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TAX E-ALERT
JANUARY 2013

FISCAL CLIFF AVERTED:
A BREAKDOWN OF THE AMERICAN TAXPAYER RELIEF ACT OF 2012

On January 2, 2013, President Obama signed into law the American Taxpayer Relief Act of 2012. The new law is a partial resolution to avert the looming fiscal cliff, and it addresses many tax provisions that were set to expire at the end of 2012. The following is a summary of some of the major provisions included in the Act as they pertain to:

- Income Tax Changes Affecting Individuals and Businesses;
- Estate Taxes;
- Charitable Giving; and
- Easier ROTH Conversions of 401(k) Accounts.

I. INCOME TAX CHANGES AFFECTING INDIVIDUALS AND BUSINESSES

HIGHER PAYROLL AND SELF-EMPLOYMENT TAXES ON ALL INDIVIDUALS

The temporary 2% reduction in (i) the employee's share of payroll taxes withheld from wages and (ii) the self-employment tax was not extended. After 2012, income at or below the ceiling amount, which is $113,700 in 2013, is subject to an additional tax of 2%.

HIGHER REGULAR INCOME TAX RATES ON CERTAIN INDIVIDUALS

As of January 1, 2013, taxable income of individuals above certain threshold amounts will be taxed at a top income tax rate of 39.6%. The threshold amounts are:

$400,000 - single filers
$425,000 - heads of households
$450,000 - married taxpayers filing jointly and surviving spouses
$225,000 - married taxpayers filing separately

After 2013, these dollar amounts will be adjusted for inflation.

PHASE-OUT OF THE PERSONAL EXEMPTIONS CLAIMED BY CERTAIN INDIVIDUALS

After 2012, personal exemptions are reduced by 2% for each $2,500 (or portion thereof) by which the taxpayer's adjusted gross income exceeds the following applicable threshold:

$250,000 - single filers
$275,000 - heads of households

$300,000 - married taxpayers filing jointly and surviving spouses
$150,000 - married taxpayers filing separately

After 2013, these dollar amounts will be adjusted for inflation.

PHASE-OUT OF THE ITEMIZED DEDUCTIONS CLAIMED BY CERTAIN INDIVIDUALS

After 2012, itemized deductions are reduced by 3% of the amount by which the taxpayer's adjusted gross income exceeds the personal exemption threshold amounts as stated in the preceding paragraph (adjusted for inflation) - not to exceed 80% of the otherwise allowable itemized deductions.

ALTERNATIVE MINIMUM TAX RELIEF

After 2011, the exemption amount is permanently increased to $50,600 for unmarried taxpayers and $78,750 for married persons filing jointly ($39,375 for married persons filing separately). After 2012, these dollar amounts are adjusted for inflation.

HIGHER TAX RATES ON CAPITAL GAINS AND DIVIDENDS REALIZED BY CERTAIN INDIVIDUALS

As of January 1, 2013, the top income tax rate imposed on capital gain and dividend income of individuals with taxable income exceeding $400,000 ($450,000 for married taxpayers) is 20% after 2012 (23.8% if the new 3.8% Medicare tax on net investment income also applies). The 0% and 15% rates (and the new Medicare tax) continue to apply for other taxpayers.

The following individual tax breaks are retroactively reinstated for 2012 and extended through 2013:

- The exclusion for a discharge incurred before 2014 of qualified principal residence indebtedness.
- The exclusion for employer-provided mass transit and parking benefits of $240 per month (increased from $125 per month).
- The above-the-line deduction for qualified tuition and related expenses.

The following depreciation provisions are retroactively reinstated for 2012 and extended through 2013:

- 15-year straight line cost recovery for qualified leasehold improvement property, qualified restaurant property and qualified retail improvement property.
- Increased expensing limitations, and the treatment of certain real property as being eligible for expensing.
- Bonus depreciation (subject to certain modifications) regarding property placed in service after 2012 in tax years ending after 2012.

The following business tax breaks are retroactively reinstated for 2012 and extended through 2013:

- The enhanced charitable deduction for contributions of food inventory.
- The exclusion of 100% of the gain on certain small business stock acquired before 2014.
- The reduction in the S corporation built-in gain recognition period to 5 years.

II. ESTATE TAXES

The new law made permanent the $5 million per person estate, gift and generation skipping tax exemptions, indexed for inflation. Despite fears that the gift tax exemption would be limited to $1 million, Congress permanently unified all three taxes. Although not confirmed by the IRS as yet, the 2013 exemption amount for all three transfer taxes as so indexed will be $5,250,000. The law also ***increased*** the top estate and gift tax rate from 35% to 40%. Effectively, a 40% flat tax rate applies on amounts exceeding the exemption amount.

The portability of any unused estate tax exemption from a deceased spouse to his or her surviving spouse was also retained and made permanent. For a complete discussion of portability, see our December 2012 Trusts & Estates Group Update.

III. CHARITABLE GIVING

The Pension Protection Act of 2006 (PPA) made significant changes, temporarily, to the rules governing charitable contributions. With the passage of the American Taxpayer Relief Act of 2012, several favorable rules have been extended through December 31, 2013.

GIFTS OF IRA ASSETS TO CHARITY

Funding lifetime charitable giving from IRA assets had traditionally been a bad choice for donors because, among other reasons, the gross income attributable to a withdrawal from an IRA may not have been fully offset by the available charitable contribution deduction. This could result in a taxable event even though the entire amount of the withdrawal was contributed to charity. The PPA provided a charitable giving incentive by granting an annual exclusion from gross income of up to $100,000 for qualified charitable distributions from an IRA, thereby removing the multitude of potential negative tax drawbacks traditionally associated with funding charitable contributions with IRA withdrawals. The new law reinstates this opportunity, which had expired at the end of 2011. It is now revived for 2012 and continues through 2013. Because 2012 has already passed, a special rule permits distributions taken in 2012 to be transferred to charities for a limited period in 2013. Another special rule permits certain distributions made in 2013 as being deemed made on December 31, 2012.

CONSERVATION EASEMENTS

To encourage contributions of real property for conservation purposes, the PPA made several favorable changes to the percentage limitation rules applicable to "qualified conservation contributions" by individuals.

Under the PPA, a limitation of 50% of the donor's contribution base (roughly, adjusted gross income) applies to conservation contributions by individuals. In the case of an individual who is a "qualified farmer or rancher" for the tax year of the contribution, the percentage limitation for qualified conservation contribution is increased to 100% of the donor's contribution base.

The deduction for qualified conservation contributions is considered after all other allowable charitable contribution deductions. Thus, current year contributions to all other organizations, and presumably any carryover from a prior year, are deducted before qualified conservation contributions. This ordering regime is particularly favorable because any unused deduction attributable to qualified conservation contributions may be carried over for up to 15 taxable years, rather than the five-year carryover period that applies to all other contributions.

LIMITED BASIS REDUCTION FOR GIFTS OF SUBCHAPTER S STOCK

A change benefiting shareholders of S corporations making charitable contributions can best be illustrated by the following example. Assume an S corporation with two equal individual shareholders makes a charitable contribution of capital gain property having a fair market value of $100,000 and an income tax basis of $25,000. Under the PPA, each shareholder has a pass-through charitable deduction equal to $50,000, but will reduce the basis of S corporation stock by only $12,500. Prior to the PPA, each shareholder's S stock basis stock would have been reduced by the entire amount of the $50,000 pass-through charitable contribution deduction.

IV. EASIER ROTH CONVERSIONS OF 401(K) ACCOUNTS

In order to pay for two months without budget savings, the new law latched on to a great source of new tax revenue: unrestricted conversions of qualified 401(k) plan money to ROTH status.

Under the old law, a qualified 401(k) plan could be amended to allow for taxable ROTH conversions of individual accounts, but only in circumstances when the plan could otherwise distribute the money. For the typical 401(k) saver, this meant that ROTH conversion within a qualified plan was not allowed until age 59½.

Beginning in 2013, that restriction has been lifted. Regardless of age, a qualified 401(k) plan participant can now elect to pay taxes early (without the 10% early payment penalty) and convert a qualified plan account to ROTH status. This is not limited to money contributed after 2012; it applies to all existing plan funds and is not limited to the 401(k) deferrals themselves. Plan amendment is necessary, and explanatory rules from IRS will be helpful, but employers with 401(k) plans should have this on their radar. Properly implemented, converted ROTH plan accounts can be transferred to ROTH IRAs after age 59½. No minimum distributions at age 70½ are required from ROTH IRAs, and investment earnings, whether earned in the ROTH Plan account or the ROTH IRA, can escape all taxes.

If you have any questions about this alert or would like further information on the recent tax changes, please contact one of the authors, Brian L. Gaudet, Marjorie Suisman, Donna M. White, or George L. Chimento.

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