

An Overview of Key Provisions of the American Taxpayer Relief Act of 2012

Tax, Trusts & Estates Department

Greenbaum, Rowe, Smith & Davis LLP Client Alert

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Signed into Law by President Obama on January 2, 2013

On January 1, 2013, Congress passed the American Taxpayer Relief Act of 2012 ("Act") which was signed into law on January 2, 2013. While certain provisions of the Act are considered to be "permanent", an overhaul of the Internal Revenue Code later this year or in a subsequent year could impact certain of the "permanent" changes. An overview of some of the Act's provisions, which are likely to be applicable to our clients, is provided below.

Important Provisions Included in the Act

Estate Tax

The \$5,000,000 gift and estate lifetime exemption has been made permanent and will be adjusted annually for inflation (it is expected that the IRS will set it at \$5,250,000 for 2013). The \$5,000,000 indexed exemption for the generation skipping transfer tax has also been made permanent. Portability (i.e., the provision in the estate tax law that allows a surviving spouse the benefit of the unused lifetime exemption of his or her predeceased spouse) has also been made permanent. The one downside of the new law is that the maximum estate tax rate has increased from 35% to 40%.

Individual Income Tax Rates

- Ordinary Income. The new law increased the highest marginal federal income tax rate to 39.6% for married couples filing jointly with \$450,000 of taxable income, heads of household filers with \$425,000 taxable income, and single filers with \$400,000 of taxable income. The existing tax brackets for lower income thresholds were not changed.

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- Long Term Capital Gains. Although the long term capital gains rate remains at 15% for most filers, those in the 39.6% tax bracket will be faced with a 20% capital gains rate and a 3.8% additional investment surtax (which will be used to fund healthcare).
- Temporary Payroll Tax Cut Expires. For each of the past two years, FICA withholding on wages had been reduced from 6.2% to 4.2% on the first \$100,000 of wages. The new law does not extend this payroll tax holiday. As a result, wage earners will see a direct adverse effect on their paychecks (of up to \$2,000 per year).

Miscellaneous Taxes

Many temporary tax provisions were extended for 2013, including but not limited to the child tax credit, the earned income credit, the American Opportunity tax credit, qualified tuition deductions, bonus depreciation, various research and energy credits, the temporary exclusion of the gain on the sale of certain small business stock, and the reduction of the recognition period for built-in gains tax in the case of S corporations.

Roth 401(k) Conversions

Effective January 1, 2013, 401(k) plans may be amended to permit participants to convert pre-tax accounts, including amounts accumulated prior to 2013, to designated Roth accounts within the same plan, without regard to the participant's eligibility to take a distribution from the plan. Prior to the enactment of the new law, 401(k) participants could only complete an in-plan Roth conversion with respect to the portion of their account balance that was otherwise distributable under the terms of the plan, such as on account of severance from employment, attainment of a particular age (e.g., 59½) or disability. Pre-tax contributions, and earnings on such amounts, that are converted to a designated Roth account are includable in the participant's gross income in the year of the conversion. Subject to certain timing and other restrictions, however, all Roth 401(k) contributions and earnings may be withdrawn tax free. The new, more flexible Roth conversion rules also apply to 403(b) and governmental 457(b) plans.

Qualified Charitable Distributions from IRAs

The Act reinstates, through the end of 2013, the ability for individuals aged 70½ or older to make "qualified charitable distributions" from their traditional or Roth IRAs to certain charitable organizations without having to include such amounts in gross income or take a charitable contribution deduction. To constitute a "qualified charitable distribution," the amount(s) donated by an IRA owner must, among other requirements, be transferred directly from the IRA to the recipient charity and cannot exceed the aggregate amount of \$100,000 in a single taxable year. Although excludible from gross income, qualified charitable deductions still count toward the annual "required minimum distribution" that generally must be taken by an IRA owner beginning in the calendar year after attaining 70½ years of age. Under special rules applicable for 2012, a taxpayer may make a qualified charitable distribution in January 2013 and

elect to treat it as having occurred in 2012. In addition, a taxpayer may retroactively elect to treat an IRA distribution received in December 2012 as a qualified charitable distribution for that year, provided, among other requirements, that cash in the distribution amount is transferred to the charitable organization in January 2013.

Important Provisions Not Included in the Act

Grantor Retained Annuity Trusts (“GRATs”). The President’s proposed changes to the taxation of grantor retained annuity trusts that had been considered, were not addressed in the Act. As a result, GRATs continue to be a tax planning technique to be considered in the appropriate circumstances.

Provisions Regarding the Tax Treatment of “Carried Interests”. As Congress has done in the past, it again considered changing the favorable tax treatment afforded “carried interests”, including profits interests that are granted in a partnership or limited liability company in exchange for services. Such changes were not contained in the Act as signed into law on January 2. As a result, the granting of such interests to a service recipient can still result in compensation for services being taxed at favorable capital gains rates under certain circumstances.

The two provisions discussed above, as well as certain others that were considered by Congress and not included in the Act, could again be considered and included as part of a tax overhaul at a later date.

Planning Opportunities and Next Steps

As a result of the stability provided under the Act in the estate and gift tax areas, it is now an opportune time for individuals to review their personal situations and consider moving forward with certain wealth transfer transactions or changes to their Wills which may have been put on hold. In addition, individuals with significant holdings in a 401(k) plan or an individual retirement account or annuity, may want to revisit the possibility of making a Roth election or contributing retirement holdings to a charity. The 4.6% increase in the highest marginal federal individual income tax rate makes contributions to qualified retirement plans more attractive than they have been in the last few years.

Please contact the attorneys in our **Tax, Trusts & Estates Department** if you have any questions regarding this Alert, or would like additional information concerning this important new tax legislation.

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