Recent Tax Developments

The following is a summary of the most important tax developments that have occurred in the past three months that may affect you, your family, your investments, and your livelihood. Please call us for more information about any of these developments and what steps you should implement to take advantage of favorable developments and to minimize the impact of those that are unfavorable.

American Taxpayer Relief Act of 2012. In early January, Congress passed, and the President signed into law, the American Taxpayer Relief Act of 2012. On the individual side of things, the Act extended the “Bush-era” tax rates for most taxpayers, but also added a new 39.6% rate that applies to taxable income in excess of certain thresholds. It also raised the top rate on capital gains and dividends to 20%, permanently “patched” the alternative minimum tax, and reinstated and extended many other tax breaks.

With respect to businesses, the Act retroactively reinstated and extended a host of business tax breaks, including the research credit, increased expensing amounts, and bonus first-year depreciation. It also extended many energy-related tax provisions.

New Health FSA limit for 2013. An IRS publication discusses how the new $2,500 health flexible spending arrangement (health FSA) contribution limitation affects both employers and employees. Health FSAs are benefit plans established by employers to reimburse employees for health care expenses, such as deductibles and co-payments. They are usually funded by employees through salary reduction agreements, although employers may contribute as well. Qualifying contributions to and withdrawals from FSAs are tax-exempt.

In discussing the new limit, the IRS points out that, as in the past, an employer may establish its own plan limitation, as long as the plan limit doesn’t exceed this statutory limit. For plan years beginning after 2013, the $2,500 limitation will be indexed for inflation. The IRS notes that the $2,500 limit isn’t applicable to dependent care FSAs, health savings accounts, Archer medical savings accounts, or any contributions an employee makes toward health insurance premiums. The IRS also stresses that limit applies on an employee-by-employee basis. That is, $2,500 is the maximum amount that an employee may contribute in 2013, regardless of the number of individuals (e.g., spouse or dependents) whose medical expenses may be reimbursed under the plan. However, if two people are married, and each has the opportunity to participate in a health FSA, whether through the same employer or through different employers, each may contribute up to $2,500.

Guidance on tax treatment of participants in HUD's Home Affordable Modification Program. The IRS has provided guidance to borrowers, mortgage loan holders and loan servicers on the tax consequences of participating in the Principal Reduction Alternative offered in the Home Affordable

Modification Program (HAMP-PRA) sponsored by the Department of the Treasury and the Department of Housing and Urban Development (HUD). Under HAMP-PRA, the principal of the borrower's mortgage may be reduced over three years by a predetermined amount called the "PRA Forbearance Amount" if the borrower satisfies certain conditions during a trial period.

The IRS explains that, at the time of the modification, the borrower realizes discharge of indebtedness income equal to any excess of the adjusted issue price of the old mortgage loan (which was satisfied in the deemed exchange) over the issue price of the new (post-modification) mortgage loan. Unless an exclusion applies—for example, the principal residence indebtedness exclusion or the insolvency exclusion—the borrower includes in gross income the discharge of indebtedness income for the tax year in which the permanent modification occurs. However, the guidance allows a borrower to choose to report the discharge of indebtedness income over a three-year period in certain situations.

Regulations on noncompensatory partnership options. The IRS has issued regulations on the tax treatment of noncompensatory options issued by a partnership. A partner's contribution to a partnership, whether being formed or operating, in exchange for a partnership interest usually doesn't result in recognized gain or loss to any partner or to the firm. In a variety of situations, partnerships issue options or convertible instruments that allow the holder to acquire, by purchase or conversion, an equity interest in the partnership. The regulations describe the income tax consequences of issuing, transferring, and exercising noncompensatory partnership options. They generally provide that the exercise of a noncompensatory option doesn't cause recognition of gain or loss to either the issuing partnership or the option holder. The regulations apply only if the call option, warrant, or conversion right grants the holder the right to acquire an interest in the issuer (or cash measured by the value of the interest).

Storm damage assessments on owners of cooperative apartments. An important Federal Court of Appeals decision has reversed the Tax Court and held that a stockholder in a residential cooperative housing corporation had a sufficient property interest under New York state law to claim a casualty loss deduction for her share of an assessment to fix damage to a retaining wall on the co-op's premises. However, the Appeals Court sent the case back to the Tax Court to determine if the loss was caused by a casualty. Whether or not the taxpayer ultimately prevails in this case, the decision is good news for the many co-op owners in New York who face special assessments for damages to common areas on the premises of their co-ops for their share of damages caused by Hurricane Sandy. Co-op owners in other states damaged by Hurricane Sandy or other storms also may benefit to the extent they have similar property interests under the laws of their states.

Supreme Court decision in DOMA case could have significant tax consequences. Recently, the Supreme Court heard oral arguments on the constitutionality of the Defense of Marriage Act (DOMA) in an estate tax case that could have far reaching tax implications for affected couples. Section 3 of DOMA defines marriage for purposes of administering Federal law as the "legal union between one man and one woman as husband and wife." The pending case concerns a surviving same-sex spouse who is seeking an estate tax refund based on the IRS's DOMA-based disallowance of the marital deduction for her spouse's estate. If the Supreme Court strikes down Section 3 of DOMA, many tax provisions beyond the marital deduction at issue in this case would be affected. Same-sex couples would be required to file as couples, either jointly or separately, and would likely be subject to a "marriage penalty" or "marriage bonus" (i.e., higher or lower tax liability), depending on the particular couple's earnings. In general, two-earner couples, especially those with higher incomes, are more likely to be subject to a marriage penalty. For instance, under the 2012 Taxpayer Relief Act, the top 39.6% rate kicks in for joint filers when income exceeds $450,000, but only applies to single filers when income exceeds $400,000.

Luxury auto depreciation limits for 2013. Under special “luxury automobile” rules, a taxpayer’s otherwise available depreciation deduction for business autos, light trucks, and minivans is subject to additional limits, which operate to extend depreciation beyond its regular period. The IRS has released the inflation-adjusted depreciation limits for business autos, light trucks and vans (including minivans) placed in service in 2013. The depreciation deduction limits for 2013 are the same as in 2012 for a passenger auto, while the limits (other than the first-year limits, which are the same) are $100 higher for a light truck or van. The first-year depreciation limit is $3,160 for autos and $3,360 for light trucks or vans first placed in service in 2013. However, if the bonus depreciation rules apply, these first-year limits are increased by $8,000 to $11,160 for autos and $11,360 for light trucks or vans.

IRS guidance issued on various aspects of health care law. The IRS has issued proposed regulations on the health care law’s post-2013 employer mandate, the post-2013 90-day waiting period for employer health coverage, and the post-2012 compensation deduction limit for health insurance providers. The regulations generally would be effective after they are issued as final, but taxpayers may rely on them until that time.

The employer mandate essentially imposes a penalty on employers if one or more of their full-time employees obtain a premium tax credit through the newly established insurance exchange. The new regulations would clarify the rules for determining whether the mandate applies to any given employer, and also provide transitional relief. The 90-day waiting period rule sets out a maximum waiting period that can be applied by a group health plan or group health insurance issuer, and the regulations explain certain eligibility requirements and how the period is computed. Finally, the regulations on the $500,000 deduction limit clarify which issuers are subject to the limit and how it is applied, notably excluding employers that maintain self-insured medical reimbursement plans.

We hope this information is helpful. If you would like more details about these provisions or any other aspect of the new law, please do not hesitate to call us at (562) 463-3818.