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News from the Potomac:
The US Tax Payer Relief Act 2012 – Consequences for Private Clients

Glenn G. Fox, Esq.

Baker & McKenzie LLP

452 Fifth Avenue

NY, NY 10018

glenn.fox@bakermckenzie.com

212-626-4689

Net Investment Income Tax (NITT)

Patient Protection and Affordable Care Act

- Passed in 2010
- Introduced 3.8% Medicare surtax to be effective 1/1/2013. IRC § 1411
- Tax is imposed on net investment income if certain income thresholds are met
- Applies to individuals as well as trusts and estates
  - Not applicable to NRAs. Special rules for those electing to be treated as resident aliens for purposes of fling MFJ
- IRS has termed it the Net Investment Income Tax (NIIT)

Effect on Individuals

- The tax is imposed on the lesser of a taxpayer's:
  - i) net investment income; or
  - ii) the excess of his adjusted gross income over the threshold amount

Filing Status	Threshold Amount*
Married filing jointly	$250,000
Married filing separately	$125,000
Single	$200,000
Head of household (with qualifying person)	$200,000
Qualifying widow(er) with dependent child	$250,000

*Not indexed for inflation

Effect on Trusts and Estates

- The tax applies to the lesser of:
  - i) the undistributed net investment income of the trust or estate; or
  - ii) the excess of the adjusted gross income of the trust or estate over the amount at which the maximum income tax rate first applies ($11,950 for 2013)

Effect on Trusts and Estates

- NIIT is Generally applicable to all trusts under Subchapter J.
  - exceptions include certain charitable, tax exempt, grantor, and foreign trusts with no US beneficiaries.
- The proposed regulations confirm that distributions from trusts and estates to their beneficiaries are considered to contain proportionate amounts of net investment income and other income.

Effect on Trusts and Estates

- For grantor trusts, the grantor simply reports the trust's net investment income on his Form 1040 and pays any tax due.
- For non-grantor trusts, it will often be advantageous for the trusts to distribute their net investment income to their beneficiaries due to the much higher threshold amount before the tax applies.

Net Investment Income

- A taxpayer's net investment income is his gross investment income reduced by deductions properly allocable to that income.
- Investment income includes:
  - interest, dividends, rents, royalties, gains from the sale of assets (other than assets used in the conduct of a business that is not a passive activity of the taxpayer) and income from non-qualified annuities, as well as income from a trade or business that is a passive activity of the taxpayer or from a business of trading commodities or financial instruments.

Net Investment Income

- Deductions include expenses that are properly allocable to items of gross investment income:
  - investment interest expense, investment advisory and brokerage fees, expenses related to rental and royalty income, and state and local income taxes

Accumulation Distribution

- Treasury is currently seeking comments on the application of section 1411 to net investment income of foreign estates and foreign trusts that is earned or accumulated for the benefit of United States beneficiaries, including whether section 1411 should be applied to the foreign estate or foreign trust, or to the United States beneficiaries upon an accumulation distribution.

The American Taxpayer Relief Act of 2012 and its impact on Private Clients

Background

- Prior to Enactment: Uncertainty as to the expiration of the “Bush tax cuts”
- Without new legislation, there would have been significant increases in many tax rates and the lowering of exemption amounts relevant to the Wealth Management practice area
- American Taxpayer Relief Act of 2012 (ATRA) signed into law on January 2, 2013

Wealth Management Topics Covered in the ATRA

- U.S. federal gift, estate and generation-skipping transfer tax (GST)
  - rates, exemption amounts and portability
- Individual income tax rate changes
  - ordinary income rates
  - itemized deductions
  - personal exemption phaseout
- Capital gains and investment income
- Consequences for trusts and charitable planning

U.S. Federal Gift, Estate and GST Changes

- Exemption amount made permanent
  - Exemption amount was scheduled to be lowered back down to $1 million
  - ATRA extended $5 million dollar exemption permanently
  - When adjusted for inflation, 2013 exemption amount will be $5,250,000
- Maximum tax rate increased permanently from 35% in 2012 to 40%
  - Was scheduled to increase to 55% before the enactment of the ATRA

U.S. Federal Gift, Estate and GST Changes

- Portability
  - Made permanent under ATRA
  - Surviving spouse is able to make use of deceased spouse's estate and gift tax exemption
  - Election must be made on deceased spouse's timely filed estate tax return
  - Does not apply to GST exemption

Individual Income Tax Rates

- Bush tax rates generally remained in effect but the highest rate was in creased to 39.6% when income is above the following thresholds:
- Married individual filing joint returns and surviving spouses: $450k
- Heads of households: $425k
- Unmarried individuals: $400k
- Married Individuals filing separate returns: $225k
- Estates and trusts: $11,950

- For individuals with income over $200k or married couples with income over $250k, there is an additional 0.9% payroll tax increase on wages in excess of these amounts

Individual Income Taxes

- Itemized Deductions
  - Limitations on various itemized deductions for taxpayers with income above certain threshold amounts
  - Ex. mortgage interest, state income tax payments, charitable contributions
  - Threshold amounts:
    - Unmarried Individuals- $250k
    - Head of household- $275k
    - Married filing jointly- $300k
    - Married filing separately- $150k
- “Pease” limitations- reduce a taxpayer’s itemized deductions by 3% of their income amount over the threshold amount as long as the total reduction is less than 80% of the taxpayer’s total deductions

Capital Gains and Investment Income

- The ATRA extends the 15% rate on long-term capital gains and qualified dividends for individuals who have taxable income up to the highest bracket threshold level for their category of filer.

- For long-term capital gains and qualified dividends above the threshold amount, long-term capital gain and qualified dividend income in excess of the threshold amount is taxed at a 20% rate.

- Also, the Medicare Tax should be considered. The effective rates are really 18.8% and 23.8%.

Impact on Trusts

- Maximum rate for trusts is now 39.6% plus the 3.8% Medicare Tax
- When a trust does not retain income but distributes to beneficiaries, the applicable rate is not the trust rate but the rate that would apply to individual beneficiaries
- New rules make the 15% capital gains rate relatively unavailable for trusts when compared to individual taxpayers
- Medicare Tax should not apply to foreign non-grantor trusts

The American Taxpayer Relief Act of 2012 :

Examples

Example: Taxpayer A

- Taxpayer A is an unmarried individual taxpayer
- Taxpayer A has $350k of 2013 ordinary income
- Taxpayer A has $50k of 2013 long-term capital gain

How will Taxpayer A be taxed for the 2013 taxable year?

Taxpayer A's ordinary income will be subject to a tax of $47,621 plus 33% of the excess over $203,150.

Taxpayer A's capital gains will be taxed at 15% and will also be subject to the 3.8% Medicare Tax.

Total federal tax liability of Taxpayer A: $105,481.50

Example: Taxpayer B

- Taxpayer B is an unmarried individual taxpayer
- Taxpayer B has $500k of 2013 ordinary income
- Taxpayer B has $0k of 2013 long-term capital gain

How will Taxpayer B be taxed for the 2013 taxable year?

Taxpayer B's ordinary income will be subject to a tax of $116,163.75 plus 39.6% of the excess over $400k.

Total federal tax liability of Taxpayer B: $155,763.75

Example: Taxpayer C

- Taxpayer C is an unmarried individual taxpayer
- Taxpayer C has $0k of 2013 ordinary income
- Taxpayer C has $500k of 2013 long-term capital gain

How will Taxpayer C be taxed for the 2013 taxable year?

Taxpayer C's income will be subject to the 15% rate on the first $400k of capital gain, and the 20% rate on the next $100k. All of the capital gain is subject to the 3.8% Medicare Tax.

Total federal tax liability of Taxpayer C: $99,000

Example: Taxpayer D

- Taxpayer D is an unmarried individual taxpayer
- Taxpayer D has $100k of 2013 ordinary income
- Taxpayer D has $400k of 2013 long-term capital gain

How will Taxpayer D be taxed for the 2013 taxable year?

Taxpayer D's ordinary income will be subject to $17,891.25 plus 28% of the excess over $87,850.

Taxpayer D's income will be subject to the 15% rate on the first $300k of capital gain, and the 20% rate on the next $100k. All of the capital gain is subject to the 3.8% Medicare Tax.

Total federal tax liability of Taxpayer D: $21,293.25

Example: “Pease” Limitation

- Facts: Unmarried taxpayer has gross income of $750k and itemized deductions totaling $50k.
- Below is the limitation formula:
- (income-threshold amount)*3% of income=reduction in deductions (as long as reduction is less than 80% of total deductions)
- Application:
- (750k-250k)*3% of 750k= $15,000
- Result:
- Because the $15,000 reduction is less than 80% of the total deductions, it is applied and the taxpayer’s deductions are reduced from $50k to $35k.

Example: Application of Medicare Tax

- Facts: Unmarried individual taxpayer has $50k net investment income and wages of $170k.
- For unmarried individual taxpayers, the tax applies on the lesser of net investment income and modified adjusted gross income over $200k.
- Result:
- The 3.8% tax applies on $20k ($220k-$200k) instead of the entire $50k of net investment income because this is the lower amount applying the formula.

