Highland Capital Brokerage

Stepping Back from the Cliff — Fiscal Cliff Tax Legislation Enacted

After much political bargaining, federal legislation has been enacted to address, among other things, the expiration of numerous tax provisions passed under the Bush and Obama administrations. Far from the "grand bargain" originally contemplated, the American Tax Relief Act of 2012 (HR 8, the "Act") only addresses the tax aspects of the so-called "fiscal cliff," leaving many other issues for later debate. The following provides a brief summary of what the Act does and does not do with regard to the taxation of high-income taxpayers.

What the Act Does

Increases Tax Rates for High-income Taxpayers

- **Reinstatement of 39.6 Percent Rate.** The Act permanently reinstates the previous highest income tax rate of 39.6 percent for taxpayers with "taxable income" over applicable thresholds (i.e., $400,000 (single filers); $450,000 (married, filing jointly); and $11,650 for estates and non-grantor trusts, the "39.6 percent thresholds"). The 39.6 percent thresholds (as well as the other income thresholds for the lower brackets) are subject to annual inflation adjustments after 2013.

  Practical Note: Generally, "taxable income" is adjusted gross income (AGI) reduced by allowances for personal exemptions and itemized deductions. These allowances will have substantially less impact for high-income taxpayers, however, due to the reinstatement of the personal exemption phase-outs and itemized deduction limitations, as discussed below.

  Practical Note: Given that the income threshold for application of the 39.6 percent income rate to non-grantor trusts is very low (e.g., $11,650 in 2012), trustees of these trusts will have greater incentives to distribute trust income to beneficiaries in lower brackets and/or to adjust trust investment portfolios toward tax-exempt and tax-deferred investments.

- **Higher Tax Rates on Capital Gains and Qualified Dividends.** For taxpayers with taxable income over the 39.6 percent tax thresholds, the tax rate on capital gains and qualified dividend income (QDI) increases from 15 percent to 20 percent.

  Practical Note: Although higher rates apply to QDI in 2013, the increase is not as significant as originally anticipated (e.g., taxation at ordinary income rates). Note, however, that the 3.8 percent Medicare contribution tax on net investment income will still apply to most capital gains and dividends at reduced threshold levels (i.e., $200,000 single filers/$250,000 married joint filers). Thus, for taxpayers in the highest income tax bracket, the effective tax rate on this income will be 23.8 percent.

- **Reinstatement of Itemized Deduction Limitations.**
  - The so-called "Pease limitation" on itemized deductions is reinstated for taxpayers with AGI in excess of specified thresholds (i.e., $250,000 for single filers; $300,000 for married, filing jointly), which are lower than the 39.6 percent thresholds. The itemized deduction thresholds are subject to annual inflation adjustments after 2013.

- The limitation is the lesser of 1) 3 percent of excess AGI over the specified threshold or 2) 80 percent of "unprotected" itemized deductions (e.g., mortgage interest, charitable contributions, state and local taxes).

  Example: B has $200,000 of unprotected itemized deductions. B's AGI is $1,500,000 ($1,250,000 over the $250,000 threshold). His $200,000 of itemized deductions is reduced by $37,500, based on the lesser of:

  - 3 percent of $1,250,000 (amount over AGI threshold) = $37,500, or
  - 80 percent of $200,000 (total itemized deductions) = $160,000.

Practical Note: The Pease limitation will effectively raise income taxes on a greater number of taxpayers than the income tax rate increases, due to application of the lower AGI thresholds (an effective tax rate increase of roughly 1.2 percent). It will also cause some taxpayers to experience real tax rates above the 39.6 percent level by limiting their ability to reduce AGI.

- **Personal Exemption Phase-out.** The Act phases out personal and dependency exemptions ($3,800 each in 2012, inflation adjusted) at 2 percent for each $2,500 of AGI in excess of the itemized deduction thresholds.

  Practical Note: This provision also raises income taxes on a broader number of individuals than affected by the 39.6 percent rate, due to the lower AGI thresholds.

Increases Top Estate, Gift and GST Tax Rates

- **Top 40 Percent Rate.** The maximum marginal estate and gift tax rates (and the flat generation-skipping transfer (GST) tax rate) increase from 35 percent to 40 percent.

  Practical Note: For "decoupled" states that impose a separate state estate tax, the combined effective estate tax rate could reach almost 50 percent (e.g., 49.6 percent in New York). This increases the incentive for lifetime gift planning, since most states do not impose a separate gift tax on lifetime transfers.

Makes Other Estate, Gift and GST Tax Provisions Permanent

- **$5 Million Estate, Gift and GST Tax Exemption, Inflation Adjusted.**
  - The Act permanently unifies the estate and gift tax exemption at $5 million, subject to annual inflation adjustments (e.g., $5.25 million in 2013).
  - The GST tax exemption amount is tied to the top estate tax exemption amount ($5.25 million in 2013).

  Practical Note: Clients who attempted to exhaust their gift and GST tax exemptions in 2012 will have some additional exemption to work with in 2013.

- **Deduction for State Death Taxes.** The Act allows continued deductions for state death taxes in calculating the federal taxable estate.
- **Exemption Portability.** The ability to elect portability of gift and estate tax exemption (but not GST tax exemption) between spouses is made permanent, with a retroactive technical correction to ensure that a surviving spouse receives the full amount of the deceased spouse's remaining estate tax exclusion (up to the basic estate tax exclusion amount in effect for the year of death).

Extends/Implements Certain Retirement Planning Options

- **Tax-free IRA Distributions for Charities.** The Act extends, until Dec. 31, 2013, the ability of individuals who have attained age 70½ to transfer up to $100,000 per year directly from an IRA to certain public charities without including the amount transferred in their gross income.
  - The Act also permits IRA distributions in January 2013 to be treated as having been made in 2012 for these purposes. In addition, it permits taxpayers who received distributions in December 2012 to treat the portion of that distribution that is transferred in cash to a public charity before Feb. 1, 2013, as if it had been transferred directly from the IRA to the charity for these purposes.
- **Roth Conversion Options for Certain Retirement Plans.** Effective after Dec. 31, 2012, the Act permits 401(k) and other qualified plans, 403(b) plans and 457(b) plans that permit Roth contributions to allow participants to elect to have the plan transfer to Roth accounts under the plan amounts that otherwise would not be distributable under the plan (for example, because of the limitations generally applicable to 401(k) or other elective deferrals). Participants would be subject to immediate tax on the amounts transferred.

Addresses Other Expiring Tax and Health Care Provisions

- **Permanent AMT Patch.** The original purpose of the alternative minimum tax (AMT) was to ensure that high net worth individuals paid a minimum amount of federal income tax. The AMT does not kick in, however, until a taxpayer earns income over a certain yearly threshold amount. To prevent an expansion of the number of households subject to the AMT, the Act increases the AMT exemption amount from $33,750 to $50,600 (and from $45,000 to $78,750 for joint returns) in 2012, and will index the AMT exemption amount, exemption phase-out threshold and income bracket beginning in 2013. As a result, fewer households will be subject to the AMT.
- **Other Extensions.** Other notable tax extensions for individuals include a one-year extension of unemployment benefits, a one-year extension of the election to deduct sales and use taxes (for individuals in states that do not charge income tax), and various extensions of individual tax credits and extenders (e.g., child tax credit, earned income tax credit, above-the-line deduction for qualified tuition and related expenses).

What the Act Does Not Do

Despite the significant energy spent in its negotiation, many tax issues were not raised or addressed by the Act and may remain of concern to individual taxpayers, including:

Expiration of the Payroll Tax Cut. The employee portion of the payroll tax will revert to 6.2 percent from 4.2 percent. That generates around $2,000 per year in additional payroll taxes for an individual earning $113,700 or more (the 2013 cap).

Health Care Taxes Have Significant Impact. The Act's tax increases for high-income taxpayers are in addition to the 3.8 percent Medicare contribution tax on net investment income and the 0.9 percent hospital insurance tax on wages, which apply at thresholds lower than the 39.6 percent thresholds (i.e., $200,000 for single filers; $250,000 for married, filing jointly).

Transfer Tax Issues May Remain on the Table. Although the Act made the estate, gift and GST tax rates and exemption levels permanent, it did not include other transfer tax changes proposed by the Obama administration in its annual federal budget proposals, including the estate taxation of grantor trust assets, imposition of 10-year minimum terms for grantor retained annuity trusts, limits on the duration of the GST tax exemption with regard to dynasty trusts, and additional limits on valuation discounts for transfers of family entity interests. As Congress continues to look for ways to reduce the federal deficit, these proposals may remain as options for revenue raisers.

More to Come

Given the significant tax increases enacted by the Act for high-income taxpayers, tax planning is more important than ever. Further analysis on the practical impact of these tax changes and possible strategies for individual income and estate tax planning will follow.

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