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Congress Avoids the Fiscal 'Cliff'—Now What?

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- Estates & Trusts
- Tax
- Health Law & Managed Care
- Administrative & Regulatory

- All Federal

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The new federal tax bill establishes permanent income, estate, gift and generation-skipping transfer tax provisions that present additional planning opportunities for 2013 and beyond.

At the very edge of the "fiscal cliff," Congress approved the **American Taxpayer Relief Act of 2012 (ATRA)** on January 1, 2013. ATRA raises income taxes on the top 2 percent of taxpayers. It also permanently extends certain income, estate, gift and generation-skipping transfer (GST) tax provisions introduced in 2001 (by deleting the sunset of those provisions scheduled to take effect after 2012). ATRA raises taxes on some taxpayers compared to their taxes in 2012, but it also provides greater certainty and additional planning opportunities for many individuals. Provisions of ATRA that are relevant to our private clients are discussed in this newsletter. A few thoughts on planning in light of ATRA also are included. This is a summary and as such omits important details. You should consult your tax adviser before taking any steps regarding your tax planning.

Income Taxes

Income Tax Rates

ATRA permanently retains the preexisting marginal income tax rates for most individuals. Absent ATRA, these rates were scheduled to increase to pre-2001 levels after 2012. However, ATRA does increase the top tax rate from 35 percent to 39.6 percent on earned income and certain other ordinary income of high income taxpayers. These are taxpayers with total income exceeding $400,000 for single filers, $450,000 for married couples filing jointly and $11,950 for trusts with taxable income that is not distributed. In addition, the previously enacted Patient Protection and Affordable Care Act adds another 3.8 percent tax on investment income of high income taxpayers over certain threshold amounts, thus raising the top rate on investment income over the thresholds to as much as 43.4 percent.

Capital Gains and Dividends

At the end of 2012, the 15 percent maximum tax rate on long-term capital gains and qualified dividends was scheduled to revert to 20 percent on long-term capital gains and as much as the top tax rate (39.6 percent) on qualifying dividends. ATRA maintains the 15 percent rates on long-term capital gains and qualified dividends for most taxpayers, but sets the rates for high income taxpayers (including trusts) at 20 percent on the amount of this income in excess of the thresholds indicated above. The 3.8 percent tax under the Patient Protection and Affordable Care Act also applies to long-term capital gains and qualifying dividends, making the top rate on such income for high income taxpayers 23.8 percent. Short-term capital gains will continue to be taxed at ordinary income tax rates, which for high income taxpayers means 43.4 percent (39.6 percent plus the additional 3.8 percent).

Limitations on Deductions and Exemptions

Under ATRA, starting in 2013 individual high income taxpayers will again be subject to the “3 percent limitation” on itemized deductions and the personal exemption phaseout (PEP) that applied before 2010. The 3 percent limitation reduces the benefit of itemized deductions, including those for charitable contributions, mortgage interest and state and local taxes. Under this provision, the amount of itemized deductions that a taxpayer may deduct is reduced by 3 percent of the amount by which the taxpayer’s adjusted gross income exceeds a threshold ($250,000 for single filers and $300,000 for married couples filing jointly), up to a maximum reduction of 80 percent of the taxpayer’s itemized deductions. These threshold amounts will be indexed for inflation for all years after 2013.

ATRA reinstates the PEP limitations that reduce a taxpayer’s total personal and dependent exemptions by 2 percent for each $2,500 (or fraction thereof) by which such taxpayer’s adjusted gross income exceeds a threshold ($250,000 for single filers and $300,000 for married couples filing jointly). These threshold amounts also will be indexed for inflation for all years after 2013.

Other Significant Income Tax Provisions

IRA Distributions to Charity

ATRA retroactively reinstates for 2012 and extends for 2013 a law that permits individuals age 70½ or older to make tax-free distributions to charity from an individual retirement account (IRA). This provision permits an individual to have his or her IRA distribute up to $100,000 to charity in 2012 and then again in 2013 without any income tax cost. In addition, this provision permits an IRA distribution of up to $100,000 to charity made before February 1, 2013, to count as having been made in the 2012 taxable year. Also, individuals who took a minimum required or larger IRA distribution in December 2012 can contribute the amount of the distribution in cash (up to $100,000) to charity before February 1, 2013, and have it count as a 2012 charitable distribution from the IRA. Individuals who are required to take distributions from their IRAs can use this provision to make charitable contributions and to reduce their tax liability on their required IRA distributions.

Alternative Minimum Tax

ATRA increases the alternative minimum tax (AMT) exemption amounts retroactively for 2012 to $50,600 (single filers) and $78,750 (married couples filing jointly), and indexes these amounts for 2013 and beyond. While this provision will reduce the number of taxpayers subject to the AMT, it will have little or no effect on high income taxpayers.

Conversion of 401(k) Plans to Roth Accounts

In the past, only money that could be taken out of a 401(k) as a result of a plan participant reaching age 59½ or separating from service could be converted to a Roth account. ATRA removes these restrictions and allows plan participants to convert vested, otherwise undistributable amounts (e.g., 401(k) deferrals, employer matching or non-elective contributions, or earnings) from their 401(k) plans into designated Roth accounts that are in the same plan, if the plan permits this. The individual who makes the conversion is taxed on the total value of the amount converted at the time of the conversion but avoids any penalty tax for an early distribution (which would have previously applied). After the conversion, the new Roth account grows tax-free and no tax will be due on distributions made from that account. For 401(k) in-plan conversions there are two important differences compared to the rules that apply to the conversion of an IRA to a Roth IRA. First, the income tax due on the 401(k) amount converted must be paid from other assets, where this is optional for a conversion from IRA to a Roth IRA. Second, there is no election to undo the conversion of a 401(k), unlike the conversion of an IRA to a Roth IRA where an individual can decide to undo the conversion by the due date for the income tax return (as late as October 15 if extended properly) of the following year.

Transfer Taxes

Transfer Tax Exemptions and Rates

Under the previous tax law, the $5 million estate and gift tax exemptions were scheduled to decrease to $1 million in 2013. The top marginal transfer tax rate in 2012 was 35 percent, but was scheduled to increase to 55 percent in 2013. The $5 million GST exemption also was scheduled to be reduced to about $1.4 million, but was indexed for inflation.

ATRA permanently maintains the estate, gift and GST exemptions at $5 million (indexed for inflation with 2011 as the base year), but increases the top tax rate on transfers in excess of the relevant exemptions from the 2012 rate of 35 percent to 40 percent for 2013 and forward. For 2013, the inflation adjustment raises all three of these exemptions to $5.25 million. Cumulative taxable gifts during life or at death that exceed the $5.25 million exemption will be taxed at the top tax rate of 40 percent.

Individuals who did not use all of their exemptions in 2012 or earlier can take advantage of any remaining amount of their $5.25 million ($10.5 million for married couples) exemption amounts in 2013 and beyond. Even those individuals who did use all of their exemptions can transfer an additional $130,000 ($260,000 for married couples) without any transfer tax liability in 2013. In either case, the inflation adjustment may provide additional estate, gift and GST tax exemptions in future years.

An individual's separate GST exemption applies to the GST tax that is imposed (in addition to any gift or estate tax) on transfers made to grandchildren or others who are two generations or more younger than the donor. You should consult your tax adviser about how you can use your GST exemption.

Portability

Starting in 2011, the estate and gift (but not GST) exemptions were made "portable," meaning a surviving spouse could use a deceased spouse's unused exemption. Portability was set to expire at the beginning of 2013. ATRA, however, permanently extends portability for the estate and gift exemptions. Now, spouses can take full advantage of their combined estate and gift exemptions without transferring assets between them or using trusts. However, portability will not allow spouses to maximize use of their GST exemptions.

Unification of the Transfer Tax Exemptions

From 2004 through 2010, the estate and gift taxes were decoupled in that each tax had a different exemption amount. While the previous tax legislation used the same amounts for these exemptions for 2011 and 2012 only, ATRA makes the estate and gift tax exemptions the same indefinitely. This unification provides increased flexibility in many estate plans by allowing an individual to use a single $5 million (indexed for inflation) exemption for gifts during life and at death.

Annual Exclusion

While not part of ATRA, the gift tax annual exclusion amount for individuals was increased by the inflation adjustment from $13,000 for 2012 to $14,000 for 2013 ($28,000 for married couples).

Planning Implications

- Individuals who did not use their full gift or GST exemptions in 2012 continue to have the opportunity for significant gift and GST planning in 2013 and beyond. Lifetime gifts shift any post-gift income from and appreciation on the transferred assets out of the donor's estate, so that using one's gift and GST exemptions during life can result in reducing the amount subject to the new 40 percent estate tax rate.
- Making a gift in 2013 can allow an individual to take advantage of the existing grantor trust income tax rules and current low interest rates.
- Individuals over age 70½ who received an IRA distribution in December 2012 can elect to treat that distribution as a 2012 distribution to charity from an IRA if they transfer the amount of the distribution in cash (up to $100,000) to one or more eligible charities before February 1, 2013.
- Individuals over age 70½ can direct distributions from their IRAs directly to eligible charities before February 1, 2013, and elect to have such distributions treated as qualified charitable distributions in 2012. They can also direct IRA distributions to eligible charities later in 2013.
- The 3 percent limitation on deductions will provide additional planning challenges for individuals with itemized deductions. One planning technique that can minimize the effect of the 3 percent limitation for the charitably inclined is the charitable lead trust (CLT). Because a CLT's income is not part of the settlor's adjusted gross income, the charitable payments made by the CLT are not affected by the 3 percent limitation. The tax effect to the settlor is the same as a complete charitable deduction for the CLT's income (but there is no charitable deduction for the amount transferred to the CLT).
- The new 3.8 percent tax on investment income applies to trusts (that are not grantor trusts) with retained investment income over $11,950 (for 2013, indexed annually). Trustees should add this to their list of considerations when deciding whether to distribute current trust income to trust beneficiaries that have higher thresholds against the 3.8 percent tax.

What's Next?

ATRA has provided permanence in the sense that its tax changes do not come with automatic "sunset" provisions that terminate the new rules in favor of prior law. Whether ATRA represents all of the tax changes we will see in the near term is anybody's guess as Congress and President Obama take on the problems of the impending debt ceiling and long-term spending cuts.

Caitlin T. Gunther, an associate based in the Firm's New York office, also contributed to this newsletter.

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