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Leverage and the New Tax Law

To explain the physical principles of a lever, the ancient Greek mathematician Archimedes declared: "Give me somewhere to stand and I will move the earth."[1] Archimedes knew well that a lever allows the user to magnify force in order to move a heavier object than the individual normally has the power to move. With the passage of the American Taxpayer Relief Act of 2012 (ATRA), professional advisors might feel the same confidence in estate and tax planning as Archimedes felt about levers, now that the new tax laws made permanent a number of federal estate tax and gift tax provisions.

Over the past decade, we lived with the knowledge that key tax items could change from year to year—rates, exemption amounts, etc.—and that those changes often came with a sunset date at which time the item would revert to the previous law. This transitory nature of the tax law made it difficult to plan with any certainty.

In 2010, Congress extended many of the Bush-era tax laws for an additional year or two, but 2013 would have marked the return of 1990's tax rates and structures unless Congress took action. After approaching the fiscal cliff, Congress did act by passing ATRA, a wide-ranging tax law that affects taxpayers in a variety of ways and adds a degree of permanence to some provisions in the tax code. While ATRA provides solid planning tools by continuing the historic estate and gift tax exclusions, it also creates new planning challenges by increasing income taxes and capital gains taxes on higher income taxpayers.

In this issue of *The Good Advisor*, we will examine recent changes to the federal tax law—both ATRA and the new tax provisions resulting from the Patient Protection and Affordable Care Act. We will also explore how the law appears to be set for the immediate future (with the caveat that Congress could make additional changes at any time). Knowing what has changed gives advisors and their clients the "lever" they need to do some heavy estate and tax "lifting" going forward.

INCOME TAX: THE THIRD ORDER LEVER

A third order lever has the force between the point of the fulcrum and the load (think of a crane lifting steel beams for a building). This type of lever requires the most force to move the load, but maximizes the force so that the load is moved further than the effort would otherwise allow.

In this sense, the high-income taxpayer does the truly heavy tax lifting—they pay more in taxes, and as a group they provide the most tax revenue for the federal government. Beginning in 2013, high-income taxpayers have a new top income tax bracket of 39.6%, a higher capital gains tax rate, and a 3.8% surtax on investment income.

Income Tax Rates

In 2013 and going forward, there are seven income tax rates – 10%, 15%, 25%, 28%, 33%, 35% and 39.6%.[2] (Estates and trusts do not have a 10% or a 35% rate.)

In 2013, the threshold for the top income tax rate of 39.6% depends on the taxpayer's status:

- $400,000 for single taxpayers
- $425,000 for heads of household
- $450,000 for married filing jointly
- $225,000 for married filing separately
- $11,950 for estates and trusts[3]

The threshold level for each status is tied to inflation and will likely increase from year to year.[4]

Long-Term Capital Gains Tax Rates

Capital gains tax rates applicable in 2012 remain the same in 2013 except for the imposition of a top tax rate of 20% for higher-income taxpayers:

Top Income Tax Rate	Long-Term Capital Gains Tax Rate
10% or 15%	0%[5]
25%, 28%, 33% or 35%	15%[6]
39.6%	20%[7]

The new 20% rate applies to income that exceeds a threshold of $450,000 for married couples filing jointly, $400,000 for single taxpayers, and $425,000 for heads of household.

Qualified Dividends Rate

Qualified dividend income is taxed in the same manner as long-term capital gains, including the top tax rate of 20%.[8]

New Tax on Unearned Income

As a part of the Patient Protection and Affordable Care Act, individuals with more than $200,000 in income ($250,000 for a married couple filing jointly) will pay an additional tax of 3.8% on net investment income or the excess of modified adjusted gross income over the threshold amount (whichever amount is less).[9] Investment income is defined as the sum of gross income from interest, dividends, annuities, royalties, and rents and net gain attributable to the disposition of property (i.e., capital gains) and does include passive income.[10] However, it does not include retirement plan distributions,[11] nor does it include income from a Subchapter S corporation or partnership subject to self-employment tax.[12]

Income Tax Itemized Deductions

ATRA also extended certain deductions:

- state and local sales tax deduction (rather than the income tax)
- tuition and expenses deduction
- student loan interest deduction.[13]

Additionally, the threshold for claiming medical expense as an itemized deduction increased to 10% of adjusted gross income (AGI), though individuals age 65 and older will continue to use 7.5% as a threshold from 2013 to 2016.[14]

Pease Limitation on Itemized Deductions

The Pease limitation on itemized deductions has also returned for single taxpayers making $250,000, married couples filing jointly who make $300,000, and heads of household making $275,000.[15] This limitation reduces the amount a high-income taxpayer can take as itemized deductions to the lesser of:

- 3% of AGI in excess of the threshold, or
- 80% of the itemized deductions allowed for the year[16]

Personal Exemption Phaseout

The personal exemption phaseout (PEP) is once again law for single taxpayers making $250,000, married couples filing jointly who make $300,000, and heads of household making $275,000.[17] The PEP reduces a high-income taxpayer's personal exemptions by 2% for each $2,500 of AGI in excess of the threshold dollar amount.[18]

Leverage: Higher Income Tax Rates = Greater Benefit from Charitable Giving

Higher income tax rates and possible limitations on itemized deductions may require higher income taxpayers to plan a little more carefully. However, one thing that hasn't changed is the tax advantage of charitable giving.

The value of a deductible charitable contribution depends on the donor's top marginal income tax rate. For instance, a taxpayer who pays a 39.6% marginal tax rate would save $3,960 on federal income taxes by contributing $10,000 to charity. Plus, for capital gain property, the capital gains tax savings can also be considerable. Of course, the donor can deduct the full value of the stock, even though the capital gain has never been taxed. That means the 2013 increase in capital gains taxes (as high as 23.8% when including both the top 20% rate and the 3.8% net investment income tax) makes the tax savings from a gift of appreciated property even more valuable to the donor.

The return of the Pease limitation concerns higher-income taxpayers because it reduces a taxpayer's total amount of deductions by either 3% of AGI in excess of the threshold, or 80% of total deductions, whichever is less. This affects charitable contributions that are taken as itemized income tax deductions. However, the limitation is more often based on a taxpayer's AGI and not the level of the taxpayer's itemized deductions.

2013 PAYROLL TAX RATES: TWO SIGNIFICANT CHANGES

1. The Old-Age, Survivors, and Disability Insurance tax rate returned to 6.2%. In 2011 and 2012, the rate paid by employees on earnings up to a certain amount ($110,100 in 2012) was cut to 4.2% as a measure to stimulate the economy.[19] Congress decided not to renew the payroll tax cut and the temporary provision expired.
2. The Hospital Insurance tax rate on earnings above a threshold amount increased. Starting in 2013, an additional 0.9% tax applies to earnings above $200,000 ($250,000 for a married couple filing jointly).[20] Unlike the OASDI tax, the HI tax applies to all earnings.

TRANSFER TAX: NO MORE UP AND DOWN

Nearly everyone is familiar with a first order lever, best exemplified by the classic playground see-saw. Previously, the unified applicable exclusion, tax rates, and spousal portability all lacked statutory certainty, leaving donors to worry whether their estate plans would be sufficient, or if the estate tax see-saw would soon move in the opposite direction. Fortunately, ATRA ended the constant teeter-tottering of plans. Now, professional advisors and clients can create plans that meet both estate planning and philanthropic goals.

Transfer Tax Rates and Applicable Exclusion

The top tax rate for gifts, estates and generation-skipping transfer tax rose from 35% to 40% and is permanent.[21] The applicable exclusion amount for estate taxes and gift taxes remains unified at $5 million and will be annually adjusted for inflation (in 2013 it is $5.25 million).[22]

Deduction for State Estate Taxes

ATRA also made permanent the change in federal tax law that granted a deduction rather than a credit for state estate taxes paid.[23] This allows a deduction for any estate, inheritance, legacy, or succession taxes actually paid to any state from the value of the gross estate.

Spousal Portability

The advantage of spousal portability (also referred to as the deceased spousal unused exclusion amount or DSUE) is now a permanent feature of the federal tax law.[24] If the executor files Form 706 and elects portability, the DSUE can be transferred to the surviving spouse and applied to lifetime or testamentary transfers.

Charitable Giving

Leverage: IRA Charitable Rollover

The IRA Charitable Rollover is effective for 2012 and 2013. This provision (technically known as a qualified charitable distribution from an IRA) permits an account owner age 70 1/2 or older to direct money straight from the IRA to the charity—up to $100,000 per year per person.[25] The distribution counts toward the owner's required minimum distribution (RMD) for that year, but does not qualify as a charitable contribution for purposes of the income tax deduction.

In addition to avoiding the penalties for failing to withdraw an RMD, the distribution amount is excluded from the owner's income on the federal level. For someone who does not need the income, this is a great way to take an RMD without increasing AGI, which is the basis for calculating many tax items. For those who do not itemize any deductions, the IRA Charitable Rollover is preferable to a cash contribution because the lowered income has the same effect as a gift made/deduction taken.

Leverage: Qualified Conservation Contributions

ATRA kept in place the enhanced deduction rules for contributions of real property for conservation purposes for all of 2012 and 2013. A taxpayer can deduct a qualified conservation contribution up to 50% of AGI the year the gift is made rather than the 30% for typical property gifts. In addition, the carryover of any excess deduction can be applied in up to 15 successive years rather than the typical five.[26] Furthermore, certain farmers and ranchers can deduct up to 100% of AGI for these gifts.[27]

LEVERS AND THE NEW TAX LAW: SMARTER, NOT HARDER

Archimedes was certainly right: using a lever allows a person to work smarter and accomplish a task that otherwise might have been impossible. In the same way, the new tax law provides professional advisors with tools to help their clients plan smarter. Using tools such as the considerable estate and gift tax applicable exclusion, the charitable IRA rollover, and making gifts with the tax-advantaged assets, you can help clients achieve both philanthropic and estate planning goals.

Endnotes

1 *Greek Mathematical Works*, by Ivor Thomas, Loeb Classical Library, Harvard University Press, Cambridge, 1941, vol. II, p. 35.
2 IRC Secs. 1 (a)-(e).
3 Rev. Proc. 2013-15.
4 IRC Sec. 1(i)(3(C).
5 IRC Sec. 1(h)(11).
6 IRC Sec. 1411.
7 IRC Sec. 1411(c)(1).
8 IRC Sec. 1411(c)(5).
9 IRC Sec. 1411(c)(4).
10 IRC Secs. 164(b)(5)(A) and (b)(5)(I); IRC Sec. 222(e); IRC Sec. 221(b).
11 IRC Sec. 56(b)(1)(B).
12 IRC Sec. 68(b)(1).
13 IRC Sec. 68(a).
14 IRC Sec. 151(d)(3)(A).
15 IRC Sec. 151(d)(3)(B).
16 IRC Sec. 3101(a).
17 IRC Sec. 3101(b).
18 IRC Sec. 2001(c); IRC Sec. 2502; IRC Sec. 2614.
19 IRC Sec. 2010; Rev. Proc. 2013-15.
20 IRC Sec. 2058.
21 IRC Sec. 2010(c)(4); IRC Sec. 2505(a).
22 IRC Sec. 408(d)(8).
23 IRC Sec. 170(b)(1)(E).
24 IRC Sec. 170(b)(1)(E)(iv).

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Impact of the American Taxpayer Relief Act of 2012

In This Issue:

- Income Tax Rates
- Itemized Deductions and Personal Exemptions
- Capital Gains and Dividends
- Income Tax Credits
- Transfer Taxes
- Corporate Taxation
- Charitable Giving
- Permanency of the Federal Tax Code

The American Taxpayer Relief Act of 2012 (ATRA) has two salient features:

- **Permanence.** Unlike prior tax legislation, ATRA does not contain a "sunset" provision that effectively repeals the law at the end of a set term. Instead of waiting for Congress to act or guessing what Congress might do, individuals, estates/trusts, and businesses can now plan with a greater degree of confidence.
- **Progressivity.** ATRA contains several measures that raise taxes on higher-income taxpayers. There are higher top marginal tax rates. There are rules on the phaseout of itemized deductions and personal exemptions for those taxpayers with income above a certain threshold. And there is the added impact of new taxes associated with the healthcare law which take effect this year.

In this issue, we not only summarize the recent changes in the tax law, we also take a look at planning opportunities offered by the newfound permanence of the tax code and consider ways to avoid the brunt of potentially higher taxes.

Income Tax Rates

Now there are seven income tax rates—10%, 15%, 25%, 28%, 33%, 35% and 39.6%.[1] (Estates and trusts do not have a 10% or a 35% rate.)

The threshold for the top income tax rate of 39.6% depends on the taxpayer's status. In 2013, the top income tax rate applies to income above:

- $400,000 for single taxpayers
- $425,000 for heads of household
- $450,000 for married filing jointly
- $225,000 for married filing separately
- $11,950 for estates and trusts[2]

The threshold level for each status is tied to inflation and will likely increase from year to year.[3]

> **Note: 35% Income Tax Rate**
> This year the 35% income tax rate will only apply to taxable income greater than $398,350 and less than $400,000 for single taxpayers. Less than 500 single taxpayers are projected to have 35% as a top marginal tax rate out of a total of over 72 million single taxpayers filing.[4]

Marriage Penalty Relief

ATRA avoids the marriage penalty by expanding the 15% income tax bracket for married couples filing jointly to twice the amount ascribed to single taxpayers,[5] and by providing a standard deduction for married couples filing jointly that is double the amount of the deduction available to single taxpayers.[6]

New Tax on Unearned Income

As a part of the Patient Protection and Affordable Care Act (PPACA), individuals with more than $200,000 in income ($250,000 for a married couple filing jointly) will pay an additional tax of 3.8% on net investment income or the excess of modified adjusted gross income over the threshold amount (whichever amount is less).[7]

Investment income is defined as the sum of gross income from interest, dividends, annuities, royalties and rents, and net gain attributable to the disposition of property (i.e., capital gains). It does include passive income.[8] However, it does not include retirement plan distributions,[9] nor does it include income from a Subchapter S corporation or partnership subject to self-employment tax.[10]

Avoid Income Tax on Estates and Trusts if Possible

The recent return to the Clinton-era top income tax rate of 39.6% is a significant jump. Plus, the 3.8% net investment income tax associated with the PPACA can increase the top rate to 43.4%. Of course, the top income tax bracket begins for a married couple filing jointly at $450,000 this year. But, income tax brackets are severely compressed for estates and trusts, so the top income tax bracket begins at the low, low threshold amount of $11,950 in 2013. For that reason, executors and trustees should take a hard look at deferring, reducing or avoiding taxable income. For example:

- Consider the timing of distributions and what tax liability an individual beneficiary would bear.
- Change asset allocation to investments that are not subject to normal income taxes and will not trigger the net investment income tax (e.g., tax-exempt bonds).

New Tax on Wages

The Hospital Insurance (HI) tax rate on earnings above a threshold amount increased. Starting in 2013, an additional 0.9% tax applies to earnings above $200,000 ($250,000 for a married couple filing jointly).[11] These threshold numbers are not indexed to inflation. Unlike the 6.2% social security tax, the HI tax applies to all earnings. Employers do not match the additional 0.9% tax.

The combined effect of a higher top income tax rate, a higher capital gains tax rate and the additional HI tax could prompt higher-income earners to look for ways to defer salary and bonuses. For example:

- Maximize contributions to employer-sponsored qualified plans such as traditional 401(k)s.
- Participate in a non-qualified deferred compensation plan (if the employer offers one, and the employee does not mind the unsecured nature of the obligation).[12]

Itemized Deductions and Personal Exemptions

Itemized Deductions

ATRA also extended certain deductions:

- State and local sales tax deduction (rather than the state income tax)
- Tuition and expenses deduction
- Student loan interest deduction[13]

The increased phaseout ranges for eligibility based on modified adjusted gross income for the student loan interest deduction are now permanent.[14] Plus, the former limit on the deduction to 60 months from repayment has been permanently deleted.[15]

Additionally, the threshold for claiming medical expense as an itemized deduction increased to 10% of adjusted gross income (AGI), though individuals age 65 and older will continue to use 7.5% as the threshold from 2013 to 2016.[16]

Pease Limitation on Itemized Deductions

The Pease limitation on itemized deductions has returned for single taxpayers making $250,000, married couples filing jointly who make $300,000, and heads of household making $275,000.[17] This limitation reduces the amount a high-income taxpayer can take as itemized deductions to the lesser of:

- 3% of AGI in excess of the threshold, or
- 80% of the itemized deductions allowed for the year[18]

The following deductions are not affected by the Pease limitation:

- Medical and dental expenses
- Investment interest
- Casualty, theft or gambling losses[19]

Aaron and Andrea have an AGI of $500,000 in 2013. They paid $60,000 in state and local taxes, $25,000 in mortgage interest, and gave away $35,000 in charitable contributions—a total of $120,000 in itemized deductions.

Because their income exceeds the $300,000 threshold, they are subject to the Pease limitation, and their itemized deductions will be reduced by either (1) 3% of AGI in excess of the threshold, or (2) 80% of total deductions—whichever amount is less.

(1) .03 x ($500,000-$300,000) = $6,000

(2) .80 x $120,000 = $96,000

Aaron and Andrea will be able to deduct $114,000 ($120,000 - $6,000) on their 2013 income tax return.

Pease Limitation and Charitable Giving

Because the Pease limitation reduces a higher-income taxpayer's total deductions, it could affect charitable contributions that are taken as itemized income tax deductions. However, as in our previous example, the limitation is more often based on a taxpayer's AGI rather than the level of the taxpayer's itemized deductions. For most donors, the Pease limitation should not be an obstacle to realizing the tax benefit of a charitable contribution.

Beth is a single taxpayer with an AGI of $400,000 and total itemized deductions (comprised of mortgage interest and state income taxes) of $20,000. She is subject to the Pease limitation, and her itemized deductions will be reduced by (1) 3% of AGI in excess of the threshold, or (2) 80% of total deductions—whichever amount is less.

(1) .03 x ($400,000-$250,000) = $4,500

(2) .80 x $20,000 = $16,000

If Beth decides to make a gift of $80,000 to a local charity—an amount four times greater than the current total of itemized deductions she plans to take—how does that impact the amount she can deduct? It doesn't, because the lesser amount continues to apply.

(1) .03 x ($400,000-$250,000) = $4,500

(2) .80 x $100,000 = $80,000

But, to be sure, a charitably minded donor like Beth should run this calculation as part of her annual income tax planning.

Personal Exemption Phaseout

The personal exemption phaseout (PEP) is once again law, affecting single taxpayers making $250,000, married couples filing jointly who make $300,000, and heads of household making $275,000.[20] The PEP reduces a high-income taxpayer's personal exemptions by 2% for each $2,500 of AGI in excess of the threshold dollar amount.[21]

> Chris is a single taxpayer with an AGI of $312,500 in 2013. His AGI in excess of $250,000 is $62,500. The percentage loss of the personal exemption would be 50% ($62,500 / $2,500 = 25 x 2%). Since the standard personal exemption is $3,900 this year, Chris could claim $1,950 as his personal exemption.

Alternative Minimum Tax

The law increased the exemption amounts for the Alternative Minimum Tax for 2012 and set them to rise with inflation from year to year.[22]

In 2013, the exemption amount depends on the taxpayer's status:

- $80,800 for married taxpayers filing jointly and surviving spouses
- $51,900 for unmarried individuals
- $40,400 for married taxpayers filing separately
- $23,100 for trusts and estates[23]

Also, the threshold between application of the 26% and 28% AMT rates has been set to rise with inflation from year to year.[24] In 2013, the initial $179,500 of AMT income will be taxed at 26%. The excess amount will be taxed at 28%.[25]

An important benefit to taxpayers potentially subject to the AMT is that nonrefundable personal tax credits are allowed to the full extent in both regular tax and AMT liability.[26]

Capital Gains and Dividends

Long-Term Capital Gains Tax Rates

Long-term capital gains tax rates applicable in 2012 remain the same in 2013 except for the imposition of a top tax rate of 20% for higher-income taxpayers:

Top Income Tax Rate	Long-Term Capital Gains Tax Rate
10% or 15%	0%
25%, 28%, 33% or 35%	15%
39.6%	20%

The implementation of ATRA not only added a new capital gains tax rate, it also increased the complexity of determining the amount of tax owed. To calculate the capital gains tax owed, the taxpayer has to look at overall income, and then apply the appropriate tax rate to the capital gain. The new 20% rate applies to capital gains income for taxpayers who exceed an income threshold of $450,000 for married couples filing jointly, $400,000 for single taxpayers, and $425,000 for heads of household. The tax is progressive so a taxpayer could be subject to both the 15% and 20% tax rate on capital gains in the same tax year.

> Denise is a single taxpayer with ordinary income of $390,000 and $60,000 of long-term capital gains. Her initial $10,000 of capital gain (the amount below the $400,000 threshold) is taxed at a 15% capital gains tax rate. The remaining $50,000 (the amount above the threshold) is taxed at a 20% capital gains tax rate.

Qualified Dividends Tax Rates

A dividend is generally defined as a corporate distribution to shareholders, based on their stock holdings, made out of current or accumulated earnings and profits, unless the distribution is specifically treated as a non-dividend by tax law (e.g., as a redemption or liquidation distribution). Dividends eligible for the special tax rate are those received from domestic corporations and certain qualifying foreign corporations whose stock is traded on a U.S. securities exchange or other established market.[27]

Qualified dividend income is taxed in the same manner as long-term capital gains, including the top tax rate of 20%.[28]

Income Tax Credits

The Child Tax Credit is a nonrefundable credit of $1,000 per child.[29] Taxpayers who owe less tax than the total credit can claim an "additional child tax credit" of the lesser of:

- The unclaimed portion of the nonrefundable credit, or
- 15% of earned income above $3,000[30]

If the taxpayer has three or more children, this calculation includes the amount paid in social security taxes.[31]

The Adoption Tax Credit is a nonrefundable credit up to $10,000 (as adjusted for inflation).[32]

The American Opportunity Tax Credit is a partially refundable credit against federal income taxes for tuition and related expenses that includes four years of college and covers books and course materials.

The Child and Dependent Care Tax Credit is a nonrefundable credit for 35% of child or dependent care expenses (up to $3,000 for one child or dependent, $6,000 for two or more) paid by the taxpayer and necessary in order for the taxpayer to be gainfully employed. (The amount is reduced to 20% for higher-income taxpayers.)[33]

Rest in Peace

The following provisions were permanently removed from the federal tax code as a result of the passage of ATRA:

- The estate tax deduction for qualified family-owned business interests (QFOBI)[34]
- The 18% reduced capital gains for property sold after a five-year holding period[35]
- The estate tax credit for estate taxes paid on the state level[36]

Transfer Taxes

Transfer Tax Rates and the Applicable Exclusion Amount

The top tax rate for gifts, estates and generation-skipping transfer tax rose from 35% to 40% and is permanent.[37] The applicable exclusion amount for estate taxes and gift taxes remains unified at $5 million and will be annually adjusted for inflation (in 2013 it is $5.25 million).[38]

The gradual shift of federal estate tax away from even modestly wealthy Americans continues under the new law. One commentator notes that more than 99.8% of estates in 2013 will owe no tax:

> Among the 3,780 estates that will pay the tax, the 810 largest—those with gross assets exceeding $20 million—will account for nearly three-fourths of the total estate tax revenue… About one-fifth of the burden will fall on estates valued between $10 million and $20 million, while just 7% will come from estates worth less than $10 million.[39]

Deduction for State Death Taxes

ATRA also made permanent the change in federal tax law that grants a deduction rather than a credit for state death taxes paid.[40] This allows a deduction for any estate, inheritance, legacy, or succession taxes actually paid to any state from the value of the gross estate.

Spousal Portability

The advantage of spousal portability (also referred to as the deceased spousal unused exclusion amount or DSUE) is now a permanent feature of the federal tax law.[41] If the executor files Form 706 and elects portability, the DSUE can be transferred to the surviving spouse and applied to lifetime or testamentary transfers.

Generation-Skipping Transfer Tax

Favorable provisions for utilizing the generation-skipping transfer (GST) tax exemption are now permanent. These provisions include:

- Deemed allocation and retroactive allocation[42]
- Qualified severance of a trust[43]
- Valuation rules with respect to the determination of the inclusion ratio[44]

Installment Payments on Estate Tax

An estate that contains a closely held business may have difficulty paying its tax liability without having to sell the business interest itself. However, qualifying estates can make equal payments on that tax liability over 14 years.[45] This 14-year period is comprised of the five initial years of interest-only payments overlapping by one year with the 10-year period for paying principal and interest.

ATRA made permanent the more permissive rules for qualifying as an estate (e.g., the increased number for partners/shareholders allowed in the closely held business).[46]

Corporate Taxation

Accumulated Earnings Tax

In addition to the regular income tax, a corporation is also liable for an extra tax if it allows earnings or profits to accumulate unreasonably inside the corporation instead of being distributed to the shareholders. This tax is designed to penalize corporations that retain income to avoid making dividend distributions that are taxable to the shareholders but not deductible by the corporation.

For tax years after December 31, 2012, the accumulated earnings tax rate is increased to 20%.[47]

Personal Holding Company

A corporation may be taxed as a personal holding company if more than half of its stock is owned by five or fewer individuals and if at least 60% of its adjusted ordinary gross income is considered personal holding company income. Such income includes investment income and income from personal service contracts where the corporation does not have the right to select the individual who will perform the services and where the person chosen by the client is the owner of 25% or more of the outstanding stock. In 2013, the tax rate on undistributed personal holding company income is 20%.[48]

A Note on Roth IRA Rollovers

Starting in 2013, employers may allow in-service rollovers from traditional to Roth accounts for employees under age 59½.[49]

The popularity of Roth accounts is on the rise, so this new provision will appeal to higher-income employees under age 59½ with substantial holdings in traditional accounts. The employee would realize the rollover amount as income for the particular tax year. However, employers must take steps to amend their plans to allow such rollovers.

Charitable Giving

Qualified Charitable Distributions from an IRA

The IRA Charitable Rollover is effective for 2012 and 2013. This provision (technically known as a qualified charitable distribution from an IRA) permits an account owner age 70½ or older to direct money straight from an IRA to a charity—up to $100,000 per year per person.[50] The distribution counts toward the owner's required minimum distribution (RMD) for that year, but does not qualify as a charitable contribution for purposes of the income tax deduction.

In addition to avoiding the penalties for failing to withdraw an RMD, the distribution amount is excluded from the owner's income on the federal level. For someone who does not need the income, this is a great way to take an RMD without increasing AGI, which is the basis for calculating many tax items. For those who do not itemize any deductions, the IRA Charitable Rollover is preferable to a cash contribution because the lowered income has the same effect as a gift made/deduction taken.

ATRA set out transition rules for donors seeking to make a qualified charitable distribution from an IRA eligible for 2012.

- Donors who took an IRA distribution in December 2012 were allowed to make a cash charitable contribution in January 2013 up to the amount distributed in December, and then count that amount as an IRA Charitable Rollover for 2012.
- Donors who completed a qualified charitable distribution in January 2013 could choose to deem it made on December 31, 2012.

The IRS issued IR-2013-6 as guidance on how taxpayers should claim and document the IRA Charitable Rollover under these special circumstances.

CRTs, CGAs and the 3.8% Net Investment Income Tax

Life income gifts are a popular way to give because they help a charity while providing a regular income to the donor. But keep in mind the 3.8% net investment income tax can apply if the beneficiaries are over the income threshold. The IRS has released proposed regulations dealing with such charitable gifts and the investment income tax.

The charitable remainder trust (CRT) itself is not subject to the net investment income tax for assets sold within the trust.[51] However, there are special rules for CRT distributions to beneficiaries in addition to the four-tier distribution rules for characterizing income.[52]

For each distribution, the trustee must determine the current and accumulated net investment income of the charitable remainder trust. Accumulated net investment income is the total amount of net investment income received by a charitable remainder trust for all taxable years that begin after December 31, 2012, less the total amount of net investment income distributed for all prior taxable years of the trust that begin after December 31, 2012.[53] Essentially, this means income and gains realized before 2013 are not subject to the tax.

If there is more than one beneficiary, the net investment income will be apportioned among them based on their respective shares of the total amount paid by the CRT that taxable year.[54]

The charitable gift annuity (CGA) payout is considered net investment income, though not the tax-free return of principal component.[55] Also, if the donor creates a CGA that benefits someone else and not the donor, the donor will realize all the capital gains attributed to the annuity at the time of the gift.[56] But, if the donor is the only annuitant (or if there is only the donor and a designated survivor annuitant) and the annuity is assignable only to the charity, the capital gains are pro-rated with each annuity payment over the donor's life expectancy.[57]

Qualified Conservation Contributions

ATRA kept in place the enhanced deduction rules for contributions of real property for conservation purposes for all of 2012 and 2013. A taxpayer can deduct a qualified conservation contribution up to 50% of AGI the year the gift is made rather than the 30% for typical property gifts. In addition, the carryover of any excess deduction can be applied in up to 15 successive years rather than the typical five.[58] Furthermore, certain farmers and ranchers can deduct up to 100% of AGI for these gifts.[59]

Permanency of the Federal Tax Code

Though ATRA has brought a degree of stability to the federal tax code, the term "permanency" is a relative one. Certain provisions are scheduled to lapse in future tax years, and the double-headed issue of debt and the deficit could prompt Congress to make further changes in the pursuit of higher revenue.

Expected Changes

The following provisions will lapse at the end of 2013:

- Deduction for certain expenses of elementary and secondary school teachers[60]
- Deduction for mortgage insurance premiums as qualified residence interest[61]
- Deduction for state and local general sales taxes[62]
- Enhanced charitable deduction for contributions of food inventory[63]
- Deduction for qualified tuition and related expenses[64]
- Tax-free distributions from individual retirement plans for charitable purposes[65]

The following provisions will lapse at the end of 2017:

- Child tax credit: the earnings threshold is scheduled to drop from $10,000 to $3,000 for the refundable portion of the credit[66]
- American opportunity tax credit[67]

Possible Changes

The watchword for possible changes in the federal tax code is "tax reform." Democrats and Republicans, Congress and the White House, lobbyists and citizens all agree that the tax code should be simpler and less onerous. But, as they say, the devil is in the details.

President Obama has advocated for the inclusion of five principles in tax reform:

- Lower the tax rates
- Cut inefficient and unfair tax breaks
- Cut the deficit
- Increase job creation and growth in the United States
- Observe the Buffett Rule

The substance of the Obama administration's tax policy can be found in the General Explanations of the Administration's Fiscal Year (commonly known as the "Green Book") published by the Treasury. The Green Book for Fiscal Year 2013 (published in February 2012) contained many proposals eventually included in ATRA. The Green Book also proposed new rules that would limit certain tax-saving methods of transferring assets—for example, requiring consistency in value for both transfer tax and income tax purposes, applying a term limit on the generation-skipping transfer tax exemption (which would discourage the creation of dynasty trusts), etc.[68]

On the other hand, House Republicans have a different idea for tax reform, which begins with the premise that the legislation should be revenue neutral in order to boost job growth and the general economy. A top income tax rate of 25% for individuals and corporations is the Republican starting point. And, in an effort to draft a comprehensive bill, the House Ways and Means Committee recently commissioned 11 working groups to examine the issue from the perspective of different taxpayers and industries.

ENDNOTES

1 IRC Secs. 1(a)-(e).
2 Rev. Proc. 2013-15.
3 IRC Sec. 1(i)(3(C).
4 Tax Policy Center, "Number of Tax Units by Tax Bracket and Filing Status, 2013." Accessed at http://taxpolicycenter.org/numbers/Content/PDF/T13-0041.pdf. Retrieved February 11, 2013.
5 IRC Sec. 1(f)(8).
6 IRC Sec. 63(c)(2)(A).
7 IRC Sec. 1411.
8 IRC Sec. 1411(c)(1).
9 IRC Sec. 1411(c)(5).
10 IRC Sec. 1411(c)(4).
11 IRC Sec. 3101(b).
12 IRC Sec. 409A.
13 IRC Secs. 164(b)(5)(A) and (b)(5)(I); IRC Sec. 222(e); IRC Sec. 221(b).
14 IRC Sec. 221(b)(2).
15 Formerly IRC Sec. 221(d).
16 IRC Sec. 56(b)(1)(B).
17 IRC Sec. 68(b)(1).
18 IRC Sec. 68(a).
19 IRC Sec. 68(c).
20 IRC Sec. 151(d)(3)(A).
21 IRC Sec. 151(d)(3)(B).
22 IRC Sec. 55(d)(1) and (4).
23 Rev. Proc. 2013-15.
24 IRC Sec. 55(b)(1).
25 Rev. Proc. 2013-15.
26 IRC Sec. 26(a).
27 IRC Sec. 1(h)(11).
28 Id.
29 IRC Sec. 24(a).
30 IRC Sec. 24(d)(1).
31 IRC Sec. 24(d)(2).
32 IRC Sec. 23(a).
33 IRC Sec. 21.
34 IRC Sec. 2057(j). Note that the recapture provisions under IRC Sec. 2057(f) still apply.
35 Formerly IRC Sec. 1(h)(2) and (9).
36 IRC Sec. 2011(f).
37 IRC Sec. 2001(c); IRC Sec. 2502; IRC Sec. 2614.
38 IRC Sec. 2010; Rev. Proc. 2013-15.
39 Benjamin Harris, "Estate Taxes After ATRA," Tax Notes, February 25, 2013.
40 IRC Sec. 2058.
41 IRC Sec. 2010(c)(4); IRC Sec. 2505(a).
42 IRC Secs. 2632(c) and (d).
43 IRC Sec. 2642(a)(3).
44 IRC Sec. 2642(b).
45 IRC Sec. 6166.
46 IRC Secs. 6166(b)(1)(B)(ii), (b)(1)(C)(ii), and (b)(9)(B)(iii)(I).
47 IRC Sec. 531.
48 IRC Sec. 541.
49 IRC Sec. 402A(c)(4)(E).
50 IRC Sec. 408(d)(8).
51 Prop. Reg. Sec. 1.1411-3(b)(3).
52 Prop. Reg. Sec. 1.1411-3(c)(2)(i).
53 Prop. Reg. Sec. 1.1411-3(c)(2)(iii).
54 Prop. Reg. Sec. 1.1411-3(c)(2)(ii).
55 IRC Sec. 1411 (c)(1)(A)(i).
56 Reg. Sec. 1.1011-2.
57 Reg. Sec. 1.1011-2(a)(4).
58 IRC Sec. 170(b)(1)(E).
59 IRC Sec. 170(b)(1)(E)(iv).
60 IRC Sec. 62(a)(2)(D).
61 IRC Sec. 163(h)(3).
62 IRC Sec. 164(b)(5).
63 IRC Sec. 170(e)(3)(C).
64 IRC Sec. 222(e).
65 IRC Sec. 408(d)(8).
66 IRC Sec. 24(d)(4).
67 IRC Sec. 25A(i).
68 Treasury Department General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals (Green Book), P. 75-84. At the time of publication, the Treasury had not yet released the FY 2014 version.

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