

Tax and Estate Planning Effects of the American Taxpayer Relief Act of 2012

The American Taxpayer Relief Act of 2012 (the Act) became effective on January 2, 2013. The Act contains a number of notable changes to the federal estate, gift, generation-skipping transfer (GST) and income tax laws, which are summarized in this Legal Update.

Estate, Gift and GST Tax Changes

Rates and Exemption Amount. Prior to the enactment of the Act, the estate, gift and GST tax rates were scheduled to increase from 35 percent to 55 percent in 2013. At the same time, the estate and gift tax exemption was scheduled to decrease from \$5.12 million to \$1 million and the GST tax exemption was scheduled to decrease from \$5.12 million to approximately \$1.39 million. However, the Act prevented these changes by providing new rates and exemption amounts for the estate, gift and GST taxes.

The Act purports to permanently unify the estate and gift taxes, meaning that the same rate and exemption amount will apply to the estate tax and the gift tax. The Act increases the estate and gift tax rate from 35 percent to 40 percent and sets the GST tax rate at a flat 40 percent. In addition, the Act makes permanent the \$5 million estate, gift and GST tax exemption that has been in effect since 2011. This amount is adjusted for inflation after 2011, resulting in \$5.25 million estate, gift and GST tax exemptions for 2013.

Portability. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation

Act of 2010 included a provision that allowed a surviving spouse to use a deceased spouse's unused estate tax exemption, referred to as "portability." The Act makes permanent this portability provision, which otherwise would have expired on December 31, 2012. Thus, a married couple has a combined federal estate and gift tax exemption of \$10.5 million in 2013. However, there is currently no portability at the state estate tax level. Accordingly, estate plans should be carefully structured so as to take advantage of federal estate and gift tax portability to the maximum extent possible, while minimizing state estate tax liability. In addition, the GST tax exemption is still not portable, so careful planning is necessary for taxpayers who wish to minimize future estate taxes by setting up GST or "dynasty" trusts for their descendants.

Annual Gift Tax Exclusion. As in prior years, the annual gift tax exclusion continues to be indexed for inflation. The annual gift tax exclusion amount increased from \$13,000 per gift recipient for 2012 to \$14,000 per gift recipient for 2013.

Income Tax Changes

Rates for Individuals. The Act makes permanent the 10 percent, 15 percent, 25 percent, 28 percent, 33 percent and 35 percent marginal income tax rates for:

- Married taxpayers filing jointly with taxable income of \$450,000 or less.

- Heads of household with taxable income of \$425,000 or less.
- Unmarried taxpayers with taxable income of \$400,000 or less.
- Married taxpayers filing separately with taxable income of \$225,000 or less.

In addition, the Act creates a new top tax bracket with a marginal tax rate of 39.6 percent, which applies to taxpayers whose taxable income is higher than those listed above.

Rates for Trusts and Estates. The Act makes permanent the 15 percent, 25 percent, 28 percent and 33 percent marginal income tax rates for trusts and estates, while adding a new top 39.6 percent tax bracket, which applies after the first \$11,950 of income. Income earned by “grantor trusts” will continue to be taxed to the grantor at the grantor’s individual income tax rate.

Capital Gains and Dividends. For most taxpayers, the tax rate for capital gains and dividends remains 15 percent. However, the Act raises the top tax rate for capital gains and dividends to 20 percent for those taxpayers in the new 39.6 percent tax bracket. It should be noted that the Affordable Care Act (also known as “Obama Care”) imposes an additional 3.8 percent tax on investment income, which effectively increases the capital gains and dividends rates from 15 percent and 20 percent to 18.8 percent and 23.8 percent, respectively. S corporation shareholders should give careful consideration to whether this additional tax will apply to investment income received from the S corporation. Specifically, the 3.8 percent tax will apply to pass-through income earned by S corporation shareholders who do not actively participate in the business. On the other hand, pass-through income earned by S corporation shareholders who do actively participate in the business will not be subject to the additional tax imposed by the Affordable Care Act.

Alternative Minimum Tax. Following years of temporary patches, the Act permanently fixes

the Alternative Minimum Tax by increasing the 2012 exemption amount and indexing the exemption amount for inflation in 2013 and beyond.

Reinstatement of Limit on Itemized Deductions. The Act reinstates the “Pease” limitation on itemized deductions. The Pease limitation, which has not been in effect since 2010, applies when a taxpayer’s adjusted gross income exceeds the following specified amounts, which are indexed for inflation:

- \$300,000 for married taxpayers filing jointly.
- \$275,000 for heads of household.
- \$250,000 for unmarried taxpayers.
- \$150,000 for married taxpayers filing separately.

The Pease limitation reduces a taxpayer’s itemized deductions by the lesser of 3 percent of the amount by which the taxpayer’s AGI exceeds the specified amount or 80 percent of the amount of itemized deductions the taxpayer would otherwise be allowed to take.

Reinstatement of Personal Exemption Phase-out. The Act also reinstates the personal exemption phase-out (the PEP), which reduces the amount of personal exemptions allowable for certain higher income taxpayers. The PEP applies to taxpayers whose AGI exceeds certain threshold amounts. The threshold amounts at which the PEP will apply are the same as those amounts listed above for the Pease limitation. Under the PEP, a taxpayer’s allowable personal exemptions are reduced by 2 percent for each \$2,500 (or portion thereof) by which the taxpayer’s AGI exceeds the threshold amount.

Charitable Gifts From Retirement Plans

The Act reinstates a tax provision allowing taxpayers over age 70 1/2 to make up to \$100,000 per year of tax-free charitable distributions from an IRA. Although this provision expired at the end of 2011, the Act provides that transfers from an IRA to charity

made in January 2013 will be treated as having been made in 2012. Any transfers to charity made after February 1, 2013 will be treated as having been made in 2013. This provision has not been made permanent and is set to expire at the end of 2013. In addition, the Act provides taxpayers with a limited opportunity to take advantage retroactively of the IRA charitable rollover in 2012. Specifically, a taxpayer who received a distribution from his or her IRA between December 1, 2012, and December 31, 2012, may make a direct qualifying gift of a portion of that distribution to a qualifying charity until January 31, 2013. Subject to certain technical requirements, the charitable gift made by the taxpayer will be treated as if it had been made directly from the IRA to the charity.

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