Rates of Change: The Effect of the American Taxpayer Relief Act of 2012 on Individual and Fiduciary Income Taxes

For all the public discussion in 2012 of the need for a significant reformation and restructuring of the Internal Revenue Code, the income tax provisions of the American Taxpayer Relief Act of 2012 (the 2012 Act) are at their core simply an adjustment to tax rates. That is not to say, however, that the 2012 Act, which was signed into law by President Obama on January 2, 2013, creates simplicity—in fact, by creating a variety of different thresholds at which top marginal rates on various types of income apply, the new law has created additional complexity for taxpayers.

New Rates for Individuals. Here's a summary of the effect of the 2012 Act on individual income tax rates:

- *Ordinary Income*. For most taxpayers, Bush-era tax rates on ordinary income were reinstated and made permanent. However, individuals with taxable income of more than $400,000 and married couples filing jointly (hereinafter referred to simply as married couples) with taxable income of more than $450,000 are now subject to a top marginal rate of 39.6%.
- *Long-Term Capital Gains and Qualified Dividends*. The 2012 Act reinstates the 0% rate for long-term capital gains and qualified dividends of lower-income taxpayers, and makes permanent the 15% rate on those types of income for most other taxpayers. Individuals and married couples subject to the 39.6% marginal rate on ordinary income will be subject to a 20% rate on all or part of their long-term capital gain and qualified dividend income.

Medicare Taxes. Although enacted in 2010 as part of the Patient Protection and Affordable Care Act rather than as part of the 2012 Act, two new Medicare taxes first effective in 2013 will further boost aggregate tax rates for high-income taxpayers. A 3.8% tax applies to all or part of the investment income of individuals with adjusted gross income (AGI) of more than $200,000 and married couples with AGI of more than $250,000. A surtax of 0.9% (in addition to the base 1.45% paid by both an employee and his or her employer) applies to the earned income of taxpayers to the extent it exceeds these thresholds.

In taxable portfolios, the above rate increases are likely to encourage high-income taxpayers to invest in assets that produce qualified dividends or long-term capital gains, which will be taxed at lower rates relative to taxable interest, royalties, short-term capital gains, or other types of ordinary income. They also make investments in tax-exempt municipal bonds more appealing, heightening the after-tax return differential between those and corporate and U.S. government bonds.

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If taxable income exceeds...		the applicable tax rate is...			
Single Filer	**Married Filing Jointly**	**Ordinary Income**	**L-T Cap Gains & Qualified Dividends**	**Medicare - Earned Income***	**Medicare - Investment Income**
$ -	$ -	10.0%	0.0%	2.9%	0.0%
$ 8,925	$ 17,850	15.0%	0.0%	2.9%	0.0%
$ 36,250	$ 72,500	25.0%	15.0%	2.9%	0.0%
$ 87,850	$ 146,400	28.0%	15.0%	2.9%	0.0%
$ 183,250	$ 223,050	33.0%	15.0%	2.9%	0.0%
$ 200,000 **	$ 250,000 **	33.0%	15.0%	3.8%	3.8%
$ 398,350	$ 398,350	35.0%	15.0%	3.8%	3.8%
$ 400,000	$ 450,000	39.6%	20.0%	3.8%	3.8%

*Includes 1.45% tax paid by employers.

** AGI, not taxable income.

Pease Limitation and Personal Exemption Phase-Out. The 2012 Act relieved many taxpayers of the burden of the Pease limitation and the phase-out of the personal exemption, two legacy provisions that were otherwise scheduled to be resurrected in 2013. Starting in 2013, however, high-income taxpayers will be subject indefinitely to "PEP and Pease", which, by reducing or eliminating deductions, raise effective marginal tax rates beyond the nominal rates.

- *PEP*. The deduction for the personal exemption (which is $3,900 for 2013) is phased out gradually for single filers with AGI of more than $250,000 and married couples with AGI of more than $300,000. The deduction is completely phased out for single filers whose AGI exceeds $372,500 and married couples whose AGI exceeds $422,500.
- *Pease Limitation*. The Pease limitation reduces itemized deductions for single filers with AGI of more than $250,000 and married couples with AGI of more than $300,000 by 3% of the excess over those dollar thresholds, but not by more than 80% of their overall itemized deductions. The Pease limitation reduces the first deductions taken, which are often the deductions for state and local taxes and home mortgage interest, and may have a muted—or even no—effect on additional deductions for charitable contributions. For affected taxpayers, the Pease limitation adds approximately 1% to the marginal tax rate on income above the Pease thresholds.

Effect on Trusts and Estates. The tax rates on undistributed net income for non-grantor trusts and estates have for many years been highly compressed, meaning the top marginal rate is reached at a much lower dollar threshold than that applicable to individuals. As a result, a large proportion of the income of trusts and estates is likely to be taxable at the highest marginal rate. The 2012 Act restores most of the Bush-era rates for trust and estate income but also allows the top marginal rate for trusts and estates to reset from 35% to 39.6%. For 2013, that top rate is effective for taxable income exceeding $11,950. Just as individuals who are subject to the 39.6% bracket are subject to the new 20% capital gains rate, so too are trusts and estates. In addition, trusts and estates are subject to the 3.8% Medicare tax on the portion of their AGI in excess of the

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$11,950 threshold for the application of the 39.6% rate (or, if less, on all their undistributed net investment income).

Thus, the vast majority of a trust's undistributed ordinary income is likely to be taxed for federal purposes at 43.4%, and a trust's undistributed long-term capital gains will be taxed at 23.8%. In many cases, these rates may substantially exceed the rates at which the trust beneficiaries would be taxed on the same income if it were distributed by the trustee. Going forward, trustees will need to weigh carefully the minimization of overall trust/beneficiary income taxes against the objectives of the trust. In cases where there are no compelling reasons to accumulate income in a trust, the trustee may regularly choose to distribute trust income and, if permitted by the trust terms or a state principal and income statute, capital gains, so that the beneficiaries bear the tax at a lower rate than the trust otherwise would. In addition, trustees, like individuals, will seek to invest trust portfolios in assets that produce long-term capital gains and qualified dividend income.

Trusts and Estates			
If taxable income exceeds:	Ordinary Income	L-T Cap Gains & Qualified Dividends	Medicare - Investment Income
$ -	15.0%	0.0%	0.0%
$ 2,450	25.0%	15.0%	0.0%
$ 5,700	28.0%	15.0%	0.0%
$ 8,750	33.0%	15.0%	0.0%
$ 11,950	39.6%	20.0%	3.8%

AMT Reform. In addition to addressing income tax rates, the 2012 Act creates new, inflation-adjusted exemptions for the alternative minimum tax (AMT). For many years, the AMT exemptions have had to be amended annually—usually at the eleventh hour—to avoid subjecting large numbers of middle class taxpayers to a tax regime that was intended to ensure that high-income taxpayers with large deductions could not avoid income tax altogether. Under the AMT provisions of the 2012 Act, the 2013 AMT exemption for single taxpayers has risen from $33,750 to $51,900 and the exemption for married couples has risen from $45,000 to $80,800. Similar increases were made retroactively to the 2012 AMT exemptions.

Extenders. Much has been made in the media of the many "extenders" in the 2012 Act, which provide special benefits to certain taxpayers. Unless they happen to be motorsports moguls or movie producers, individual taxpayers may find some of the following extenders to be most beneficial:

- *Deduction for State and Local Sales Taxes*. The provision permitting a taxpayer to deduct state and local sales taxes in lieu of state and local income taxes has been extended for the 2012 and 2013 tax years. This provision has been particularly appealing to individuals who live in states without an income tax.
- *IRA Charitable Rollover*. The 2012 Act reintroduces the opportunity for individuals who are age 70 ½ or older to make qualified charitable distributions (sometimes called charitable "rollovers") of up to $100,000 per year from their IRAs. Except as provided below, these distributions, which are excluded from the taxpayer's income (and for which no deduction is available as a result), must be made

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directly to public charities (other than donor advised funds or supporting organizations). The 2012 Act makes the IRA charitable rollover available for the 2012 and 2013 tax years. Those taxpayers without sufficient prescience to have executed a charitable rollover while the law was off the books in 2012 have two opportunities to revise history:

- If a taxpayer makes a qualified charitable distribution from his or her IRA during January, he or she can elect to count it for 2012.
- If a taxpayer took a distribution from his or her IRA in December 2012, the taxpayer can contribute those funds to a public charity in January and treat the transaction as a qualified charitable distribution, as long as it would otherwise qualify as such. Thus, taxpayers who took their required minimum distributions in December can use those funds to make charitable contributions in January and exclude the amounts contributed from their 2012 taxable income.

- *Conservation Easement Deduction Rules*. A provision allowing an income tax charitable deduction of up to 50% of a taxpayer's contribution base (which for most taxpayers is their AGI) for a qualified conservation contribution, commonly referred to as a conservation easement, has been extended for the 2012 and 2013 tax years. In addition, to the extent that the deduction exceeds this limitation, the taxpayer can carry it forward for 15 years, rather than the standard 5 years. For qualified farmers and ranchers, such an income tax charitable deduction can be taken with respect to 100% of their contribution base, subject to certain limitations.

Roth Retirement Plan Conversions. The 2012 Act expands the opportunities for participants in certain types of qualified retirement plans (including 401(k), 403(b) or 457(b) plans) to convert their traditional retirement accounts to Roth retirement accounts. Post conversion, assets in the Roth account can grow and eventually be withdrawn free of further income tax. This Roth conversion feature, which formerly was available only with respect to amounts a plan participant was otherwise permitted to withdraw (e.g., after reaching age 59 ½, separating from service, or becoming disabled), is now available with respect to any amount in a traditional retirement account, provided that Roth accounts are offered under the retirement plan. As in the case of a Roth IRA conversion, a participant who converts a traditional retirement account to a Roth account will be subject to income tax on the amount converted.

We would be happy to talk with you about the effect of the 2012 Act on your situation. Please contact your advisor at Ropes & Gray with any questions.

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