Over the Fiscal Cliff and Back Again - Highlights from the American Taxpayer Relief Act of 2012

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After briefly plunging over the "fiscal cliff" – the combination of tax increases and spending cuts that automatically came into effect on January 1, 2013 – Congress quickly passed the American Taxpayer Relief Act of 2012 (the "Act"), which has now been signed into law by President Obama. Following is a brief summary of those aspects of the Act that we believe are most relevant to our clients in the areas of (i) gift and estate taxes, (ii) personal income tax, and (iii) business tax.

Gift and Estate Taxes

- Exemption Amounts: The estate tax, gift tax and generation-skipping transfer (GST) tax exemptions have been set at $5 million, adjusted annually for inflation from 2011.

Planning Note: Though it seems a minor detail, the inflation-adjustment provision may offer significant additional gifting opportunities. For example, it is estimated that by 2020, the exemption will increase to $6.5 million (assuming 3% inflation), allowing additional tax-free gifts of close to $1.5 million above and beyond the 2012 exemption. The exemption amount for 2013 is estimated to be roughly $5.25 million, a $130,000 increase from the $5.12 million exemption amount in 2012.

- Gift and Estate Tax Rate: Any gift or gross estate that exceeds the exemption amount will be taxed at a 40% rate. Though this is higher than the 35% rate that was in effect for 2012, it is significantly lower than the 55% rate that would have automatically taken effect if the Act had not been passed.

Planning Note: For those subject to state transfer taxes, bear in mind that many states still have a high estate tax rate (in some cases as high as 20%) with much lower exemption amounts, so combined federal and state estate taxes may be well above 50% in many cases and there is no state level foreign tax credit. Currently, only one state (Connecticut) has a gift tax, but many people are concerned that state budgetary constraints may lead other states to institute or reinstitute gift taxes and/or estate taxes.

- Portability: Surviving spouses will be able to utilize any unused portion of their deceased spouse's exemption for their own gifts and estate. This provision, which was first enacted in 2010, has been made permanent. Portability only applies to gift and estate taxes; the GST tax exemption is not portable.

Planning Note: The lack of portability of GST tax exemption, coupled with the fact that many states have not adopted portability provisions, means portability is not a panacea, and it remains important to consider utilizing both spouses' exemptions during their lifetimes where possible.

- What Wasn't Covered: From our perspective, one of the main highlights of the Act was the range of previously proposed law changes that were not included. The Obama Administration and the IRS have proposed various law changes that would effectively eliminate or greatly curtail the use of grantor retained annuity trusts, valuation discounts, grantor trusts and dynasty trusts. However, none of these planning techniques were covered by the Act.

Personal Income Tax

- Income Tax Rates: The Act preserves the 2012 tax rates for individuals earning less than $400,000 and married couples earning less than $450,000. For those with income over this threshold — referred to as "High-Income Taxpayers" in the Act – any income over the threshold is taxed at 39.6%.

Planning Note: The 39.6% tax rate does not take into account the additional 0.9% increase in the Medicare Tax on individuals who earn more than $200,000 and joint filers who earn more than $250,000, bringing the total employee-paid Medicare Tax to 2.35% and the Medicare tax on self-employment income to 3.8%.

- Investment Income Rates: Capital gains tax for High-Income Taxpayers (defined using the same $400,000/$450,000 thresholds) has increased from 15% to 20%. The 0% and 15% rates will remain in effect for the other brackets. Qualified dividends continue to be treated as long-term capital gains for this purpose.

Planning Note: Though not covered directly by the Act, as of January 1, 2013, investment income of taxpayers with income in excess of $200,000 (individual) or $250,000 (joint) is subject to an additional 3.8% Medicare Tax. This applies to capital gains, ordinary investment income and income from flow-through entities where the taxpayer is not an active participant in the business.

- Tax Rates for Trusts: Non-grantor trusts (i.e., trusts that pay tax on their own income) are, in effect, treated under the Act as High-Income Taxpayers; the 39.6% income tax rate and the 3.8% Medicare tax are assessed on trust income in excess of $11,850 (for 2013, indexed for inflation thereafter).
- Itemized Deductions: Most important, the Act did not impose any new limitations on key itemized deductions, such as the mortgage interest and charitable deduction; for the time being, these deductions remain in effect. However, the Act did re-introduce a "haircut" on itemized deductions for taxpayers above a threshold (confusingly, $250,000 for individuals and $300,000 for joint filers). Itemized deductions for affected taxpayers are reduced by 3% of their income above the threshold.

_Planning Note: For most high-income taxpayers — especially those in states with income tax rates higher than 3% — this provision effectively results in a tax increase of roughly 1.2%. _

- Personal Exemption Phaseout: For taxpayers earning more than $250,000 (individual) or $300,000 (joint), the Act re-introduced a gradual phase-out of the personal exemption (currently $3,800 per person/dependent) based on the level of income above the threshold.

- Charitable Contributions from IRAs: For 2013, the Act permits individuals over 70.5 years to donate up to $100,000 annually from their IRA to a US charity and to exclude the amount from income. The legislation also allows taxpayers to (i) make a contribution in January 2013 and treat it as a 2012 transfer and (ii) contribute to a charity in January 2013 out of a December 2012 IRA distribution and treat the contribution as though it were a 2012 contribution made directly from the IRA.

- Conservation Easements: The Act reinstated provisions allowing taxpayers to take a deduction of up to half of their adjusted gross income for donations of a conservation easement made in 2012 or 2013. Excess deductions may be carried forward for 15 years. Note that this deduction may not be available under non US income tax rules.

- What Wasn't Covered: While Congress continues to express interest in the topic, this legislation once again declined to enact previously proposed "carried interest" rules, which would tax profit participation to fund principals (and other providers of services to investment partnerships) at ordinary income rates without regard to the tax character of the profit.

Business Taxes

- Qualified Small Business Stock: The Act extends the 100% exclusion of the gain on the sale of qualifying small business stock that was held for more than five years. This provision applies to stock acquired prior to January 1, 2014.

- S Corporation Recognition Period for Built-in Gain: When a taxable "C Corporation" makes a subchapter S election, its built-in gains at the time of conversion remain subject to double taxation for a "recognition period" of a number of years thereafter. The designated holding period has fluctuated over the past decade and would have increased to 10 years had previous legislation been allowed to expire. However, the Act extended the current 5-year recognition period for sales occurring in 2012 and 2013.

- Depreciation: Three major provisions related to depreciation of business assets were in the Act. First, the phase-out threshold under Section 179 (which allows, in lieu of depreciation, a deduction of up to $500,000 for property newly placed into service) will remain at $2 million. Second, the 15-year straight-line depreciation for qualified properties will be extended for buildings placed into service prior to January 1, 2014. Finally, businesses are allowed to take an additional 50% depreciation deduction for depreciable property placed into service prior to January 1, 2014.

- Look-Through Rule for Subsidiary/Related Controlled Foreign Corporations (CFCs): The Act extends through 2013 the current law allowing a CFC receiving certain payments (dividends, interest, royalties, rents) from subsidiary or related CFCs to look through to the activities of the paying CFC and, to the extent such activities constitute the conduct of an active business, to avoid characterization of such payments as "Subpart F income" taxable currently at ordinary income rates to those US shareholders who own 10% of more of the parent CFC.

- Subpart F Exceptions for Active Financing: The Act extends through 2013 the current law permitting a US parent company to defer tax on income earned by a foreign subsidiary that actively engaged in the conduct of a banking, financing or similar business.

- Research and Development: The research and development tax credit has been extended so that it now applies to the 2012 and 2013 tax years.

- What Wasn't Covered: Broad-based corporate tax reform, lowering rates but closing loopholes, generally thought to be near the top of President Obama's tax agenda, was not addressed by the Act.

Further Developments to Come

While the Act describes many of these changes as "permanent," this term can be misleading. In this context "permanent" merely means that the provisions are not scheduled to expire automatically, so any "permanent" provision can be changed by future legislation. Though the Act took steps to pull us back from the fiscal cliff, the coming months are expected to bring two major debates that may re-open discussion of any or all of these provisions: one over the debt ceiling and one over the automatic spending cuts that were postponed to February by the Act. Both political parties continue to discuss reform to the tax code for individuals and corporations as a means of raising revenue, and we expect to see further developments this year.

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