SMALL BUSINESS LEGISLATIVE COUNCIL

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AVOIDING THE TAX CLIFF

Congress has passed and the President has signed into law, the American Taxpayer Relief Act, Public Law 112-240 on January 2, 2013, which turns the nation away from the tax cliff. From a pure tax perspective, small business obtains the certainty it wanted and in some cases, we have improved our status.

We can embrace the positives and small business can turn its attention to creating economic growth and jobs.

INCOME TAX RATES

Prior to the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), the rate brackets were 15, 28, 31, 36, and 39.6 percent. The 2001 Act created a new 10-percent regular income tax bracket for a portion of taxable income that was previously taxed at 15 percent. The EGTRRA also reduced the tax rates in excess of 15 percent to 25, 28, 33, and 35 percent, respectively.

Effective January 1, 2013, the rates and brackets will be configured as follows with a new 39.6 percent bracket for incomes over $400,000 for individuals. (The lower brackets are adjusted for inflation and the top bracket fixed by the new law (in later years it is indexed as well)).

For an individual, if taxable income is: Then income tax equals:

Not over $8,925:
10% of the taxable income

Over $8,900 but not over $36,250:
$892.50 plus 15 percent of the excess over $8,925

Over $36,250 but not over $87,850:
$4,991.25 plus 25 percent of the excess over $36,250

Over $87,750 but not over $183,250:
$17,891.25 plus 28 percent of the excess over $87,750

Over $183,20 but not over $398,350:
$44,603.25 plus 33 percent of the excess over $183,250

Over $398,350 but not over $400,000:
$115,86.25 plus 35 percent of the excess over $398,250

Over $400,000:
$116,163.75 plus 39.6 percent of the excess over $400,000

There is a phase out of itemized deductions based on hitting a certain income threshold.

CAPITAL GAINS RATES

Under long time “temporary” law, the maximum rate of taxation on the adjusted net capital gains of an individual was 15 percent. Any adjusted net capital gains which otherwise would be taxed at a 10- or 15-percent rate was taxed at a zero rate.

For taxable years beginning January 1, 2013, the maximum rate of taxation on the adjusted net capital gains of an individual is 20 percent for individual taxpayers with taxable income over $400,000 ($450,000 for married couples). It remains at 15 percent for incomes below that level except any adjusted net capital gains which otherwise would be taxed at a 10- or 15-percent rate are taxed at a zero rate.

DIVIDENDS RATES

Under long time “temporary” law, an individual’s qualified dividend income was taxed at the same rates that applied to net capital gains. This treatment applied for purposes of both the regular tax and the alternative minimum tax. Thus, an individual’s qualified dividend income was taxed at rates of zero and 15 percent. The zero-percent rate applied to qualified dividend income which otherwise would be taxed at a 10- or 15-percent rate if the special rates did not apply.

Effective January 1, 2013, the dividends rates link to the capital gains rates continues, so for taxable years beginning January 1, 2013, an individual's qualified dividend income is taxed at rates of zero, 15 percent or 20 percent depending on income levels.

ESTATE TAX

The temporary estate tax provisions enacted in 2010, except for the top rate, have been made permanent. The exemption is $5 million inflation adjusted (It was $5.12 million for 2012 and $5.25 million for 2013). Spousal portability of the exemption (unused exemption of a deceased spouse can be used by the surviving spouse) and other revisions made by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 continue except the top marginal rate is 40 percent.

Effective January 1, 2013, the tax schedule for the estate tax is:

Not over $10,000:
18 percent of such amount.

Over $10,000 but not over $20,000:
$1,800, plus 20 percent of the excess of such amount over $10,000.

Over $20,000 but not over $40,000:
$3,800, plus 22 percent of the excess of such amount over $20,000.

Over $40,000 but not over $60,000:
$8,200 plus 24 percent of the excess of such amount over $40,000.

Over $60,000 but not over $80,000:
$13,000, plus 26 percent of the excess of such amount over $60,000.

Over $80,000 but not over $100,000:
$18,200, plus 28 percent of the excess of such amount over $80,000.

Over $100,000 but not over $150,000:
$23,800, plus 30 percent of the excess of such amount over $100,000.

Over $150,000 but not over $250,000:
$38,800, plus 32 percent of the excess of such amount over $150,000.

Over $250,000 but not over $500,000:
$70,800, plus 34 percent of the excess of such amount over $250,000
Over $500,000 but not over $750,000:
$155,800, plus 37 percent of the excess of such amount over $500,000.

Over $750,000 but not over $1,000,000:
$248,300, plus 39 percent of the excess of such amount over $750,000.

Over $1,000,000:
$345,800, plus 40 percent of the excess of such amount over $1,000,000.

DIRECT EXPENSING

Internal Revenue Code Section 179 allows business to write off small amount of annual investment in capital assets such as machinery in the year of purchase in lieu of depreciating the investment over a number of years. While it commonly referred to as a small business provision, there is no size limitation on business eligibility. The allowance is reduced and eliminated completely the more capital assets a business buys during the year.

The bill "saved" the provision from reverting to pre-2003 levels of $25,000 as the amount that can be written off and $200,000 as the purchase amount "cap". Unfortunately, the amounts will revert to those pre-2003 levels without indexing, in 2014.

For 2012 and 2013, the amounts are increased back to what they were in 2011, $500,000 as the amount that can be written off in a year and a taxpayer cannot use the provision if more than $2,000,000 of equipment and machinery is purchased in the year. Neither amount is inflation indexed. (In effect, this is a retroactive increase for 2012 when the indexed amounts were $139,000 and $560,000.)

DEPRECIATION BONUS

The 50 percent depreciation bonus that was set to expire is extended for another year through 2013.

ALTERNATIVE MINIMUM TAX

A creation of the 60's, the alternative minimum tax (AMT) was designed to make sure the wealthy paid taxes. The AMT applied if taxpayers had income over certain levels. The income levels were not inflation indexed. Over the years, Congress applied "patches" to the income levels, adjusting them for inflation. The last patch actually expired at the end of 2011. As a result, the lower income levels were scheduled to apply to 2012 income.

The new law applies a permanent patch with inflation indexing.

The levels that apply to your 2012 income are $78,750 for married couples filing jointly and $50,600 for individuals. or 2013, the amounts are $80,800 and $51,900 respectively.

RESEARCH AND EXPERIMENTATION CREDIT

The current credit, which had actually expired at the end of 2011, is extended for 2012 and 2013.

PLENTY MORE

There were four dozen additional extenders in the law, extending them for various lengths of time including an extension of 15-year straight-line cost recovery for qualified leasehold improvements, qualified restaurant buildings and improvements, and qualified retail improvements; an extension of temporary exclusion of 100 percent of gain on certain small business stock. (this is very narrow technical type of stock); an extension of credit for energy-efficient existing homes; and an extension of the deduction for state and local general sales tax.

NOT ALL NEWS IS GOOD NEWS

The new law does not stop the clock on some tax increases.

PAYROLL TAXES

A refresher on terminology is necessary for the first two tax increases for 2013.

Under the Federal Insurance Contributions Act (FICA), employers pay a tax based on the amount of wages paid to an employee during the year. The tax imposed is composed of two parts: the Old Age, Survivors, and Disability Insurance ((OASDI) and sometimes referred to as the ("Social Security tax") tax equal to 6.2 percent of covered wages up to the taxable wage base ($113,700 for 2013); and the Medicare Hospital Insurance (HI) tax amount equal to 1.45 percent of covered wages.

In addition to the tax on employers, each employee is subject to FICA taxes equal to the amount of tax imposed on the employer (the "employee portion"). The employee portion of FICA taxes is withheld and remitted to the Federal government by the employer. The same wage base rules apply.

SOCIAL SECURITY TAX HOLIDAY OVER

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 reduced the OASDI rate by two percentage points to 4.2 percent for the employee portion of the FICA tax. Similarly, for taxable years beginning in 2011, two percentage points to 10.4 percent reduced the OASDI rate for a self-employed individual. The Temporary Payroll Tax Cut Continuation Act of 2011 extended that two-percentage point reduction through the end of February 2012. In 2012, the Middle Class Tax Relief and Job Creation Act of 2012 (MCTRJCA) extended the temporary two-percentage point payroll tax "holiday" for employees (and to the same extent, to the self-employed) through the end of 2012.

Effective January 1, 2013, the OASDI tax rate for employees returns to 6.2 percent (and comparable return in the self-employment tax).

NEW TAXES

The health care reform law, the Patient Protection and Affordable Care Act (PPACA) included two tax increases that took effect on January 1, 2013.

NEW HI TAX INCREASE

The first of those two is also a "payroll tax" increase. Effective January 1, 2013, the Hospital Insurance (HI) trust portion) of the payroll tax increased to 2.35 percent from 1.45 percent (i.e. a 0.9 increase) on the wages or self-employment income over $200,000 for an individual return and $250,000 for a joint return. There is no limit on the amount of wages or self-employment income that is subject to the tax (unlike the social security portion of the FICA tax, which has a wage cap). This is an increase in the employee's share only. The employer will continue to pay its 1.45 percent rate share on the employee's wages. In the case of the self-employed, they will pay "only" the additional 0.9 percent on the income above the $200,000/$250,000 threshold.

INVESTMENT TAX

The second tax new tax effective January 1, 2013, that comes to us courtesy of PPACA, is a bit more complicated.

PPACA established a new “Unearned Income Medicare Contribution” (UIMC) tax. The IRS is calling it the “Net Investment Income Tax” or the “NIIT.” This tax applies to “net investment income” which 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). The rate is 3.8 percent. The NIIT on net investment income will not apply if modified adjusted gross income is less than $250,000 in the case of a joint return, or $200,000 in the case of a single return.

The tax is paid when you file your tax return for the year. Since the tax is effective on January 1, 2013, the first time most taxpayers will include the tax will be in 2014 when they file their returns for tax year 2013. However, if you pay estimated taxes during the year the IRS observes, taxpayers “should adjust their income tax withholding or estimated payments to account for the tax increase in order to avoid underpayment penalties.”

The IRS has a page with information on this new tax: http://www.irs.gov/uac/Newsroom/Net-Investment-Income-Tax-FAQs