Fiscal Cliff Tax Legislation Brings Certainty to Estate, Gift and GST Taxes and Makes Changes Affecting Charitable Giving

January 18, 2013

The American Taxpayer Relief Act of 2012 (the "Act"), which Congress passed on January 1, 2013 and the President signed into law on January 2, 2013, provides a permanent (i.e., there is no currently-scheduled change to the law) set of federal estate, gift and generation skipping transfer ("GST") tax laws for the first time in 12 years and contains a number of important changes to federal income tax laws that relate to charitable giving. In addition, the 3.8% Medicare surtax on net investment income went into effect on January 1, 2013.

ESTATE, GIFT AND GST TAXES

40% Rate

The Act extends without sunset the federal estate, gift and GST tax regime in place in 2012, and makes only one change, which is to increase the top estate, gift and GST tax rate from 35% to 40%. The 40% rate is a permanent rate, not subject to expiration. (If the new legislation had not been passed, the top rate for 2013 would have been 55%. The new rate is also lower than the 45% the Obama Administration proposed.)

$5 Million Exemptions

The Act sets the estate, gift and GST tax exemptions at $5 million, indexed for inflation since 2011. The estate, gift and GST tax exemptions for 2013 are $5.25 million, up from $5.12 million in 2012.

Portability

The Act makes portability permanent, which allows a surviving spouse to use his or her last deceased spouse's unused federal estate and gift tax exemption against the surviving spouse's own transfers. Planning will still be necessary to fully utilize exemptions, however, given that the GST tax exemption and state level estate tax exemptions are not "portable" to the surviving spouse.

3.8% MEDICARE NET INVESTMENT INCOME SURTAX

The 3.8% Medicare surtax on the net investment income of certain individuals, trusts and estates, enacted as part of the Health Care and Education Reconciliation Act of 2010, went into effect on January 1, 2013. For trusts and estates, the new tax is imposed on the lesser of (i) undistributed "net investment income" (a complicated definition that includes most gains and income from passive business and investments, reduced by allocable deductions) and (ii) the amount by which adjusted gross income exceeds the dollar amount at which the highest tax bracket for a trust or estate begins (for 2013, this amount is $11,950). However, certain trusts, including wholly charitable trusts and charitable remainder trusts, are not subject to this tax. In the case of grantor trusts, the grantor, and not the trust, is potentially subject to the 3.8% tax; the trust's items of income or deduction are treated as received or incurred by the grantor for purposes of calculating the grantor's net investment income. The new tax also applies to individuals, excluding non-resident aliens, and is imposed on the lesser of (i) net investment income and (ii) modified adjusted gross income in excess of the applicable threshold ($250,000 for married couples filing jointly and $200,000 for single persons).

CHANGES AFFECTING CHARITABLE GIVING

Tax-free Distributions from Individual Retirement Plans for Charitable Purposes

The Act extends the rule allowing individuals over the age of 70-1/2 to make tax-free qualified charitable distributions of up to $100,000 each year out of their individual retirement plans. This extension is retroactive to December 31, 2011 and applies through the end of 2013. To qualify, the distributions must be made to public charities (other than supporting organizations or donor advised funds), certain government units, or private operating foundations. Special rules apply with respect to qualified charitable distributions made in December 2012 or January 2013. First, any qualified charitable distribution made in January 2013 may be treated as made in 2012, at the taxpayer's election. Second, an individual who received a distribution from his or her retirement account in December 2012 may treat as a qualified charitable distribution any portion of the distribution (up to $100,000) that is transferred before February 1, 2013 to one of the types of organizations listed above. Given that retroactive treatment is only available with respect to distributions made before February 1, individuals over 70-1/2 should consider whether any savings can be achieved in their particular situation by taking advantage of these short-lived provisions.

Reinstatement of the Limitation on Itemized Deductions

The Act permanently reinstates the Pease limitation on itemized deductions, including the charitable deduction. Specifically, the limitation provides that for those with adjusted gross income in excess of the applicable threshold ($300,000 for married couples filing jointly and $250,000 for single persons) the amount of itemized deductions otherwise allowable in any taxable year will be reduced by 3% of the amount by which adjusted gross income exceeds the applicable threshold, up to a maximum reduction equal to 80% of itemized deductions. These dollar amount thresholds will be adjusted for inflation in future years.

Other Changes

The Act contains a number of other specific changes that affect charitable giving, including with respect to donations of food inventory, donations of real property interests for conservation purposes, and donations made by S corporations. We would be happy to discuss any of these changes with you.

For more information, please contact one of the following members of the Firm's Personal Planning Department or Exempt Organizations Department, as appropriate.

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This memorandum is for general information purposes and should not be regarded as legal advice. Please contact your relationship partner if we can be of assistance regarding these important developments. The names and office locations of all of our partners, as well as our recent memoranda, can be obtained from our website, www.simpsonthacher.com.

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