss* rules, you may be deemed to be a *"passive"* owner unless you spend more than 500 hours working in the business during the year. Furthermore, subject to limited exceptions, rental income is generally deemed to be "passive" income

under the *passive activity loss* rules, regardless of how many hours you spend working in the rental activity. If you believe that you may have income that could be classified as "passive" under these rules, please contact our firm. We will be glad to evaluate your situation to determine whether there are steps you could take to avoid "passive" income classification, and thus, minimize your exposure to the 3.8% Medicare tax on *net investment income*.

FINAL COMMENTS

Please contact us if you are interested in a tax topic that we did not discuss. Tax law is constantly changing due to new legislation, cases, regulations, and IRS rulings. Our firm closely monitors these changes. In addition, please call us before implementing any planning ideas discussed in this letter, or if you need additional information. **Note!** The information contained in this material represents a general overview of tax developments and should not be relied upon without an independent, professional analysis of how any of these provisions may apply to a specific situation.

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