CHANGING TIMES

PARACHUTING FROM THE TAX RATE FISCAL CLIFF

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As we all breathe a sigh of relief, yet wait in anticipation for the upcoming sequester legislative showdown, we review in this column whether relief really exists for the business owner in the "fiscal cliff" legislation passed on January 2, 2013. There is no question but that a full reversion of both ordinary and capital gain tax rates under the EGTRRA sunset provisions would have hurt a large majority of the taxpayers. And we still would have landed with the highest marginal ordinary income tax rate of 39.6 percent. The *American Taxpayer Relief Act, P.L. 112 - 240* (ATRA), [1] signed by the president on January 3, walked some taxpayers back from the cliff on a tentative path by avoiding a full reversion to the higher tax rates prior to the "Bush-era" tax reduction legislation. Yet when combined with other recent legislation, the results need reviewing with a skeptical eye.

President George Bush's proposed tax legislation in 2001 reduced individual marginal income tax rates significantly in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). [2] Shortly after this legislation followed another major tax bill, the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), [3] which incorporated significant dividend and capital gain tax rate reductions. The original proposed EGTRRA legislation was to expire in 2006. However, in its final form these rates were extended past that date, accompanied by the now famous "sunset provision." Under the "sunset provision" all of the tax rate decreases would revert to the pre-2001 rates as of January 1, 2011. These rates were extended with a two-year "band-aid" under the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 ("2010 Tax Act"), which held the lower tax rates and other favorable tax provisions in place through the fateful "fiscal cliff" date of December 31, 2012.

The latest round of solutions for the fiscal cliff finally passed in ATRA. This legislation promotes an extension of the Bush-era tax rate reductions for many taxpayers, except those considered "high-income" taxpayers. Since it does contain significant provisions affecting the individual taxpayer, we will focus our discussion on the most relevant issues that impact construction entrepreneurs. Those subject to the new higher tax bracket, such as the successful entrepreneurs operating multiple business ventures through pass-through entity structures, will certainly be impacted by this legislation, as well as other tax rate increases previously enacted that become effective in 2013. This legislation also impacts certain smaller construction entrepreneurs with short-term extender provisions offering limited opportunities to lower taxable income through bonus depreciation, increased limitations on the IRC §179 immediate expensing provision, and enhancement of exclusions for certain gains on Qualified Small Business stock. Additionally, the entrepreneur may see some tax rate relief or business impact from certain extended business credits as well as from possible reduction of the "built-in gains" tax assessed at the S Corporation entity level. Finally, one of the most promising benefits to the entrepreneur is the ability to institute succession-planning techniques for a family business with some certainty due to the permanent stabilization of the estate and gift tax provisions. This particularly will offer some relief from the past ten years of turbulence in succession planning.

2013 trigger stages for tax rate increases

The best place to begin our discussion as to our “parachute” from the fiscal cliff is with the now *permanent* tax rate structure for individuals. Refer to Exhibit 1, summarizing the marginal rates applicable from 2013 forward, which are permanent enactments no longer attached to looming “sunset” provisions. [4] (That is, unless Congress manages to pass legislation in the future revising these rates, although that seems highly unlikely given their prior stalemates!)

Exhibit 1.

Individual Tax Rates

Single		Married Filing Joint (“MFJ”)*	
Taxable Income - $0 to $8,925	10%	Taxable Income - $0 to $17,850	10%
Taxable Income - $8,925 to $36,250	15%	Taxable Income - $17,850 to $72,500	15%
Taxable Income - $36,250 to $87,850	25%	Taxable Income - $72,500 to $146,400	25%
Taxable Income - $87,850 to $183,250	28%	Taxable Income - $146,400 to $223,050	28%
Taxable Income - $183,250 to $398,350	33%	Taxable Income - $223,050 to $398,350	33%
Taxable Income - $398,350 to $400,000	35%	Taxable Income - $398,350 to $450,000	35%
Taxable Income over $400,000	39.6%	Taxable Income over $450,000	39.6%

*See IRC§1(f) for related brackets for taxpayers filing as head of household, married filing separately, and for estates and trusts.

In comparison to 2012, the impact here begins with an inflation adjustment to the tax brackets. [5] In conjunction with that, our prior top rate of 35 percent now applies only up to $400,000 of taxable income for the single taxpayer and $450,000 for the married filing joint (MFJ) taxpayer. Then, for all taxable income in excess of those amounts, the 39.6 percent income tax rate applies. [6] For purposes herein, in order to control some of the confusion, I refer to these threshold taxable income amounts as the “high marginal rate threshold range.”

The lowered income tax rate enacted in JGTRRA [7] for capital gains and qualified dividends of 15 percent will now be available for taxpayers whose taxable income is *below* the high marginal rate threshold range. (The 0 percent rate for capital gains and qualified dividends will also still apply for taxpayers falling within only the 15 percent marginal ordinary income tax rate.) The ultimate result is that when the entrepreneur's taxable income is within the “high marginal rate threshold range,” he will also be subject to a 20 percent tax rate for both capital gains and qualified dividends. [8] Except, of course, higher capital gain rates will continue to apply in certain tax scenarios on unrecaptured IRC §1250 depreciation and gains from the sale of Qualified Small Business stock. [9]

The increase in tax rates for 2013 does not end there. A second stage of yet another 2013 income tax rate increase was discussed a year ago in our January/February 2012 issue. The additional surtax rate, labeled the Net Investment Income tax (NII tax) as enacted in the Health Care and Education Reconciliation Act of 2010, [10] became effective on January 1, 2013. Some types of income generated through the entrepreneur's pass-through entity will be subject to this additional 3.8 percent surtax. [11] The surtax applies to the lower of NII or the amount by which Modified Adjusted Gross Income (MAGI) [12] exceeds threshold amounts of $200,000 for a single taxpayer or $250,000 for a taxpayer with a MFJ filing status. [13] (For purposes herein, I refer to these threshold taxable income amounts as the “NII rate threshold amount.”) So, at a minimum, to the extent the entrepreneur's MAGI exceeds the NII rate threshold amount, yet that excess remains less than the entrepreneur's total NII, a higher effective tax rate is triggered on this excess amount. Otherwise, where the NII is less than the MAGI excess over the threshold amounts, the NII is subject in full to a higher effective tax rate. What that rate will be depends on the character of the NII.

NII for applying the surtax includes several components of gross income not normally considered “investment income” under prior tax applications as interpreted by Proposed Regulations issued at the end of 2012. [14] For example, income generated by an activity that meets the requirements of a trade or business under IRC §162 and is further classified as either a passive activity under IRC §469 or a financial instrument trading business income is included as a component of NII. [15] Additionally, gross income from dividends, royalties, interest, and rents are included in NII and subject to the surtax unless derived from a trade or business that is determined at the entrepreneur/owner level *not* to be a passive activity. [16] Alternatively, such types of income will be included in NII if derived from a business of trading in financial instruments as determined at the entity level. For this purpose, financial instruments are defined to include commodities, “stocks and other equity interests, evidence of indebtedness, options, forward or futures contracts, notional principal contracts, any other derivatives or any evidence of an interest” [17] in these, such as through short positions or partial units.

In light of the combination of the NII surtax and the increased marginal tax rates where both are triggered by different threshold amounts, planning for the entrepreneur can difficult at best. Pass-through qualified dividends and capital gains included in an

entrepreneur's NII will be subject to a tax rate that can range from 18.8 percent (15 percent ordinary income tax rate increased by the 3.8 percent NII surtax) to a potential maximum of 23.8 percent (20 percent ordinary income tax rate increased by the 3.8 percent NII surtax). [18] Which rate applies depends on whether taxable income falls within the “high-marginal” rate range, thereby subjecting the entrepreneur to the higher dividend/capital gain tax rate of 20 percent. Alternatively, other types of NII as derived from pass-through entities to be taxed at the entrepreneur's level, such as rental income, interest, royalties, or passive activity income as defined above, similarly can be taxed at up to a 43.4 percent marginal rate (39.6 percent ordinary income tax rate increased by the 3.8 percent NII surtax).

Unfortunately, the final permanent legislative change possibly creating higher tax rates for the entrepreneur is not simply contained to tax rate increases either through the NII tax or through triggering the 39.6 percent marginal tax. ATRA also reinstates a former limitation on itemized deductions commonly known as the Pease limitation and the PEP limitation by which the personal exemption is phased out at certain income levels.

The Pease limitation is named after its proponent, a deceased former eight-term Ohio Democrat from the U.S. House of Representatives, Donald Pease. EGTRRA had eliminated the Pease limitation, yet it now “lives again” through ATRA as a mechanism to raise tax revenues by forcing a “haircut” to total itemized deductions. [19] This creates an increase to the taxable income of high-income taxpayers, which has the impact of pushing the taxpayer into a higher marginal tax rate. Therefore, for those clients not yet in the high-income 39.6 percent rate, these limitations could push them there. The Pease limitation is applied at its own income thresholds, which are triggered at certain levels of adjusted gross income. For example, a single entrepreneur with adjusted gross income exceeding $250,000 will incur a reduction of allowable itemized deductions equal to the smaller of 80 percent of certain itemized deductions or 3 percent of the excess of his adjusted gross income over the $250,000 threshold. For purposes of defining itemized deductions to calculate this limitation, medical expenses, investment interest expense, casualty and theft expenses, and wagering losses are excluded. [20] The threshold limitations range from $150,000 for a married taxpayer filing a separate return, $250,000 for a single taxpayer, $275,000 for a taxpayer filing as head of household, and $300,000 for a couple filing a joint tax return. [21] The PEP limitation reinstatement eliminated in EGTRRA is a phase-out of personal exemptions effective in 2013 and triggered when adjusted gross income exceeds the same thresholds applicable to the Pease limitations. Yet here for *every* $2,500 of excess adjusted gross income over those threshold amounts, 2 percent of each $2,500 excess directly reduces the personal exemption. [22] Both of these limitations curtail deductions and raise taxable income for the taxpayer. Thus, the combination of these three staggered tax rate adjustments will likely raise the ultimate marginal tax rate for the entrepreneur whose business income from “pass-through” entities combine to be taxed at a higher individual marginal rate.

A glimmer of extended business deductions and credits

A “glimmer” of additional relief appeared in the legislation, yet it is only provided for a brief, temporary basis with the retroactive extension of several popular business deductions and credits through 2013.

Smaller construction entrepreneurs will continue to benefit from the extension of 50 percent bonus depreciation of capital expenditures through 2013. Additionally, there was an increase of the IRC §179 immediate expensing of new or used depreciable assets. This provision retroactively increased the reduced limit of $139,000 (as adjusted for inflation) to $500,000, as originally scheduled to be effective in 2012. Yet after 2013, without further action by Congress, the IRC §179 immediate expensing limit drops dramatically to $25,000 annually. [23] Since the IRC §179 immediate expensing is designed to assist the small business entrepreneur, there continues to be a limitation in place through which the expensing deduction is phased out at certain investment levels. Prior to the enactment of ARTA, the $2 million investment limitation was to revert to a $200,000 annual limitation. Now the $2 million limitation is reinstated retroactively for 2012 and applies through 2013 to reduce the $500,000 IRC §179 immediate expensing limitation dollar for dollar. When investments exceed $2.5 million, the $500,000 of IRC §179 expensing will be reduced to zero, obviously limiting the benefit of this deduction to smaller entities. The important take-away from this issue is to remember that, as of January 2014, the scheduled IRC §179 immediate expensing drops to $25,000 and is phased out for any entity that invests more than $225,000 in that year. 2013 is the time to act.

There is a series of other extended tax benefits that may either provide the construction entrepreneur with a tax benefit or serve as a catalyst to boost activity, and they are recapped here as opportunities set to expire after 2013. See the following recap for a checklist of those you want to remember as you advise your construction clients in planning for the remainder of 2013.

1. The Work Opportunity Tax Credit (WOTC) for seven target groups (as discussed in this column in our May/June issue) is

extended through 2013 for wages paid to qualifying employees prior to 2014. [24] The credit offers another year of direct tax credits to businesses employing individuals from these target groups based on 40 percent of first-year wages in varying amounts depending on the target group, as well as 50 percent of the first $10,000 of second-year wages for long-term family aid recipients. Do not forget one important target group: veterans who are part of a family receiving food stamps, or have service-connected disabilities, or are unemployed. The extension of this tax credit offers an excellent opportunity to match employment opportunities with some of our veterans returning home with construction experience as the Afghanistan drawdown continues.

2. Qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property [25] were all given an accelerated depreciable period of 15 years in prior tax legislation. Without these special provisions, these properties would have been depreciated over a recovery period of 39 to 40 years. Prior to an extension of this statute in ARTA, these recovery periods were to revert as of January 1, 2012. Yet now they are extended through December 31, 2012 for qualifying properties placed in service by that date. [26]

3. Specialty accelerated deductions for depreciating motorsports entertainment complexes and for business property placed in service on Indian reservations have been extended for such properties placed in service by 2013. [27]

4. Construction entrepreneurs supporting residential energy-efficiency improvements as well as residential energy property expenditures have an extended promotional period to attract customers due to the extension of the personal tax credit for such installations. [28]

5. Eligible contractors who build homes qualifying as new energy-efficient homes have an extended period to claim a general business tax credit ranging from $1,000 to $2,000 depending on the documented level of energy-saving measures incorporated into the home. This credit was extended to apply for all properties that are sold from the contractor to one using it as residence prior to January 1, 2014. As part of this extension, for residences acquired after 2012 and 2013, the statute measures the energy-saving results based on the use of updated standards from the 2006 International Energy Conservation Code. [29]

Reduced recognition period for S corporations for built-in gain tax

An S corporation is a pass-through entity with several exceptions by which a corporate tax can be assessed to the S corporation despite the pass-through of income to the individual shareholder. One of the most onerous of these exceptions is the built-in gains tax that assesses a tax on net unrealized gains existing on S corporation assets owned at the date it converted to an S corporation from a C corporation status. [30] The result is the recognition at the S corporation level of the built-in gain tax when an asset is sold during the recognition period in a taxable transaction subject to limitations as to the aggregate gain at the time of the conversion. [31] Prior to 2009 legislation, built-in gains were recognized for 10 years after such a conversion. This period was retroactively reduced to a seven-year period in the American Recovery and Reinvestment Act of 2009. [32] Now, under the ARTA of 2012, for the tax years of 2012 and 2013, the recognition period of the built-in gain tax is five years following the conversion of the C corporation to an S corporation. [33] This is certainly a favorable consideration for those entities having elected S corporation status from C corporation status in 2006 or 2007, particularly if the aggregate built-in gain at conversion has not yet been fully recognized. Now is the opportunity where asset sales may be strategically delayed to avoid the double taxation by delaying such sale until after the expiration of the five-year period.

Estate, gift, and generation-skipping transfer tax reliefs for succession planning

With permanency, finally, in the estate, gift, and generation-skipping transfer tax exemptions and tax rates as enacted in ARTA, there is at last some stability in this planning area. Needless to say, much of the planning has occurred in a flurry over these past two years of transition under the Tax Reform Act of 2010 to take advantage of the unification of the gift and generation-skipping exemptions at a $5 million level through 2012. [34] Anticipating the sunset reversion and fearful of Congressional lack of action to prevent a reversion to the pre-EGTRRA one million estate, gift, and generation-skipping tax exemption levels, with a 55 percent maximum tax rater, there has been a lot of succession planning occurring prior to the enactment of ARTA at the end of 2012. This planning centered on the acceleration of significant gifting to shelter larger gifts from gift and generation-skipping transfer taxes, particularly in light of opportunities for family business transfers while the $5 million exemptions per person applied through December 31, 2012. Yet where such transfers did not occur, there now is at least certainty in the exemption amounts and tax rates. For decedents dying after December 31, 2012, there is a unified estate, gift, and generation-skipping transfer tax exemption of $5 million per taxpayer indexed for inflation to an estimated amount of $5.25 million per taxpayer. Also the maximum estate tax rate is now permanently 40 percent. [35] Of course, if any portion of the $5 million gift and generation-skipping transfer tax exemptions remains available, opportunities for

transfer planning may still exist. For those of us working in the estate planning arena, the permanency of portability of any unused portion of a predeceased spouse's lifetime $5 million exemption is a welcome permanent amendment to the statute. This allows us to avoid what has previously been the very difficult planning to avoid the loss of one spouse's unused lifetime exemption where such spouse did not own sufficient assets to fully utilize the exemption amount. [36] Caution must still be considered to assure the proper filings and elections occur at the first spouse's death where any unused lifetime exemption exists that the surviving spouse can utilize. [37] One further caveat to remember about portability is that the lifetime estate tax exemption is portable, yet the generation-skipping transfer tax exemption is not portable. [38] Therefore, where either spouse, or both, have an estate exceeding the $5 million generation-skipping exemption, it is still crucial to properly structure asset ownership for utilizing trusts that effectively provide for multiple generational asset transfers. [39] Effective planning to maximize the use of each spouse's generation-skipping transfer tax exemption is still an essential part of the planning process, particularly where family businesses are transferred to multiple generations. This type of planning is essential with an entrepreneurial entity structure where business value has been managed for estate planning through discounted entity structuring. Often owners of family entities planning to transfer the business to the next generation will need to create split ownership between spouses to maximize discounted valuation. Split ownerships between spouses valued at a discount are sustained with bypass and marital trust planning, in conjunction with other gifting techniques. [40] In addition, asset protection issues often dictate trust planning techniques that may no longer be needed for full utilization of both spouse's estate tax exemptions with portability, yet are often used for protection from creditors as well. [41] So, despite of long-awaited arrival of permanent higher exemption amounts and lower maximum estate tax rates, some simplicity is now available for many families, yet not for many with complex asset and estate plans.

1

American Taxpayer Relief Act of 2012, P.L. 112–240, 126 STAT 2313, January 2, 2013.

2

Economic Growth and Tax Relief Reconciliation Act of 2001, P.L. 107-16, 115 STAT 28, June 7, 2001.

3

Jobs and Growth Tax Relief Reconciliation Act of 2003, P.L. 108-27, 117 STAT 752, May 28, 2003.

4

Under Exhibit 1, for “Married Filing Joint (MFJ),” see IRC§1(f) for related brackets for taxpayers filing as head of household, married filing separate, and for estates and trusts.

5

IRC§1(f).

6

IRC§1(i)(2) as enacted in the American Taxpayer Relief Act of 2012, P.L. 112-240, 126 STAT 2313 (2012) Sec. 101(a).

7

Jobs and Growth Tax Relief Reconciliation Act of 2003, P.L. 108-27, Sec. 301 & 302.

8

IRC§1(h)(1) as enacted in the American Taxpayer Relief Act of 2012, P.L. 112-240, 126 STAT 2313 (2012). Sec. 102.

9

IRC§1(h)(1)(E) & IRC§1(h)(4).

10

Health Care and Education Reconciliation Act of 2010, Sec. 1401(a)(1).

11

IRC§1411(a).

12

Modified Adjusted Gross Income (MAGI) will most often equate to adjusted gross income except where a taxpayer uses the foreign earned income exclusion under IRC§911(a)(1).

13

IRC§1411(b).

14

Prop. Treas. Reg. §1.1411-0 through §1.1411-10, 77 Fed. Reg. 234 (Dec. 5, 2012), as corrected in 78 Fed. Reg. 21 (Jan. 31, 2013) [REG-13057-11].

15

Prop. Treas. Reg. §1.1411-4(b); Treas. Reg. §1.1411-5(a)(1). REG-13057-11, Dec. 5, 2012 (corrected Jan. 31, 2013).
16

Prop. Treas. Reg. §1.1411-4(a)(1).
17

Prop. Treas. Reg. §1.1411-5(a)(2); Prop. Treas. Reg. §1.1411-5(c); REG-13057-11, Dec. 5, 2012 (corrected Jan. 31, 2013).
18

IRC§1411(a)(1); IRC§1(h)(1).
19

IRC§68 as enacted in the American Taxpayer Relief Act of 2012, P.L. 112-240, 126 STAT 2313 (2012) Sec. 101(b)(2).
20

IRC§68(c).
21

IRC§68(b)(1).
22

IRC§151(d)(3).
23

IRC§179(b)(1).
24

IRC§51(c)(4)(B) as enacted in the American Taxpayer Relief Act of 2012, P.L. 112-240, 126 STAT 2313 (2012) Sec. 309(b).
25

IRC§168(e)(3)(iv); IRC§168(e)(3)(v); IRC§168(e)(3)(E)(ix).
26

IRC§168(a)(3)(E) as enacted in the American Taxpayer Relief Act of 2012, P.L. 112-240, 126 STAT 2313 (2012) Sec. 311.
27

American Taxpayer Relief Act of 2012, P.L. 112-240, 126 STAT 2313 (2012) Sec. 312 & 313.
28

IRC§51 as enacted in the American Taxpayer Relief Act of 2012, P.L. 112-240, 126 STAT 2313 (2012) Sec. 401.
29

IRC§45L(c)(1)(A)(i) as enacted in the American Taxpayer Relief Act of 2012, P.L. 112-240, 126 STAT 2313 (2012) Sec. 408 (a)-(c).
30

IRC§1374(d)(3).
31

IRC§1374(d)(2).
32

IRC§1374(d)(7)(C) enacted in the American Recovery and Reinvestment Act of 2009, P.L. 111-5, Sec. 326.
33

American Recovery and Reinvestment Act of 2009, P.L. 111-5, Sec. 1251.
34

Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, P.L. 111-312, 124 STAT 3296, December 17, 2010, Title III Sect. 301-302-304.
35

IRC§2001(c); IRC§2502; IRC§2010; IRC§2505; IRC§2631 as amended in the American Taxpayer Relief Act of 2012, P.L. 112-240, Sec. 101(a)(3) & 101(c)(3)(A).
36

Campfield, R., *Estate Planning and Drafting* 2nd Ed. (CCH, 1995): 391.
37

Temp. Treas. Reg. §20.2010-2T (July 9, 2012).
38

American Taxpayer Relief Act of 2012, P.L. 112-240, 126 STAT 2313, Sec. 101(a) permanently extending Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, P.L. 111-312, 124 STAT 3296, December 17, 2010, Title III, Sect. 303(a)(4)

— Definition of Deceased Spousal Unused Exclusion Amount.

[39]

Stephens, R.B., Lind, S.A., Maxfield, G.B., and Calfee, D., *Federal Estate & Gift Taxation* 8th Ed. (Warren, Gorham & Lamont, 2002).

[40]

Estate of Mellinger 112 T.C. 26 (1999), acq. AOD 1999-006, 12; 78 T.C.M. 46 (1999); *Estate of Nowell v. Commissioner*, 77 T.C.M. 1239 (1999); *Estate of Bonner v. United States*, 84 F.3d 196 (5th Cir. 1996).

[41]

Fox IV, Charles D. and Huft, M.J., *Asset Protection and Dynasty Trusts: 37 Real Prop. Prob. & Tr. J. 287, 294* (2002–2003).