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An Overview of Changes in the American Taxpayer Relief Act of 2012 Impacting Agriculture

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On Jan, 1, 2013, the U.S. Senate finally took up H.R. 8 which had passed the U.S. House on Aug. 1, 2012. The bill was received in the Senate on Sept. 10, 2012, and was placed on the Senate Legislative Calendar where it remained until Jan. 1, 2013. On Jan. 1, 2013, the Senate renamed the bill "The American Taxpayer Relief Act of 2012" (Act), made changes to the bill, passed it, and shipped it back to the House. The House approved the changes late on Jan. 1. President Barack Obama signed the legislation into law on Jan. 2, 2013.

The Act makes "permanent" key parts of the 2001 tax law, including a repeal of the sunset provisions in that law with respect to individual income tax brackets, and certain other income tax and transfer tax provisions. The Act also permanently increases the alternative minimum tax (AMT) exemption and reinstates some pre-2001 provisions.

The Act also contains significant tax increases, and did not extend the payroll tax cut that was in effect for 2011 and 2012. Thus, all wage earners and self-employed persons will see a tax increase in 2013. Specifically, the employee share of Social Security Old-Age, Survivors, and Disability Insurance (OASDI) for 2013 increases from 4.2% to 6.2% and the self-employed tax rate increases from 10.4% to 12.4%. For a taxpayer with wage and/or self-employment income at or above the maximum wage base of $113,700 for 2013, an additional $2,274 in tax liability results as compared to 2012. For a typical family earning $50,000 in 2013, the additional tax will be $1,000. In 2013, most U.S. households, whether farming or not, will face the highest tax burden since 2008.

Major Provisions Affecting Agriculture

The Act contains numerous provisions that impact agricultural producers and rural landowners. Included in the provisions of primary impact are those that involve tax rates, transfer taxes,, and the AMT.

Income Taxes

While the Act makes permanent the 2001 tax rates, it does impose a 39.6% rate on taxable income above $450,000 (married, filing jointly; and surviving spouses); $425,000 (head of household); $400,000 (single); and $225,000 (married, filing separately). The thresholds are indexed for inflation starting in 2014 (for tax years after 2013).

With respect to the new top bracket, a significant "marriage penalty" is imposed. For instance, married persons filing jointly or separately hit the threshold at $450,000, but two unmarried persons living together would each have their own $400,000 threshold.

In addition to the marriage penalty, the Act also contains provisions that cause taxes to increase at income levels beneath the thresholds. For example, the phase-out of personal exemptions starts at $300,000 for joint filers or surviving spouses. The phase-out starts at $275,000 (head of household); $250,000 (single); and $150,000 (married, filing separately). Once the applicable threshold is exceeded, otherwise available exemptions drop by 2% for every $2,500 (or portion thereof) that the taxpayer's adjusted gross income exceeds the applicable threshold. The phase-out, however, does not apply to itemized deductions (investment interest, medical expenses, casualty or theft losses, and gambling losses), and is indexed for inflation for tax years beginning after 2013. This provision is also inflation-indexed for tax years that begin after 2013. Likewise, the same thresholds apply to the phase-out of itemized deductions. Once the applicable threshold is exceeded, itemized deductions are given a 3% "haircut" with the reduction capped at 80% of the otherwise allowable itemized deductions. What all of this means is that taxpayers with incomes beneath the beginning of the 39.6% bracket will experience a higher effective tax rate.

Capital Gains and Dividends

Under the Act, the top capital gain and dividend rate rises to 20% for taxpayers with incomes exceeding the $450,000 threshold (married, filing jointly) and $400,000 for other taxpayers—those in the 39.6% individual income tax bracket. For these taxpayers, the actual capital gain and dividend tax rate is 23.8% due to an additional 3.8% surtax beginning in 2013 as a result of the 2010 Patient Protection and Affordable Care Act (more commonly known as "Obamacare").

The zero percent capital gain rate is retained for taxpayers with ordinary income, taxed at an individual income tax rate of 10% or 15%. For taxpayers who are in the 25% to 35% tax brackets, the applicable capital gain rate is 15%.

Transfer Taxes

The Act, effective for transfers after 2012, establishes a $5 million (inflation-adjusted) unified credit exemption equivalent for estate, gift and Generation Skipping Transfer Tax (GST) purposes. For 2013, the inflation-adjusted amount is $5.25 million. For gift tax purposes, the present interest annual exclusion is set at $14,000 for 2013. That is the total amount that can be gifted outright to an individual in 2013 without the need to file a gift tax return.

Portability of the unused amount of the exclusion at the death of the first spouse is also retained and made permanent. With portability, the deceased spouse's unused exemption equivalent of the unified credit (the deceased spouse's unused exclusion amount) can be transferred by election to the surviving spouse. To make the portability election, IRS Form 706 must be filed in the estate of the first spouse to die, regardless of the size of the decedent's estate, to make the election. Portability simplifies the estate planning process by eliminating the need to establish marital deduction wills for spouses, containing both a credit shelter bypass trust and a marital deduction trust. But, for those plans that have already established such trusts, there is no need to change the plan based on the Act.

The Act does increase the rate on transfers above the amount covered by the credit to 40%. Specifically, under the Act, transfers exceeding $500,000 are taxed at 37%. Transfers over $750,000 are taxed at 39%. Tranfers over $1 million are taxed at 40%. Thus, with an exemption equivalent of $5.25 million for 2013, the unified credit is $2,045,800.

Permanent AMT Relief

While the AMT was not eliminated, the Act imposes a permanent (no sunset) increase in the exemption amounts that are then indexed for inflation retroactive to tax years beginning after 2011. The AMT exemption for 2012 is $78,750 (married, filing jointly); $50,600 for unmarried persons (single or head of household); and $39,375 for married, filing separately. The AMT exemption phases out at 25% beginning at an alternative minimum taxable income of $150,000, with a taxpayer fully phased out at $465,000 (married, filing jointly).

Income Taxation of Estates and Trusts

The Act eliminates the 35% rate bracket for the income of estates and trusts, and replaces it with a 39.6% rate bracket. The starting point for the new 39.6% rate is $11,950 for 2013.

Permanency of Personal Nonrefundable Credits

The Act makes permanent the Internal Revenue Code (I.R.C.) §§21-25D credits that offset both regular tax and AMT. Those credits include the household and dependent care credit, the credit for the elderly, the adoption credit, the child tax credit, the Hope and Lifetime Learning Credit (and the American Opportunity Tax Credit), the Savers credit, the credit for non-business energy property, the residential energy efficient property credit, and the credit for interest on certain home mortgages.

Most Significant Extended Provisions

In addition to the major provisions affecting agricultural taxpayers discussed in the preceding section, a number of other provisions in the Act were extended from prior law and have potential implications for agriculturally related taxpayers.

Tax-free Distribution from an IRA to Charity

The provision allowing tax-free distributions (up to $100,000 annually) by individuals 70.5 years and older to charity is retroactively restored for 2012 and extended through 2013. Because the distribution is direct to the charity, the amount is not included in income and, therefore, avoids the applicable phase-outs and the 3.8% Obamacare surtax on passive income since the surtax is based on modified adjusted gross income. Thus, the provision is a benefit for taxpayers who don't itemize.

Under the Act, a qualified taxpayer could elect to have a distribution that was made in January 2013 be treated as having been made as of December 31, 2012. Likewise, an election can be made to treat any portion of an IRA distribution to the taxpayer in December 2012 as a qualified charitable distribution (up to $100,000) if it was transferred in cash after the distribution to an eligible charity before Feb. 1, 2013, and the distribution otherwise satisfies I.R.C. §408(d)(8)

Depreciation Provisions

First-year 50% "bonus" depreciation is extended through 2013 (and through 2014 for certain "long-lived" assets). The provision is based on the taxpayer's calendar year and applies to "new" property where its original use is with the taxpayer, and the property has a cost recovery period of 20 years or shorter. The provision applies to light trucks or vans, including SUVs, built on a truck chassis if rated at 6,000 pounds loaded vehicle weight or less. As applied to autos and trucks, an additional $8,000 deduction is allowed for the year the vehicle is placed in service.

Expense method depreciation is retroactively reinstated for 2012 at the $500,000 amount (with a $2 million investment ceiling) and is extended at that level for 2013. This method allows an off-the-top depreciation allowance of up to $500,000 for the first year that a qualified asset is placed in service. The Act also extends for tax years beginning before 2014—in conjunction with clear IRS pronouncements on the matter—the ability to make or revoke an expense method depreciation election on an amended return for an open tax year. IRS auditors are allowing the process of making as well as revoking an expense method depreciation election on an amended return in audit, and the IRS is successfully processing such returns.

It should be noted that this is a huge opportunity for taxpayers, especially if they are planning to sell an asset in 2013 on which they claimed expense method depreciation at an elevated level in a prior year for which the return remains within the statutory timeframe to amend (generally the previous three years). Revoking the election on such an asset on an amended return and making it on a different asset which will not be disposed of will restore basis in the item being sold, and minimize income tax and depreciation recapture.

Also, the Act reinstates for 2012 and extends through 2013 the ability to utilize expense method depreciation for up to $250,000 (as part of the overall limitation of $500,000) of qualified real property (qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property). For example, if a taxpayer puts in service during the tax year $500,000 worth of qualified property, $200,000 of which is qualified real property, $300,000 of expense method depreciation is available for "normal" expense method property that is also placed in service during the tax year.

The ability to treat certain types of qualified real property (qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property) as 15-year Modified Accelerated Cost Recovery System (MACRS) property—the current U.S. tax depreciation system—is retroactively reinstated for 2012 and extended through 2013. Since qualified leasehold improvement property was reinstated for 2012, it is eligible for 50% bonus depreciation if placed in service in 2012 or 2013 under the special rule that applies to it under the bonus provision. As noted above, all three categories qualify for up to $250,000 of expense method depreciation.

Small Business Stock Gain Exclusion

Restored for 2012 and extended through 2013 is the ability to exclude all of the gain on the sale of I.R.C. §1202 stock. This provision is designed to spur investment in small businesses. The stock must have been acquired after September 27, 2010. A five-year holding period must be satisfied and the corporation—taxed at the corporate level (except for certain types of C corporations)—during the holding period.

Employer Tax Credit for Hiring Certain Employees

The Act restores the Work Opportunity Tax Credit (WOTC) for nonveterans for 2012, and extends the credit through 2013 for both veterans and nonveterans. To get the credit, the employer must file IRS Form 8850 that certifies employment, to the appropriate state agency within 28 days of the hire date. Under the WOTC there can be employees from targeted rural areas whose hiring can make the employer eligible for the credit

S Corporation Built-in Gain Tax

For tax years beginning in 2012 or 2013, the recognition period for built-in gains—which represent the appreciation of asset value while the assets were in a C corporation—of an S corporation is a five-year period beginning with the first day of the first tax year for which the corporation was an S corporation (one which is not taxed at the corporate level). During that recognition period, C corporations that elect S status are subject to a 35% tax on built-in gains during the recognition period. Thus, for S elections effective January 1, 2007, or earlier, gains recognized are not subject to the built-in gain tax.

Also, S corporations that sell assets in 2012 or 2013 and report the built-in gain from those sales under the installment method where the sale occurred after the end of the five-year recognition period—but not before the end of the 10-year recognition period—the gain reported is not subject to the 35% built in gains tax.

Principal Residence Debt

For 2013, the provision allowing the discharge of a qualified principal residence debt to be excluded from income (up to $2 million) is available, as is the provision allowing mortgage insurance premiums to be deducted as qualified residence interest. The latter provision was also retroactively reinstated for 2012.

Energy-related Provisions

Numerous energy-related provisions were extended, including $12 billion in subsidies for the wind energy industry via the wind energy production tax credit. Other energy-related provisions applicable for 2013 include the energy efficient principal residence improvements credit ($500 lifetime), the credit for energy efficient appliances, the credit for energy efficient new homes, and a credit for 2- and 3-wheeled electric vehicles (electric bikes and scooters).

Education-related Provisions

The Act extends the American Opportunity Tax Credit through 2017 and applies it to the first $2,000 of qualified tuition and related expenses plus 25% of the next $2,000. Also, deductibility of student loan interest is no longer capped at 60 months, and Coverdell Education Savings Accounts are fixed at $2,000.

Revenue Raiser

As a revenue-raiser, for transfers after 2012, in tax years ending after 2012, plan provisions in a retirement plan (such as a 401(k)) can allow participants to elect to transfer amounts to a designated Roth account. The transfer is taxed at ordinary income rates in the year of the transfer. Thus, the amount transferred will be treated as a taxable qualified rollover contribution with income tax due, but no penalty assessed.

Higher 2013 Taxes for All

The American Taxpayer Relief Act of 2012 made permanent some provisions of the tax code which had been the source of significant uncertainty for tax planning. Some of the provisions related to tax rates, transfer taxes, and the AMT are very significant for agricultural producers and rural landowners. But there are also a number of other changes that will be important benefits to them. Bottom line, however, all taxpayers and wage earners will face higher taxes in 2013.

For More Information

The American Taxpayer Relief Act of 2012, P.L.122-240, Available online: http://thomas.loc.gov/cgi-bin/query/D?c112:5:./temp/~c112Gd1NJ6.

The Internal Revenue Code of 1986.

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