Morgan Lewis

alert

tax-exempt organizations lawflash

January 4, 2013

Important New Provisions in the American Taxpayer Relief Act

From tax rates and tax extenders to the revival of the Pease limitation, the act includes a host of provisions affecting tax-exempt organizations.

On January 2, President Barack Obama signed the American Taxpayer Relief Act of 2012 (ATRA) into law. The law averts the scheduled income tax rate increases and spending reductions required by the Budget Control Act of 2011. Highlighted below are several of the many ATRA tax provisions of interest to tax-exempt organizations.

Tax Rates

- **Income tax rates.** ATRA permanently extends the 2001 tax cuts for taxpayers in the 10%, 25%, 28%, 33%, and 35% brackets. It also imposes a 39.6% tax bracket for individuals earning more than $400,000 a year and couples earning more than $450,000 a year.
- **Unrelated business taxable income (UBTI).** UBTI is taxed at the corporate tax rates for most organizations; however, charitable trusts may pay tax on UBTI at the individual tax rates.
- **Capital gains.** ATRA permanently extends the 0% and 15% capital gains and dividends tax rates but imposes a 20% tax on such income to the extent that a taxpayer's income exceeds the thresholds for the 39.6% bracket. Qualified dividends continue to be taxed at capital gain rates.
- **Alternative Minimum Tax.** ATRA permanently patches the alternative minimum tax by increasing the exemption amounts and indexing it to inflation. ATRA also allows taxpayers to use certain personal tax credits to reduce taxable income to the credit's full amount.
- **Pease limitation.** ATRA revives the overall limitation on total itemized deductions, known as the Pease limitation, which reduces itemized deductions by the lesser of 80% of itemized deductions and 3% of the amount by which a taxpayer's adjusted gross income (AGI) exceeds the applicable amount. The applicable amount is $300,000 for taxpayers who file jointly, $275,000 for heads of household, $250,000 for individuals, and $150,000 for married individuals filing separately. The applicable amounts are indexed for inflation for years after 2013.
- **Personal exemption phaseout.** ATRA reduces the value of personal exemptions (i.e., amounts claimed for taxpayers, their spouses, or their qualifying dependents) for high-income taxpayers such that the total amount of exemptions is reduced by 2% for each $2,500 by which the taxpayer's AGI exceeds the applicable amounts described above.
- **Gift and estate taxes.** ATRA maintains the unified gift and estate tax exemptions at their 2011 and 2012 levels of $5 million, indexed for inflation ($5.12 million in 2012 and $5.25 million in 2013), with portability. The top gift and estate tax rate is 40% (35% for gifts made or for decedents dying after December 31, 2010 and before January 1, 2013).
- **Portability.** ATRA enables spouses to elect to apply the unused portion of a decedent spouse's exclusion to the surviving spouse's own transfers during life and death. As a result, the total gift and estate tax exclusions for spouses may exceed $10 million.

 © 2013 Morgan, Lewis & Bockius LLP

Expiring Provisions

ATRA extended the following tax-exempt-related provisions until December 31, 2013:

- Extension of tax-free distributions from individual retirement accounts to certain public charities for individuals aged 70½ or older, not to exceed $100,000 per taxpayer per year. (Under special rules, any qualified charitable distribution made during January 2013 shall be deemed to have been made on December 31, 2012.)
- Enhancement of charitable deductions for contributions of food inventory (no extension of the similar provision that applied to contributions of books or computer equipment).
- Modification of the tax treatment of certain payments under existing arrangements to controlling exempt organizations under section 512(b)(13) of the Internal Revenue Code (IRC).
- Extension of the special rule for contributions of capital gain real property made for conservation purposes.
- Extension of the basis adjustment to stock of S corporations making charitable contributions of property.
- Extension of the New Markets Tax Credit, with a $3.5 billion allocation in 2012 and 2013.

Effect of Pease Limitation on the Charitable Contribution Deduction

One consequence of reviving the overall limitation on itemized deductions (section 68 of the IRC) is the limitation on the amount by which a taxpayer's charitable contribution deductions reduce his or her tax liability. The provision, which is commonly referred to as the "Pease" limitation after Congressman Don Pease from Ohio who originally proposed it, was first enacted in 1990 as a way of raising tax revenue without raising tax rates, but it has been repealed since 2006.

To calculate the Pease limitation, all limitations applicable to each deduction are applied first, then the otherwise allowable total amount of itemized deductions is reduced by 3% of the amount by which the taxpayer's AGI exceeds the applicable amount. The applicable amount is $300,000 for taxpayers who file jointly, $275,000 for heads of household, $250,000 for individuals, and $150,000 for married individuals filing separately. The applicable amounts are indexed for inflation for years after 2013. Certain deductions are not subject to the Pease limitation, including medical expenses, investment interest, and casualty, theft, or wagering losses. The total overall limitation is the lesser of (i) 3% of the amount by which AGI exceeds the applicable amount and (ii) 80% of the total itemized deductions.

For example, if an individual with an AGI of $500,000 in 2013 has deductible charitable contributions of $20,000, mortgage interest of $50,000, and state taxes of $30,000—for a total of $100,000 of deductions—the individual's Pease limitation would be $7,500, which is 3% of $250,000 (the amount by which the taxpayer's AGI exceeds the $250,000 applicable amount). As a result, the individual would be able to claim only $92,500 of deductions ($100,000 – $7,500), rather than the full $100,000.

The Pease limitation is applied in addition to the charitable contribution percentage limitations. Under current law, charitable contributions by individual taxpayers are limited to a specified percentage of the individual's contribution base. The contribution base is the taxpayer's AGI for a taxable year (disregarding any net operating loss carryback to such year). In general, the contribution limit is higher for contributions of cash and ordinary income property than it is for contributions of capital gain property, and it is higher for contributions to public charities (and certain operating foundations) than it is for contributions to nonoperating private foundations.

The Pease limitation was enacted on a temporary basis as part of the Omnibus Budget Reconciliation Act of 1990, effective for taxable years beginning after December 31, 1990, but prior to January 1, 1996. The legislative history states that the objective of the provision was to better reflect taxpayers' ability to pay taxes. It was believed that the higher an individual's AGI, the less likely that an otherwise deductible expense would significantly affect the individual's ability to pay taxes. The Omnibus Budget Reconciliation Act of 1993 permanently extended this limitation on total itemized deductions. The legislative history states that the permanent extension of the overall limitation on itemized deductions would enhance the progressivity of the federal individual income tax system.

 © 2013 Morgan, Lewis & Bockius LLP

The Economic Growth and Tax Relief Reconciliation Act of 2001 phased out and ultimately repealed the Pease limitation. The legislative history states that Congress believed that the Pease limitation was an unnecessarily complex way to impose taxes, that the "hidden" way in which the limitation raises marginal tax rates undermines respect for the tax laws, and that repealing the Pease limitation would reduce complexity for affected taxpayers. For example, computing the Pease limitation requires a 10-line worksheet that includes numerous computations using information from Schedule A of the Form 1040.

Tax Reform

In a January 1, 2013, press release,[1] House Committee on Ways and Means Chairman Dave Camp (R-MI) stated that tax reform is next on his committee's agenda. The Senate Committee on Finance has also indicated a willingness to take up tax reform, having held hearings for the past several years on various tax reform topics. It is therefore possible that the 113th Congress will address issues of interest to tax-exempt organizations, such as reforming the charitable deduction, in the coming legislative session.

Implications

The Pease limitation adds considerable complexity to calculating the amount by which itemized deductions, including the charitable contribution deduction, reduce income tax liability. It is unclear how this added complexity will affect charitable giving in 2013 and future years. Donors who are subject to higher marginal tax rates as a result of ATRA may have a greater incentive to make charitable contributions than they previously had. Exempt organizations may wish to apprise donors of the advantages of making charitable gifts through IRAs and other enhanced charitable deduction incentives that ATRA has extended until December 31, 2013.

Contacts

If you have any questions or would like more information on the issues discussed in this LawFlash, please contact any of the following Morgan Lewis attorneys:

Philadelphia

Frances Emmeline Babb	215.963.5169	ebabb@morganlewis.com

Washington, D.C.

Celia Roady	202.739.5279	croady@morganlewis.com
Matthew R. Elkin	202.739.5285	melkin@morganlewis.com
Alexander L. Reid	202.739.5941	areid@morganlewis.com
Kimberly M. Eney	202.739.5825	keney@morganlewis.com
Edward T. Chaney	202.739.5831	echaney@morganlewis.com
Caroline W. Waldner	202.739.5993	cwaldner@morganlewis.com

About Morgan, Lewis & Bockius LLP

With 24 offices across the United States, Europe, and Asia, Morgan Lewis provides comprehensive litigation, corporate, transactional, regulatory, intellectual property, and labor and employment legal services to clients of all sizes—from globally established industry leaders to just-conceived start-ups. Our international team of lawyers, patent agents, benefits advisers, regulatory scientists, and other specialists—more than 1,600 legal professionals total—serves clients from locations in Almaty, Beijing, Boston, Brussels, Chicago, Dallas, Frankfurt, Harrisburg, Houston, Irvine, London, Los Angeles, Miami, Moscow, New York, Palo Alto, Paris, Philadelphia, Pittsburgh, Princeton, San Francisco, Tokyo, Washington, D.C., and Wilmington. For more information about Morgan Lewis or its practices, please visit us online at www.morganlewis.com.

IRS Circular 230 Disclosure

To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. federal tax advice contained in this communication (including any attachments) is not intended or written to be used, and cannot be

1. View the press release at http://waysandmeans.house.gov/news/documentsingle.aspx?DocumentID=316027.

 © 2013 Morgan, Lewis & Bockius LLP

Morgan Lewis

used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing, or recommending to another party any transaction or matter addressed herein. For information about why we are required to include this legend, please see http://www.morganlewis.com/circular230.

This LawFlash is provided as a general informational service to clients and friends of Morgan, Lewis & Bockius LLP. It should not be construed as, and does not constitute, legal advice on any specific matter, nor does this message create an attorney-client relationship. These materials may be considered **Attorney Advertising** in some states. Please note that the prior results discussed in the material do not guarantee similar outcomes. Links provided from outside sources are subject to expiration or change. © 2013 Morgan, Lewis & Bockius LLP. All Rights Reserved.