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2012

AMERICAN TAXPAYER RELIEF ACT OF 2012

UPDATED January 3, 2013

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TABLE OF CONTENTS

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TABLE OF CONTENTS (continued)

AMERICAN TAXPAYER RELIEF ACT OF 2012

On January 2, 2013, President Obama signed into law The American Tax Relief Act of 2012 The American Taxpayer Relief Act allows the Bush-era tax rates to sunset after 2012 for individuals with incomes over $400,000 and families with incomes over $450,000; permanently "patches" the alternative minimum tax (AMT); revives many now-expired tax extenders, including the research tax credit and the American Opportunity Tax Credit; and provides for a maximum estate tax of 40 percent with a $5 million exclusion. The bill also delays the mandatory across-the-board spending cuts known as sequestration.

Individuals with incomes above the $450,000/$400,000 thresh olds will pay more in taxes in 2013 because of a higher 39.6 percent income tax rate and a 20 percent maximum capital gains tax. Nevertheless, all taxpayers will find less in their paycheck in 2013 because of what the American Taxpayer Relief Act did not include: the new law effectively raises taxes for all wage earners (and those self-employed) by not extending the 2012 payroll tax holiday that had reduced OASDI taxes from 6.2 percent to 4.2 percent on earned income up to the Social Security wage base ($113,700 for 2013).

The American Taxpayer Relief Act avoids sunset provisions that were scheduled to take effect after 2012 under the Bush-era tax cuts in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTTRA) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) (both as extended by subsequent legislation, including the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (2010 Tax Relief Act). Without the American Taxpayer Relief Act, individual tax rates on all income groups would have increased, favorable tax treatment of capital gains and dividends would have completely disappeared, the child tax credit would have decreased to $500, enhancements to education tax incentives would have ended, the federal estate tax would have reverted to a maximum rate of 55 percent, and many other popular but temporary incentives would no longer be available.

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Individual Income Tax Rates

The American Taxpayer Relief Act of 2012 makes permanent for 2013 and beyond the lower Bush-era income tax rates for all, except for taxpayers with taxable income above $400,000 ($450,000 for married taxpayers, $425,000 for heads of households). Income above these levels will be taxed at a 39.6 percent rate.

Individual marginal tax rates of 10, 15, 25, 28, 33, and 35 percent at the end of 2012, therefore, are now set going forward at the same 10, 15, 25, 28, 33, and 35 rates, but with an additional 39.6 percent rate carved out from the old 35 percent bracket range. The fiscal cliff agreement also uses the same $400,000/$450,000 taxable income threshold to apply a higher capital gains and dividend rate of 20 percent, up from 15 percent *(see discussion, at "Capital Gains and Dividends," below)*.

> **Note!** *The bracket ranges for the extension of the 35 percent rate now cover only a relatively small sliver of what had constituted the upper-income range. As projected for annual inflation, the range of the 35 percent tax bracket for 2013 because of the Bush-era rate extensions begins at $398,350, for all individual brackets, except half ($199,175) for married taxpayers filing separately. The 35 percent income bracket ranges for 2013, therefore, are:*
>
> - *$398,350 - $400,000 for single filers*
> - *$398,350 - $425,000 for heads of household*
> - *$398,350 - $450,000 for joint filers. surviving spouses*
> - *$199,175 - $225,000 for married filing separately*
>
> **Tax Tip.** *Taxpayers who find themselves within the 39.6 percent marginal income tax bracket nevertheless also benefit from extension of all Bush-era rates below that level.*

As with all tax bracket ranges, the new law directs that the $450,000/$400,000 beginning of the 39.6 percent bracket be adjusted for inflation after 2013.

PROJECTED* TAX RATES FOR 2013

UNDER AMERICAN TAXPAYER RELIEF ACT OF 2012

Single Individuals

If taxable income is:	The tax will be:
Not over $8,925	10% of taxable income
Over $8,925 but not over $36,250	$892.50 plus 15% of the excess over $8,925
Over $36,250 but not over $87,850	$4,991.25 plus 25% of excess over $36,250
Over $87,850 but not over $183,250	$17,891.25 plus 28% of excess over $87,850
Over $183,250 to $398,350	$44,603.25 plus 33% of excess over $183,250
Over $398,350 to $400,000	$115,586.25 plus 35% of excess over $398,350
Over $400,000	$116,163.75 plus 39.6% of excess over $400,000

Married Couples Filing Jointly

If taxable income is:	The tax will be:
Not over $17,850	10% of taxable income
Over $17,850 but not over $72,500	$1785 plus 15% of the excess over $17,850
Over $72,500 but not over $146,400	$9,982.50 plus 25% of excess over $72,500
Over $146,400 but not over $223,050	$28,457.50 plus 28% of excess over $146,400
Over $223,050 to $398,350	$49,919.50 plus 33% of excess over $223,050
Over $398,350 to $450,000	$107,768.50 plus 35% of excess over $398,350
Over $450,000	$125,846 plus 39.6% of excess over $450,000

*The IRS is expected to release official 2013 tax rate tables shortly

Marriage Penalty Relief

The American Taxpayer Relief Act extends all existing marriage penalty relief. EGTRRA also gradually increased the size of the 15 percent income tax bracket for a married couple filing a joint return to twice the size of the corresponding rate bracket for an unmarried individual filing a single return.

Capital Gains/ Dividends Sunsets

The American Taxpayer Relief Act raises the top rate for capital gains and dividends to 20 percent, up from the Bush- era maximum 15 percent rate. That top rate will apply to the extent that a taxpayer's income exceeds the thresholds set for the 39.6 percent rate ($400,000 for single filers; $450,000 for joint filers and $425,000 for heads of households).

All other taxpayers will continue to enjoy a capital gains and dividends tax at a maximum rate of 15 percent. A zero percent rate will also continue to apply to capital gains and dividends to the extent income falls below the top of the 15 percent in- come tax bracket—projected for 2013 to be $72,500 for joint filers and $36,250 for singles. Qualified dividends for all taxpayers continue to be taxed at capital gains rates, rather than ordinary income tax rates as prior to 2003.

The 28 and 25 percent tax rates for collectibles and recaptured Code Sec. 1250 gain, respectively, continue unchanged after 2012. Also unchanged is the application of ordinary income rates to short-term capital gains; only long-term capital gains, those realized on the sale or disposition of assets held for more than one year, can benefit from the reduced net capital gain rate.

Generally, dividends received from a domestic corporation or a qualified foreign corporation, on which the underlying stock is held for at least 61 days within a specified 121-day period, are qualified dividends for purposes of the reduced tax rate. Certain dividends do not qualify for the reduced tax rates and are taxed as ordinary income. Those include (not an exhaustive list) dividends paid by credit unions, mutual insurance companies, and farmers' cooperatives.

> **Caution!** *Installment payments received after 2012 are subject to the tax rates applicable in the year of receipt not the year of the sale.*
>
> **Caution!** *Starting in 2013, under the Patient Protection and Affordable Care Act (PPACA) higher income taxpayers also start paying a 3.8% additional tax on Net Investment Income ("NII") to the extent certain threshold amounts of income are exceeded ($200,000 for single filers, $250,000 for joint returns and surviving spouses, $125,000 for married taxpayers filing separately). Those threshold amounts stand, despite higher thresholds now set for the 20 % capital gain rate. The NII surtax thresholds are not affected by the American Taxpayer Relief Act. Starting in 2013, therefore, taxpayers within the NII surtax range must pay the additional 3.8 percent on capital gain, whether long-term or short-term. The effective top rate for net capital gains for many "higher-income" taxpayers thus becomes 23.8% for long term gain and 43.4% for short- term capital gains starting in 2013.*

Permanent AMT Relief

The American Taxpayer Relief Act "patches" the Alternative Minimum Tax ("AMT") for 2012 and subsequent years by increasing the exemption amounts and allowing nonrefundable personal credits to the full amount of the individual's regular tax and AMT. Additionally, the American Taxpayer Relief Act provides for an annual inflation adjustment to the exemption amounts for years beginning after 2012.

The American Taxpayer Relief Act increases the 2012 exemption amounts to $50,600 for unmarried individuals; $78,750 for married taxpayers filing jointly and surviving spouses; and $39,375 for married taxpayers filing separately. The 2013 AMT exemption amounts are projected to be $80,750 for married filing joint and surviving spouses, $51,900 for single and head of household, and $40,375 for married filing separate filers.

> **Note!** *The American Taxpayer Relief Act provides that all nonrefundable personal credits are allowed to the full extent of the taxpayer's regular tax and AMT liability, effective for tax years beginning after 2011.*

Itemized Deduction Limitation

The American Taxpayer Relief Act officially revives the "Pease" limitation on itemized deductions, which was eliminated by EGTRRA as extended by the 2010 Tax Relief Act.

However, higher "applicable threshold" levels apply under the new law:

- $300,000 for married couples and surviving spouses;
- $275,000 for heads of households;
- $250,000 for unmarried taxpayers; and
- $150,000 for married taxpayers filing separately.

The dollar amounts are adjusted for inflation for tax years after 2013.

The Pease limitation, named after the member of Congress who sponsored the original provision, reduces the total amount of a higher-income taxpayer's otherwise allowable itemized deductions by three percent of the amount by which the taxpayer's adjusted gross income exceeds an applicable threshold. However, the amount of itemized deductions is not reduced by more than 80 percent. Certain items, such as medical expenses, investment interest, and casualty, theft or wagering losses, are excluded.

Personal Exemption Phase-out

The American Taxpayer Relief Act also officially revives the personal exemption phase-out rules, but at applicable income threshold levels slightly higher than in the past:

- $300,000 for married couples and surviving spouses;
- $275,000 for heads of households;
- $250,000 for unmarried taxpayers; and
- $150,000 for married taxpayers filing separately.

Under the phase-out, the total amount of exemptions that may be claimed by a taxpayer is reduced by two percent for each $2,500, or portion thereof (two percent for each $1,250 for married couples filing separate returns) by which the taxpayer's adjusted gross income exceeds the applicable threshold level. The amount can not be reduced below zero.

Federal Estate, Gift & GST Taxes

The American Taxpayer Relief Act permanently provides for a maximum federal estate tax rate of 40 percent with an annually inflation-adjusted $5 million exclusion for gifts and estates of decedents dying after December 31, 2012.

Portability

The American Taxpayer Relief Act makes permanent "portability" between spouses. Prior to the permanent extension, portability was only available to the estates of decedents dying after December 31, 2010 and before January 1, 2013.

> ***Note!*** *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 (the deceased spousal unused exclusion amount (DSUE)) to the surviving spouse's own transfers during life and at death.*

State Death Tax Credit/Deduction

The American Taxpayer Relief Act extends the deduction for state estate taxes.

More Estate Tax Provisions

The American Taxpayer Relief Act extends a number of provisions affecting qualified conservation easements, qualified family-owned business interests (QFOBIs), the installment payment of estate tax for closely-held businesses for purposes of the estate tax, and repeal of the five percent surtax on estates larger than $10 million.

Gift Tax

The American Taxpayer Relief Act provides a 40% tax rate and a unified estate and gift tax exemption of $5 million (inflation adjusted) for gifts made after 2012.

Generation Skipping Transfer ("GST") Tax

The American Taxpayer Relief Act extends a number of GST tax-related provisions scheduled to expire after 2012. They include the GST deemed allocation and retroactive al- location provisions; clarification of valuation rules with respect to the determination of the inclusion ratio for GST tax purposes; provisions allowing for a qualified severance of a trust for purposes of the GST tax; and relief from late GST allocations and elections.

State & Local Sales Tax Deduction

The American Taxpayer Relief Act extends through 2013 the election to claim an itemized deduction for state and local general sales taxes in lieu of state and local income taxes.

Child Tax Credit

The American Taxpayer Relief Act extends permanently the $1,000 child tax credit. Certain enhancements to the credit under Bush-era legislation and subsequent legislation are also made permanent.

The child tax credit has been set at the $1,000 level since 2003 and is not adjusted each year for inflation. The American Taxpayer Relief Act keeps the child tax credit at the $1,000 level, still without inflation adjustments, for future years. Bush-era and subsequent legislation modified the refundable component of the child tax credit, provided that the refundable portion of the credit does not constitute income, provided that the credit is allowable against regular income tax and AMT, repealed the AMT offset against the additional child tax credit for families with three or more children; and eliminated the supplemental child tax credit. The American Taxpayer Relief Act extends all these modifications as well.

The current provision that reduces the earnings threshold for the refundable portion of the child tax credit to $3,000 is extended through 2017.

Earned Income Credit

The American Taxpayer Relief Act makes permanent or extends through 2017 enhancements to the earned income credit (EIC) in Bush-era and subsequent legislation. The enhancements to the EIC made by Bush-era and subsequent legislation include (not an exhaustive list) a simplified definition of earned income, reform of the relationship test and modification of the tie-breaking rule. The IRS also has additional authority with respect to mathematical errors.

Other Child-Related Tax Relief

Adoption Credit/Assistance

The American Taxpayer Relief Act extends permanently Bush-era enhancements to the adoption credit and the income exclusion for employer-paid or reimbursed adoption expenses up to $10,000 (indexed for inflation) both for non-special needs adoptions and special needs adoptions. The adoption credit phases out for taxpayers above specified inflation-adjusted levels of modified adjusted gross income. The phase-out level for 2012 started at $189,710. For 2013, the beginning point for phasing out the adoption credit is projected to be $191,530. The limit on the adoption credit is projected to be $12,770 for 2013.

Child & Dependent Care Credit

The American Taxpayer Relief Act extends permanently Bush-era enhancements to the child and dependent care credit. The current 35 percent credit rate is made permanent along with the $3,000 cap on expenses for one qualifying individual and the $6,000 cap on expenses for two or more qualifying individuals.

Expenses qualifying for the child and dependent care credit must be reduced by the amount of any dependent care benefits provided by the taxpayer’s employer that are excluded from the taxpayer’s gross income. For 2012, total expenses qualifying for the dependent credit are capped at $3,000 in cases of one qualifying individual or at $6,000 in cases of two or more qualifying individuals subject to income thresholds. For 2013, absent extension, these monetary amounts would have decreased to $2,400 in cases of one qualifying individual or $4,800 in cases of two or more qualifying individuals, subject to income thresholds.

The child and dependent care credit is intended to help individuals pay child and dependent care expenses so the taxpayer (if married, a joint return must be filed) can work or look for work. A child, for purposes of this tax benefit, must be under 13 years of age at the close of the tax year. A qualifying dependent who is disabled, however, may be of any age if he or she is a dependent, or spouse, who lives with the taxpayer for more than half the year. EGTRRA and subsequent legislation increased the maximum amount of eligible employment-related expenses for purposes of the dependent care credit and made other enhancements. The 2010 Tax Relief Act had extended these enhancements through 2012.

Employer-Provided Child Care Credit

The American Taxpayer Relief Act extends permanently the Bush-era credit for employer-provided child care facilities and services.

American Opportunity Tax Credit

The American Taxpayer Relief Act extends through 2017 the American Opportunity Tax Credit (AOTC). The AOTC is an enhanced, but temporary, version of the permanent HOPE education tax credit.

The AOTC rewards qualified taxpayers with a tax credit of 100 percent of the first $2,000 of qualified tuition and related expenses and 25 percent of the next $2,000, for a total maximum credit of $2,500 per eligible student. Additionally, the AOTC applies to the first four years of a student's post- secondary education. The HOPE credit, in contrast, is less generous and applies to the first two years of a student's post- secondary education.

Other Education Incentives

The American Taxpayer Relief Act makes permanent or extends a number of enhancements to tax incentives designed to promote education. Many of these enhancements were made in Bush-era legislation, extended by sub- sequent legislation and are scheduled to expire after 2012. Some enhancements, notably the American Opportunity Tax Credit, had been made in President Obama's first term.

Deduction for Qualified Tuition and Related Expenses

The American Taxpayer Relief Act extends until December 31, 2013 the above-the-line deduction for qualified tuition and related expenses. The bill also extends the deduction retroactively for the 2012 tax year.

Taxpayers cannot claim the higher education tuition deduction in the same tax year that they claim the AOTC or the Lifetime Learning credit. A taxpayer also cannot claim the higher education tuition deduction if anyone else claims the AOTC or the Lifetime Learning credit for the student in the same tax year.

Student Loan Interest Deduction

The American Taxpayer Relief Act extends permanently suspension of the 60-month rule for the $2,500 above-the-line student loan interest deduction. The American Taxpayer Relief Act also expands the modified adjusted gross income range for phase-out of the deduction permanently and repeals the restriction that makes voluntary payments of interest nondeductible permanently.

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Coverdell Education Savings Accounts

The American Taxpayer Relief Act extends permanently Bush-era enhancements to Coverdell education savings accounts (Coverdell ESAs). These enhancements include a $2,000 maximum contribution amount and treatment of elementary and secondary school expenses as well as post-secondary expenses as qualified expenditures.

Under the American Taxpayer Relief Act, qualified educational expenses continue to include expenses incurred while attending an elementary, secondary school or post-secondary school.

Employer-Provided Education Assistance

The American Taxpayer Relief Act extends permanently the exclusion from income and employment taxes of employer-provided education assistance up to $5,250.
The employer may also deduct up to $5,250 annually for qualified education expenses paid on behalf of an employee.

Federal Scholarships

The American Taxpayer Relief Act makes permanent the exclusion from income for the National Health Service Corps Scholarship Program and the Armed Forces Scholarship Program.

More Individual Tax Extenders

Teachers' Classroom Expense Deduction

The American Taxpayer Relief Act extends through 2013 the teacher's classroom expense deduction. The deduction, which expired after 2011, allows primary and secondary education professionals to deduct (above-the-line) qualified expenses up to $250 paid out-of-pocket during the year.

Exclusion or Cancellation of Indebtedness on Principal Residence

Cancellation of indebtedness income is includible in income, unless a particular exclusion applies. This provision excludes from in- come cancellation of mortgage debt on a principal residence of up $2 million. The American Taxpayer Relief Act extends the provision for one year, through 2013.

> **Note!** *This provision provides an additional itemized deduction by treating mortgage insurance premiums as deductible qualified residence interest.*

Mortgage Insurance Premiums

This provision treats mortgage insurance premiums as deductible interest that is qualified residence interest. The American Taxpayer Relief Act extends this provision through December 31, 2013. The provision originally expired after 2011.

Contribution of Capital Gains Real Property for Conservation

The Act extends for two years, through December 31, 2013, the special rule for contributions of capital gain real property for conservation purposes. The special rule allows the contribution to be taken against 50 percent of the contribution base. The Act also extends for two years the special rules for contributions by certain corporate farmers and ranchers.

IRA Distributions to Charity

The American Tax Relief Act extends for two years, through December 31, 2013, the provision allowing tax-free distributions from individual retirement accounts to public charities, by individuals age 70½ or older, up to a maximum of $100,000 per taxpayer per year.

The Act provides special transition rules. One rule allows taxpayers to re-characterize distributions made in January 2013 as made on December 31, 2012. The other rule permits taxpayers to treat a distribution from the IRA to the taxpayer made in December 2012 as a charitable distribution, if transferred to charity before February 1, 2013.

BUSINESS TAX PROVISIONS

Many popular but temporary tax extenders relating to businesses are included in the American Taxpayer Relief Act. Among them is Code Sec. 179 small business expensing, bonus depreciation, the research tax credit, and the Work Opportunity Tax Credit.

Code Sec. 179 Small Business Expensing

The American Taxpayer Relief Act extends through 2013 enhanced Code Sec. 179 small business expensing. The Code Sec. 179 dollar limit for tax years 2012 and 2013 is $500,000 with a $2 million investment limit. The rule allowing off-the-shelf computer software is also extended.

Bonus Depreciation

The American Taxpayer Relief Act extends 50 percent bonus depreciation through 2013. Some transportation and longer period production property is eligible for 50 percent bonus depreciation through 2014.

Research Tax Credit

The American Taxpayer Relief Act extends through 2013 the Code Sec. 41 research tax credit, which expired after 2011. The incentive rewards taxpayers that engage in qualified research activities with a tax credit.

Commonly called the research or research and development credit, the incremental research credit may be claimed for increases in business-related qualified research expenditures and for increases in payments to universities and other qualified organizations for basic research. The credit applies to excess of qualified research expenditures for the tax year over the average annual qualified research expenditures measured over the four preceding years.

Work Opportunity Tax Credit

The American Taxpayer Relief Act extends through 2013 the Work Opportunity Tax Credit (WOTC), which rewards employers that hire individuals from targeted groups with a tax credit.
Under the revived WOTC, employers hiring an individual within a targeted group (generally, otherwise hard-to- employ workers) are eligible for a credit generally equal to 40 percent of first-year wages up to $6,000. The WOTC is part of the general business credit.

The Vow to Hire Heroes Act of 2011 (Heroes Act) extended the WOTC for unemployed veterans and unemployed veterans with service connected disabilities through 2012. The WOTC for qualified veterans can be as high as $9,600. The Heroes Act did not extend the non-veteran

WOTC provisions. The American Taxpayer Relief Act extends the WOTC for qualified veterans as well as for those within prior targeted groups.

Qualified Leasehold/Retail Improvements, Restaurant Property

The American Taxpayer Relief Act extends through 2013 the 15-year recovery period for qualified leasehold improvements, qualified retail improvements and qualified restaurant property.

More Business Tax Extenders

A number of other business tax extenders expired after 2011 and they are extended through 2013 under the American Taxpayer Relief Act. They include, among others:

- New Markets Tax Credit
- Employer wage credit for activated military reservists
- Subpart F exceptions for active financing income
- Look through rule for related controlled foreign corporation payments
- Railroad track maintenance credit Seven-year recovery period for motorsports entertainment complexes
- 100 percent exclusion for gain on sale of qualified small business stock
- Reduced recognition period for S corporation built-in gains tax
- Enhanced deduction for charitable contributions of food inventory
- Tax incentives for empowerment zones Indian employment credit
- Accelerated depreciation for business property on Indian reservations
- Special expensing rules for qualified film and television productions
- Mine rescue team training credit Election to expense advanced mine safety equipment
- Qualified zone academy bonds Low-income tax credits for non-federally subsidized new buildings
- Low-income housing tax credit treatment of military housing allowances
- Treatment of dividends of regulated investment companies (RICs)
- Treatment of RICs as qualified investment entities
- S corporations making charitable donations of property
- New York Liberty Zone tax-exempt bond financing
- Economic development credit for American Samoa

Not extended. Certain business provisions were not extended by the American Taxpayer Relief Act. These include:

- Enhanced deduction for corporate charitable contributions of book inventory;
- Enhanced deduction for corporate charitable contributions of computers;
- Tax incentives for the District of Columbia; and
- Expensing of brownfields remediation costs

ENERGY INCENTIVES

The American Taxpayer Relief Act extends a number of energy tax incentives, primarily business-related credits. The Act also extends the Code Sec. 25C non-business energy property credit.

Energy Credits for Individuals

The Code Sec. 25C credit is available to individuals who make energy efficiency improvements to their existing residence. The lifetime credit limit is $500 ($200 for windows and skylights) under the 2010 Tax Relief Act. The American Taxpayer Relief Act extends the credit at the $500 level through December 31, 2013.

Renewable Resources

The American Taxpayer Relief Act extends through 2013, the Sec. 45 production tax credit for facilities that produce energy from wind facilities. The Act also excludes recycled paper from the definition of municipal solid waste.

Other energy tax incentives extended by the American Taxpayer Relief Act through 2013, include:

- Credits for alternative fuel vehicle refueling property;
- Credits for cellulosic biofuel production;
- Credits for biodiesel and renewable diesel;
- Production credits for Indian coal facilities;
- Credit for energy-efficient new homes;
- Credit for energy-efficient appliances;
- Allowance for cellulosic biofuel plant property;
- Special rules for sales of electric trans- mission property; and
- Tax credits and outlay payments for ethanol.

No extension. Certain incentives have not been extended by the American Taxpayer Relief Act:

- Credits for refined coal facilities
- Percentage depletion for oil and gas from marginal wells; and
- Grants for certain energy property in lieu of tax credits.

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CONCLUSION

Please contact us if you are interested in a tax topic that we did not discuss. Tax law is constantly changing due to new legislation, cases, regulations, and IRS rulings. Our firm closely monitors these changes. Please call us before implementing any planning ideas discussed in this letter, or if you need additional information.

Note: The information contained in this material represents a general overview of tax developments and should not be relied upon without an independent, professional analysis of how any of these provisions may apply to a specific situation.

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