ALERT

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Post-election Tax Implications

Dear Clients and Friends:

With the 2012 election behind us, we wanted to provide you with a brief overview of the likely changes immediately ahead of us and its implications for taxpayers from both a federal and California perspective. The election, which ultimately turned out to be a status-quo election with the same parties that controlled the White House, the Senate and the House of Representatives in 2012 end up being in control starting in 2013, will non-the-less have a long lasting impact on taxpayers, with certain provisions having an effective date retroactive to January 1, 2012.

Of immediate concern is the plight of the tax provisions enacted in 2001 and 2003, which are set to expire by the end of this year. In addition, several other provisions which were enacted at the end of 2010 are also about to expire by the end of 2012. The tax discussions in Washington are part of a gargantuan debate which includes automatic budget sequestration culminating in a perfect storm famously referred to as the "fiscal cliff". We are now witnessing the opening arguments for what promises to be a long and arduous set of negotiations.

The picture in California is a bit clearer. With the passage of Proposition 30 coupled with what amounts to a single party control of the state government, paves the way for California to be at the very top of the states with the highest overall tax burden.

Looking at the current landscape, with the partisan scrimmages ahead of us, the 2012 election promises to be the most consequential election in recent memory. The professionals at Green Hasson Janks have put together an analysis of current state of affairs and where we are likely headed.

Individuals

	Current Tax Rate	Tax Rate without Action of Congress	Tax Rate Proposed by President
Individual Tax Rate	Top Tax Rate 35%	Top Tax Rate 39.6%	•Top Tax Rate 35% annual income less than $250,000 for married couple; $200,000 single taxpayer •39.6% annual income more than $250,000 for married couple; $200,000 single taxpayer
Alternative Minimum (AMT) Tax Rate	•26% on first $175,000 of income above the exemption •28% on income above 175,000 •AMT exemption: $74,450 for married couple filed jointly and surviving spouses, $48,450 for single taxpayers, and $37,225 married couple filed separately respectively	•26% on first $175,000 of income above the exemption •28% on income above 175,000 •AMT exemption: $45,000 for married couple filed jointly and surviving spouses, $33,750 for single taxpayers, and $22,500 married couple filed separately	•Top Tax Rate28% extended permanently •Indexes AMT exemption for inflation •30% for annual income more than $1,000,000
Dividend Tax Rate	15%	39.6%	15% for taxpayer annual income less than $250,000
Long-term Capital Gain Rate	15%	20%	15% for taxpayer annual income less than $250,000

- The current top tax rate of 35 percent is set to expire at the end of the year. Without any legislative action, the top tax rate will revert back to 39.6 percent which was in effect for much of the 1990s. Additionally, all other tax rates affecting middle and lower income taxpayers will also go back up to rates in effect prior to 2001. The president campaigned on extending the tax cuts for married taxpayers with less than $250,000 in annual income or single filers with less than $200,000 in annual income.
- Absent congressional action, the tax rate on qualified dividend income will rise from 15 percent to the top individual tax rate (39.6 percent), and the tax rate on long-term capital gains will rise from 15 percent to 20 percent. The administration's campaign proposal was to maintain the 15 percent long-term capital gain rate for taxpayers with incomes of less than $250,000.
- Taxpayers currently must pay the greater of regular income tax or alternative minimum tax (AMT), which has a top tax rate of 28 percent. The administration's campaign proposal was to permanently extend the AMT while indexing the AMT exemption for inflation. Additionally, the administration had proposed the so-called "Buffet rule" in early 2012. The Buffet Rule states that households earning more than $1 million per year would be subject to a minimum 30 percent overall income tax rate.
- Currently individuals claim itemized deductions and personal exemptions without limit. Absent congressional action, the deductibility of itemized deductions will become subject to phase-outs that were enacted in the 1990s. The administration made the following two proposals during the campaign: (1) eliminate itemized deductions for housing, healthcare, retirement and childcare for individuals with more than $1 million in annual income, and (2) limit the benefit of itemized deductions to 28 percent for taxpayers in higher rate brackets.
- The tax elements of the Patient Protection Act will start coming into effect on January 1, 2013. The significant tax increases are: (1) the new 3.8 percent Medicare tax on net investment income, and (2) an additional 0.9 percent Medicare surtax on earned income. There are additional changes by limiting the deductibility of medical expenses as itemized deductions and limiting the benefits of flexible spending accounts.

Business Entities

- The current corporate tax rate is 35 percent. The administration has previously indicated a willingness to lower the corporate tax rate to 28 percent, with a 25 percent rate for manufacturers.
- Manufacturers currently receive a 9 percent deduction on qualified domestic production income. The deduction for most manufacturers could be increased to 10.7 percent and the deduction for high-technology manufacturing companies could be increased to 18 percent. Fossil fuel production would no longer be eligible for the deduction.
- During the campaign, President Obama proposed making a research and development tax credit permanent, but did not indicate if the current credit would remain or be substantially modified.
- Companies may currently use the last in, first out (LIFO) inventory method. The President's tax plan would repeal LIFO. Though this proposal is not new, industry lobbying has prevented prior attempts to repeal it.
- The tax code contains targeted deductions for taxpayers in specific industries. In previous proposals, the administration had indicated its intention to eliminate many targeted provisions available to fossil fuel industries (oil, gas and coal) while extending incentives for renewable energy.

International Tax

- Currently, income earned by foreign subsidiaries of US companies is generally deferred until the earnings are repatriated into the United States. Foreign income taxes paid are generally available as a credit against the U.S. tax liability on foreign income. Previously, the administration had proposed to continue the current system with some modifications. These modifications included imposition of a minimum tax on income earned from foreign operations whether repatriated or not, closing of loopholes related to leveraged foreign distributions, covered asset acquisitions and earnings stripping, and imposition of an excess returns tax on inappropriate income shifting to overseas subsidiaries.

The Outlook in California

Proposition 30

- California voters approved the passage of Proposition 30 and Proposition 39. Proposition 30 increases the state portion of the California sales tax rate from 7.25% to 7.5% for a four year period. The .25% increase is likely to become effective when the votes of the November 6th election are fully certified in December 2012.

- Proposition 30 also increases the personal income tax rates for high income earners for a seven year period as follows:

    Single or Married Filing Separately
    - 10.3% tax rate on marginal taxable income over $250,000 but less than $300,00
    - 11.3% tax rate on marginal taxable income over $300,000 but less than $500,000 and;
    - 12.3% tax rate on marginal taxable income over $500,000 but less than $1,000,000

    Married Filing Jointly
    - 10.3% tax rate on marginal taxable income over $500,000 but less than $600,00
    - 11.3% tax rate on marginal taxable income over $600,000 but less than $1,000,000 and;
    - 12.3% tax rate on marginal taxable income over $1,000,000

- The personal income tax rate increases are effective retroactively on income earned as of January 1st, 2012 and taxpayers with taxable income above $1 million should be aware that the 1% mental health tax is not affected by Proposition 30 and will be imposed in addition to the tax rate increases under Proposition 30.

- Taxpayers who have already made estimated tax payments for 2012 based on the prior marginal tax rates will not be subject to underpayment penalties. California law contains a safe-harbor provision for underpayments for any provision of law that is chaptered and operative during the year of underpayment. Consequently, taxpayers will not have to make catch up estimated tax payments and have until April 15th, 2013 to pay additional tax related to the Proposition 30 rate increases.

- Proposition 30 is expected to generate an additional $6 billion of tax revenue for the state.

Proposition 39

- California currently requires legal entities to apportion income to California utilizing a three factor apportionment formula consisting of a property factor, payroll factor and sales factor. The property factor and payroll factor are weighted 25% each and the sales factor is weighted at 50%. For tax years beginning on or after January 1st, 2011 and before January 1st, 2013, taxpayers may annually elect into a singles sales factor apportionment formula, however, this election currently is not mandatory.

- For tax years beginning on or after January 1st, 2013, multi-state businesses will be required to apportion income utilizing a mandatory single sales factor apportionment formula. A single sales factor provides a fraction used to allocate taxable income to California for multi-state businesses. The fraction will be determined based on California sales in the numerator and total sales in the denominator. This sales factor is then applied to taxable income to determine the amount subject to California tax.

- Additionally, businesses that generate revenue from sales other than the sale of tangible personal property will be required to use a market based sourcing approach to determine which state or country sales should be sourced for purposes of the sales factor computation. Under a market based sourcing approach, a business looks to where its customers benefit from its services or activities to determine where revenue should be sourced. Under the current "cost of performance" sourcing approach a business looks to where a majority of the costs associated with the performance of the services or activities occurs to determine the location to where the revenue should be sourced. For California based businesses with a majority of their costs and expenses in California, the movement to a market based sourcing approach generally provides tax relief. The move to a mandatory single sales factor should also provide relief for those businesses with significant capital and employee investments in California.

- The use of a single sales factor would apply to corporations and pass-through entities. Individual taxpayers do not generally apportion income to California using an apportionment factor.

- The use of a single sales factor formula is designed to shift the tax burden to out of state businesses that can no longer dilute their California apportionment formula through the significant property and payroll they employ outside the state. As we have seen with a number of other states that require the use of a single sales factor apportionment formula, California based businesses will generally find this tax law change to be tax favorable. The passage of this proposition is expected to bring an increase in tax revenue of approximately $1 billion.

Like many tax matters, these rules are complex and we have only provided a brief overview of the issues. For more information, please contact your Green Hasson Janks advisor for further details at (310) 873-1600.

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