Client Alert

Chapman and Cutler LLP
Attorneys at Law · Focused on Finance®

CURRENT ISSUES RELEVANT TO OUR CLIENTS JANAUARY 8, 2013

The American Taxpayer Relief Act of 2012

Late in the evening of January 1, 2013, Congress passed the American Taxpayer Relief Act of 2012 (ATRA), avoiding the tax portion of the so-called "fiscal cliff." President Obama signed ATRA into law on January 2, 2013.

The American Taxpayer Relief Act of 2012 makes permanent many provisions of prior tax laws that were set to expire, although some are only extended and others phased out. Significantly, ATRA maintains the income tax rates/brackets for most taxpayers and keeps the $5 million transfer tax exclusion limit. This newsletter provides a brief overview of these provisions and others under the new law.

Estate, Gift, and GST Tax Highlights

Exemption amount. ATRA provides a $5 million unified estate and gift exemption (or "exclusion limit"), which is adjusted annually for inflation. The GST exemption also remains at $5 million. Thus, significant transfers of wealth still may be made free of taxation.

Transfer tax rates. ATRA increases the maximum federal estate, gift and GST tax rates to 40% from 35%.

Portability. If the estate of a decedent survived by a spouse makes the proper tax election, ATRA retains the surviving spouse's ability to add any unused exclusion amount of the decedent spouse to his or her own exclusion limit in calculating future transfer taxes.

Miscellaneous provisions. By making prior tax acts from 2001, 2003 and 2010 permanent, ATRA also preserves a variety of other provisions, such as: replacement of the state death tax credit with a deduction for state death taxes; repeal of the 5% surtax on estates greater than $10 million; expanded rules for the automatic allocation of GST exemption; and various other GST tax provisions.

Effective dates. These rules apply to estates of decedents dying and gifts and generation-skipping transfers made after December 31, 2012.

Permanency. ATRA makes the above changes permanent (i.e. there is no sunset), although additional tax legislation is possible.

Annual exclusions. Although not part of ATRA, the gift tax annual exclusion for 2013 has increased from $13,000 to $14,000.

Income Tax Highlights

Individual income tax rates. The income tax rates provided by the 2001 Tax Act are made permanent. However, ATRA increases the maximum income tax rate to 39.6% from 35% for a new top bracket of earners, those whose income exceeds $400,000 for individuals or $450,000 for married couples filing jointly. Taxpayers who are subject to the 39.6% income tax rate still benefit from the extension of all tax rates below that level.

Capital gains and qualified dividend rates. ATRA maintains the 15% maximum tax rate on both qualified dividends and long-term capital gains (with a 0% rate for taxpayers below the income thresholds for the 15% income tax bracket). However, for taxpayers who meet the new thresholds set for the 39.6% income tax rate, the maximum tax rate will be 20%. Other special purpose rates apply to categories such as collectibles.

Payroll taxes. ATRA did <u>not</u> extend the 2012 reduction in Social Security tax withholding, which results in a 2% increase from 4.2% to 6.2% for employees and from 10.4% to 12.4% for self-employed taxpayers.

Phase out of itemized deductions and personal exemptions. ATRA reinstates a phase out of personal exemptions and itemized deductions (as under pre-2001 rules), but at higher thresholds than the pre-2001 rules. These phase outs had been completely eliminated for 2010, 2011 and 2012. The new thresholds are $250,000 for individuals and $300,000 for married couples filing jointly and surviving spouses.

AMT. ATRA provides many taxpayers with relief from the alternative minimum tax (AMT) by retroactively increasing the exemption amounts for 2012 and permanently indexing these amounts for inflation in subsequent years.

Sales tax deduction. ATRA extends the deduction for state and local sales tax through 2013.

IRA distributions to charity. ATRA extends the so called "charitable rollover" rule for 2012 and 2013. An individual aged 70-1/2 or older may make an income tax-free distribution of up to $100,000 per year from an individual retirement account (IRA) to a public charity, which will satisfy the required minimum distribution (RMD) rules. Rollovers completed by February 1, 2013 can be treated as made in 2012, and an IRA distribution taken in December 2012 can be treated as a qualified charitable distribution in 2012 if transferred to a charity before February 1, 2013.

New Roth conversion rule*.* ATRA expands the ability of workers to convert traditional retirement accounts to Roth accounts. In 2010, the Roth conversion rules were expanded to allow employees who received a distribution from a traditional employer retirement plan (due to separation from service, attaining age 59-1/2, death or disability) to convert the distribution to a Roth IRA. ATRA expands these conversion rules to allow an "in plan" conversion. Under the new rule, any employee, regardless of age or employment status, may convert a traditional defined-contribution plan, including 401(k), 403(b), 457(b), and thrift savings plans, into a Roth 401(k) or Roth IRA, if offered by the employer. Employers may need to amend their plans to first allow for Roth accounts and then authorize the in-plan conversions. Amounts converted will be taxed as ordinary income. This strategy can be used to avoid future taxation on earnings and withdrawals and avoid mandatory retirement distributions.

Miscellaneous extensions. ATRA extends or makes permanent a variety of additional provisions, including marriage penalty relief, education incentives, consumer energy credits, and business tax credits.

Medicare contribution tax*.* Although not part of ATRA, as planned under the Patient Protection and Affordable Care Act, a Medicare contribution tax takes effect in 2013, taxing 3.8% of net investment income for certain taxpayers.

Planning Considerations

The American Taxpayer Relief Act of 2012 eliminated much of the recent uncertainty surrounding the tax laws. While ATRA provides a potentially permanent resolution to the "fiscal cliff" or the sunset and end to many tax provisions, Congress will still need to take action on the major issues of spending cuts and the debt ceiling when it reconvenes in February. As such, a variety of tax reform proposals still exist, including proposals designed to raise additional tax revenues. Therefore, comprehensive changes to the tax code remain possible.

If you have any questions regarding the implications of ATRA for your estate, gift, GST, and income tax planning purposes, contact one of your Chapman and Cutler LLP Trusts and Estates attorneys.

David S. Crossett
312.845.3011
crossett@chapman.com

Rebecca Wallenfelsz
312.845.3442
wallen@chapman.com

David A. Lullo
312.845.3902
lullo@chapman.com

Robert V. Lewis, Of Counsel
312.845.3733
rlewis@chapman.com

Ryan P. Powell
312.845.3487
rpowell@chapman.com

Molly Carney
312.845.3438
carney@chapman.com