

TAX RELIEF IN 2012

Governor Brownback has signed legislation that makes sweeping changes to Kansas taxes. We have discovered some important nuances that have not received much attention in the news. This newsletter will provide you with details of the important parts of the Kansas bill and will also alert you to many Federal provisions which have expired or are set to expire unless Congress takes action. We expect Congress to act on some of these expiring tax provisions after the presidential election. Late changes to 2012 law may create delays as the IRS and software providers catch up with the changes.

ALTERNATIVE MINIMUM TAX (AMT)

To prevent the AMT from encroaching on middle-income taxpayers, Congress has routinely “patched” the AMT. The patch provides higher exemption amounts along with other targeted relief. The most recent patch in the 2010 Tax Relief Act expired at the end of 2011. President Obama and some Republicans have proposed to repeal the AMT. They differ, strongly, on what would replace it.

The President has proposed the so-called “Buffett Rule,” which would ensure taxpayers making over \$1 million annually would pay an effective tax rate of at least 30 percent.

House Republicans have proposed to eliminate the AMT along with consolidating the individual tax rates from six to two. The most likely outcome is another patch for 2012, followed by a more permanent

solution found within broader efforts toward “tax reform” in general. But again, we don’t expect to see a patch until after the November elections.

EXTENDERS FOR CONGRESS TO DEAL WITH

Congress must decide the fate of the so-called “extenders.” These are popular but temporary tax incentives, many of which expired after 2011. They include:

- **2% payroll tax cut (expires after 2012)**
- **100% bonus depreciation (reduced to 50% in 2012)**
- **Enhanced \$179 expensing (was \$500,000 for 2011
Reduced to \$139,000 for 2012 and \$25,000 for 2013)**
- **Research credit (expired 2011)**
- **State & local sales tax deduction (expired 2011)**
- **Teacher’s classroom expense deduction (expired 2011)**

MORROW & CO.
WE TAKE PRIDE IN PROVIDING
PERSONAL SERVICE TO OUR CLIENTS



- Higher education tuition deduction (expired 2011)
- American Opportunity Credit (expires after 2012 – after 2012 the Hope Credit will return)
- Exclusion for charitable contributions of IRA proceeds (expired 2011)
- Mortgage insurance premium deduction (expired 2011)
- Cancellation of mortgage indebtedness exclusion for personal residence (expires after 2012)
- Energy tax incentives (most, but not all expired 2011)

KANSAS CHANGES

PERSONAL INCOME TAX RATE REDUCTION

The current three-bracket system will be condensed into two brackets after 2012. Married filing joint taxpayers will pay tax at 3.0% (previously 3.5%) on the first \$30,000 of taxable income and 4.9% (previously 6.25% & 6.45%) on income over \$30,000. All other individuals will pay 3.0% (previously 3.5%) on the first \$15,000 of taxable income and 4.9% (previously 6.25% & 6.45%) on income over \$15,000.

STANDARD DEDUCTION INCREASE

The legislation increases the standard deduction amount for head-of-household filers to \$9,000 (previously \$4,500) and for married taxpayers filing jointly to \$9,000 (previously \$6,000) for tax years after 2012. The standard deduction will be \$3,000 for individuals. The law, as drafted, contains an error which eliminates the option to deduct the higher of the standard deduction or itemized deductions. Our research provider spoke with the Kansas Legislative Research Department and was told that it was their belief that it was the intent of the legislators to maintain the ability to choose the higher of the two deductions. We will have to wait and see how the legislature reacts when they go back into session.

BUSINESS INCOME EXEMPTION

This is absolutely huge! For tax years beginning after 2012, the legislation exempts certain non-wage business income (income reported by Sole Proprietors, Farmers, LLC's, Partnerships, S-Corporations, Trusts, and Rentals on lines 12, 17, and 18 on Federal Form 1040). Accordingly, business losses will also be dis-allowed on the Kansas return. The law removes net operating losses for all entities other than C-Corporations.

The sleeper in the Bill no one is discussing is that the law de-couples the tax-basis rules for determining gain and loss on the sale of a business from Federal law.

This is also huge (but not in a good way)! Businesses will no longer receive an increase in tax basis for reported income as they do on their Federal return. This is a complicated subject, but what it really means is that profits reinvested into the business may be taxed for Kansas purposes when the business is sold even though there may be very little tax at the Fed level. We have confirmed our understanding of the law with our tax research provider who contacted Kansas Legislative Research to verify our understanding of the law. Our response from Kansas Legislative Research follows-

... profits reinvested into the business may be taxed for Kansas purposes when the business is sold even though there may be very little tax at the Fed level.

MEDICARE TAX ON EARNED INCOME

Beginning in 2013, an additional tax equal to 0.9% of earned income will be imposed on earnings in excess of \$250,000 on a joint return and \$200,000 on a single or head of household return, and over \$125,000 on a married filing separate return. Employers will not withhold the additional tax. The tax will be assessed on the 1040.

MEDICARE TAX ON INVESTMENT INCOME

Beginning in 2013 there will be a 3.8% tax on the lesser of Net Investment Income or Adjusted Gross Income in excess of \$250,000 (married) \$200,000 (single and head of household) \$125,000 (married filing separate).

Investment income includes-

- Interest (but not tax exempt interest)
- Dividends
- Annuities
- Royalties (including oil royalties)
- Rents
- Passive activity income
- Net gains from the sale of investments and passive activities

Investment income does not include income from a trade or business or income from a partnership or S-corp if you are an active participant or are subject to self-employment tax. The gain on the sale of business income property is also excluded if the property is used in an active trade or business.

Higher income taxpayers should get with us to plan for disposals of rental properties, second homes, or gains in excess over \$500,000 (\$250,000 for single persons) on primary residences.

MEDICAL EXPENSES

Currently, medical expenses must exceed 7.5% of adjusted gross income before a deduction is available. Beginning in 2013, this floor is increased to 10% unless you are over the age of 65. The increase in the exclusion is delayed until 2017 for taxpayers over age 65.

POSSIBLE TAX PLANNING MOVES

- Consider deferred contracts for farm income (saves Kansas tax – may incur higher Federal rates)
- Consider pre-paying farm expenses (saves Kansas tax – may incur higher Federal rates)
- Consider paying your 4th Quarter Kansas estimate before year end (unless you expect AMT in 2012)
- Consider selling appreciated assets to take advantage of present capital gains rates
- Consider selling rental property to avoid the Medicare surtax coming in 2013
- Consider gifting to take advantage of the \$5 million estate exemption

PLANNING CHALLENGES

Uncertainty is always a factor in tax planning. Life brings countless changes, such as increases or decreases in income, birth of a child, death of a spouse, and so on. In 2012, uncertainty is magnified by the unknown fate of countless tax provisions on which taxpayers have relied in recent years. The uncertainty is expected to continue. Our office can help you plan by adopting strategies that allow you to remain flexible for as long as possible while being prepared to act on opportunities before they are lost to time and changing laws. Making plans now to accelerate certain income, defer deductions, realize capital gains, and take advantage of current gift tax rules are only some of the strategies that might fit your situation. Please contact us and we can discuss your tax plans in detail.





MORE EXPIRING INCENTIVES

A lengthy list of tax cuts in the 2010 Tax Relief Act are scheduled to expire after 2012. They include (and this is not an exhaustive list):

- **Marriage penalty relief** – If marriage penalty relief is not extended, the standard deduction for married couples will be 167% of the deduction for single individuals rather than 200%. The upper limit of the 15% tax bracket will be 167% of the bracket for single individuals rather than 200%.
- **Limitation on itemized deduction for higher income taxpayers** – The limitation on itemized deductions for high income individuals is scheduled to be revived after 2012. The limitation reduces the total amount of a taxpayer's otherwise allowable itemized deductions by 3% of the amount by which the taxpayer's adjusted gross income exceeds an applicable threshold. Itemized deductions cannot be reduced below 80%. (The threshold would have been \$173,650 for 2012)
- **Phase-out of personal exemptions for higher income taxpayers** – The phase-out of personal exemptions is scheduled to be revived after 2012. Under the phase-out, the total amount of exemptions that may be claimed by a taxpayer is reduced by 2% for each \$2,500 or portion thereof (2% for each \$1,250 for married filing separate) by which the taxpayer's adjusted gross income exceeds the applicable threshold. The thresholds would have been \$173,650 for single taxpayers and \$260,500 for married filing joint.
- **Child tax credit** – The \$1,000 child tax credit for dependents under age 17 will be cut to \$500 after 2012. EGTRRA raised the credit to \$1,000 and the 2010 Tax Relief Act extended the \$1,000 amount through 2012. Additionally, the 2010 Tax Relief extended other enhancements to the credit, which also are scheduled to expire after 2012.
- **Enhanced child and dependent care credit** – Total expenses qualifying for the dependent care credit are capped at \$3,000 for one qualifying child and \$6,000 for two qualifying children. Absent extension, these amounts will be reduced to \$2,400 and \$4,800 respectively.
- **Student loan interest deduction** – For 2012, student loan interest is deductible up to \$2,500 unless the deduction is phased out for incomes above \$125,000 for married filing jointly and \$60,000 for single persons. After 2012, the income phase-outs will be lowered from \$125,000 to \$75,000 (married) and from \$60,000 to \$50,000 (single). Prior laws also eliminated a rule that only allowed deductions for student loan interest for the first 60 months of required payments. This elimination was extended through 2012. As such, this rule will be back beginning in 2013.
- **Enhanced Coverdell Education Savings Accounts** – The maximum contribution amount to a Coverdell Education Savings Account is \$2,000. It is scheduled to revert to \$500 after 2012.
- **Special rules for certain tax-exempt bonds** – Bonds used to provide "qualified public educational facilities" are treated as exempt facility bonds under Code Sec. 142(a)(13) through 2012. This treatment is scheduled to sunset after 2012.
- **Enhanced adoption credit and adoption assistance programs** – The 2010 Tax Relief act extended the enhancements to the adoption credit through 2012. In addition the patient protection and affordable care act made the adoption credit refundable for 2010 and 2011. The adoption credit phases out for taxpayers above specified inflation-adjusted levels of modified adjusted gross income. For 2012, the phase-out level starts at \$189,710.



ADJUSTED GROSS INCOME MODIFICATIONS

As discussed earlier, business losses will be added back to Kansas Income. In addition, the following Federal subtractions from Gross Income will be added back to Kansas Income after 2012:

- Domestic Production Activities Deduction
- Self-Employment Tax
- Pension, Profit Sharing & Annuity Plans for Self-Employed Individuals
- Self-Employed Health Insurance
- Long-Term Care Insurance

REPEAL OF FOOD SALES TAX REFUND

Effective January 1, 2013 the legislation repeals the Food Sales Tax Refund for elderly persons, persons with disabilities, and low income households.

HOMESTEAD PROPERTY TAX REFUND

Beginning in 2013, renters will no longer be eligible for refunds under the Homestead Property Tax Refund Act.

REPEAL OF 24-MONTH SEVERANCE TAX EXEMPTION

The law repeals the 24-month exemption from the severance tax for the severance and production of oil of more than 50 barrels per day from any pool from which oil was first produced on or after July 1, 2012.

"You are correct in that Section 37 does decouple from the federal basis rules for determining shareholder basis for state income tax purposes in S corporation stock and partnership interests. Under the federal income tax rules, basis for a partnership interest or S corporation stock would be adjusted/increased by the partner's or S corporation owner's distributive share taxable/nontaxable income to the partnership or S corporation, and basis would be adjusted/decreased by distributions to the partner or S corporation owner. Section 37 should prevent the basis adjustment increases from being made for partnership interests and S corporation stock basis, for Kansas income tax purposes, for the distributive share of taxable/nontaxable income to the partnership or S corporation. The rationale is that since business income is exempt from Kansas income tax starting in 2013 for these types of entities, it would be inappropriate for adjustment increases to basis to occur for this now-exempted income, for Kansas income tax purposes.

Taxation of this income (or a portion of it) could possibly occur in the form of "gain" income when the partnership interest or S corporation stock is sold, depending on the circumstances.

You also asked about contributions of capital to the partnership interest. This should be covered in IRC Section 722, which is not affected by Section 37 of HB 2117. Section 37 of HB 2117 does not permit the IRC Section 705 adjustments to basis, but would not affect basis determination under IRC Section 722."

So, the impact of the law is that Business Income will be exempt from Kansas tax, but it may catch up with you when you sell the business. It's surprising this provision hasn't received more attention.

Section 37 should prevent the basis adjustment increases from being made for partnership interests and S corporation stock basis for Kansas income tax purposes, for the distributive share of taxable/nontaxable income to the partnership or S corporation....

PERSONAL INCOME TAX CREDITS ARE BEING REPEALED

Effective for tax years beginning after 2012, a number of credits allowed against personal income tax are repealed. Credits previously available to corporations are still available against corporate tax. The following personal credits are being repealed:

- Adoption expenses
- Agri-tourism liability insurance credit
- Alternative fuel equipment expenditures
- Assistive technology
- Child & dependent care expenses
- Child day care expenses
- Disabled access expenditures
- Environmental compliance expenditures
- Individual development account expenditures
- Law enforcement training center contributions
- Research & development
- Small employer health benefit plan contributions
- Swine facility improvement expenditures
- Port authority contributions
- Plugging an abandoned gas or oil well
- Venture capital contributions
- Venture & local seed capital credit
- Temporary assistance to family contributors
- Telecommunications property tax payments

FEDERAL CHANGES

More than 10 years ago, Congress passed a far-reaching tax cut law - the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). The 2001 tax cuts continue to impact virtually every taxpayer: individuals, businesses, exempt-organizations, and more. The tax cuts were also temporary and were scheduled to expire after 2010. As you know, 2010 arrived and Congress could not decide whether to make the tax cuts permanent or not; they extended them for two more years. Now, the expiration date moves closer every day and any quick resolution is doubtful. In the meantime, taxpayers are left with many questions about tax planning for 2012 and beyond.

INDIVIDUAL TAX RATES

Unless extended, the current individual marginal income tax brackets of 10, 15, 25, 28, 33, and 35 percent are scheduled to expire after 2012. In their place, the pre-EGTRRA rates will be revived; that is, the rates are scheduled to revert to 15, 28, 31, 36, and 39.6 percent effective for tax years beginning after December 31, 2012. Both President Obama and the GOP have indicated their opposition to allowing the rates to revert for middle-income taxpayers after 2012.

However, the White House and the GOP differ sharply on whether to extend the top two current rates (33 and 35 percent) or not. At this time, it is increasingly unlikely that the White House and the GOP will reach an agreement before the November elections.

CAPITAL GAINS & DIVIDENDS

Taxpayer-friendly tax rates on qualified capital gains and dividends are scheduled to expire after 2012. Under current law, the maximum tax rate on qualified capital gains and dividends is 15% (0% for taxpayers in the 10 and 15% income tax brackets). After 2012, the maximum capital gains tax rate is scheduled to revert to 20% (10% for taxpayers in the 15% bracket) and dividends will be taxed at the ordinary income tax rates (potentially up to 39.6%). Note that installment payments received after 2012 are subject to the tax rates for the year of the payment, not the year of the sales. Thus, the capital gains portion of payments made in 2013 and later may be taxed at the 20% rate.

Under the 2010 Tax Relief Act, there is no special capital gain treatment for property held for more than five years. After 2012, lower capital gain rates for five-year gain of individuals, estates and trusts are scheduled to be revived. Long-term gain on the sale or exchange of property held for more than five years generally will be taxed at 18% (8% for taxpayers in the 15% bracket).

Another capital gains provision expiring this year is the 0% rate on taxpayers in the 10% or 15% brackets. The 0% rate applies to taxpayers with taxable income up to \$70,700 (married filing jointly) and \$35,350 (singles). There are some real planning opportunities available for taxpayers with taxable incomes below these limits. Be sure to contact our office for information if you think you may benefit from this provision.

Like the individual rate cuts, the White House and Republicans are far apart on the fate of the capital gains/dividends rate cuts. Some taxpayers are accelerating capital gains into 2012 while the tax rates are lower as one strategy to deal with the uncertainty.

FEDERAL ESTATE TAX

No provision in the Tax Code has been subject to more uncertainty in recent years than the Federal estate tax. Under EGTRRA, the Federal estate tax was scheduled to be repealed for 2010 and replaced with a modified carryover basis regime for that year only. The 2010 Tax Relief Act made some significant changes, providing for a maximum estate tax rate of 35% for decedents dying after December 31, 2009 and before January 1, 2013 and an applicable exclusion amount of \$5 million. In addition, estates of decedents dying after December 31, 2009 and before January 1, 2011, have the option to elect not to apply the basic estate tax regime under the 2010 Tax Relief Act. These 2010 estates may elect to apply the estate tax based on the 2010 Tax Relief Act's 35% top rate and \$5 million exclusion amount, with stepped-up basis or no estate tax and modified carryover basis rules under EGTRRA.

The complex rules under the 2010 Tax Relief Act are scheduled to expire after December 31, 2012. Unless Congress acts, the Federal estate tax will revert to a maximum tax rate of 55% with a \$1 million exclusion amount after 2012.

Another key concept introduced in 2010 related to "portability" of estate exemptions. Portability allows the estate of a decedent who is survived by a spouse to make a portability election to permit the surviving spouse to apply the decedent's unused exclusion to the surviving spouse's own transfers during life and at death. Portability is available to the estates of decedents dying after December 31, 2010 and before January 1, 2013.

Along with the Federal estate tax, many taxpayer-friendly changes to the Federal gift tax and the generation-skipping transfer (GST) tax are scheduled to expire after 2012. Please contact our office for more details about the Federal gift and GST taxes.