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Recent Legislative & Other Developments in Federal Income Taxation

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Introduction

- With the passage of the American Taxpayer Relief Act of 2012 (Pub. L. 112–240, H.R. 8, 126 Stat. 2313) (“ATRA”) on January 2, 2013, Congress added many new provisions to the Code that will have a significant impact on taxpayers for 2013 and beyond.
- Other recent tax changes also go into effect in 2013, most notably those changes enacted under the Patient Protection and Affordable Care Act (Pub. L. 111–148, 124 Stat. 119) and the Health Care and Education Reconciliation Act of 2010 (Pub. L. 111–152, 124 Stat. 1029), both enacted in March 2010.
- This presentation surveys some of the more important recent tax law changes.

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Income Tax Rates

- Until the passage of ATRA, it was unknown whether the "Bush-era tax cuts" with respect to marginal income tax rates and tax rates on qualified dividends and capital gains would continue (Sec. 1(h)). These rates had been due to sunset in 2010, but were extended through the end of 2011 by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Pub. L. 111–312, H.R. 4853, 124 Stat. 3296) (the "2010 Tax Relief Act").
- ATRA made these tax rates permanent, but with rate increases for high-income taxpayers exceeding the following levels:
  - $400,000 for Single Filers;
  - $425,000 for Head of Household; and
  - $450,000 for Married Filing Jointly.

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Graduated Income Tax Rates on Taxable Income of Individuals

2012 Taxable Income	2012 Rates	2013 Taxable Income	2013 Rates
S: Not over $8,700 M: Not over $17,400	10%	S: Not over $8,925 M: Not over $17,850	10%
S: Over $8,700 but not over $35,350 M: Over $17,400 but not over $70,700	S: $870 + 15% over $8,700 M: $1,740 + 15% over $17,400	S: Over $8,925 but not over $36,250 M: Over $17,850 but not over $72,500	S: $892.50 +15% over $8,925 M: $1,785 + 15% over $17,850
S: Over $35,350 but not over $85,650 M: Over $70,700 but not over $142,700	S: $4,867.50 + 25% over $35,350 M: $9,735 + 25% over $70,700	S: Over $36,250 but not over $87,850 M: Over $72,500 but not over $146,400	S: $4,991.25 + 25% over $36,250 M: $9,982.50 + 25% over $72,500
S: Over $85,650 but not over $178,650 M: Over $142,700 but not over $217,450	S: $17,442.50 + 28% over $85,650 M: $27,735 + 28% over $142,700	S: Over $87,850 but not over $183,250 M: Over $146,400 but not over $223,050	S: $17,891.25 + 28% over $87,850 M: $28,457.50 + 28% over $146,400
S: Over $178,650 but not over $388,350 M: Over $217,450 but not over $388,350	S: $43,482.50 + 33% over $178,650 M: $48,665 + 33% over $217,450	S: Over $183,250 but not over $398,350 M: Over $223,050 but not over $398,350	S: $44,603.25 + 33% over $183,250 M: $49,919.50 + 33% over $223,050
S: Over $388,350 M: Over $388,350	S: $112,683.50 + 35% over $388,350 M: $105,062 + 35% over $388,350	S: Over $398,350 but not over $400,000 M: Over $398,350 but not over $450,000	S: $115,586.25 + 35% over $398,350 M: $107,768.50 + 35% over $398,350
		S: Over $400,000 M: Over $450,000	S: $116,163.75+39.6% over $400,000 M: $125,846 + 39.6% over $450,000

Capital Gains and Dividend Rates

- For most taxpayers, the general 15% tax rate on capital gains and qualified dividends was made permanent under ATRA.
- However, ATRA instituted a 20% tax rate for these items of income to the extent they would otherwise be taxable at the new 39.6% graduated tax rate (*i.e.*, for taxpayers exceeding the $400,000 single/$450,000 married threshold).

Income Taxes – Estate and Trust

- ATRA permitted top income tax rate for estates and trusts to return to 39.6%, but retained decreased marginal rates for lower estate and trust income levels (Sec. 1(e), (i)).

2012

If taxable income is – The tax is:

Not over $2,400 – 5% of taxable income
Over $2,400 but not over $5,600 – $360 plus 25% of the excess over $2,400
Over $5,600 but not over $8,500 – $1,160 plus 28% of the excess over $5,600
Over $8,500 but not over $11,650 – $1,972 plus 33% of the excess over $8,500
Over $11,650 – $3,011.50 plus 35% of the excess over $11,650

2013

If taxable income is – The tax is:

Not over $2,450 – 15% of the taxable income
Over $2,450 but not over $5,700 **–** $367.50 plus 25% of the excess over $2,450
Over $5,700 but not over $8,750 **–** $1,180 plus 28% of the excess over $5,700
Over $8,750 but not over $11,950 **–** $2,034 plus 33% of the excess over $8,750
Over $11,950 **–** $3,090 plus 39.6% of the excess over $11,950

Transfer Taxes – Estate and Gift

- Prior to enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001 (Pub. L. 107–16, 115 Stat. 38) ("EGTRRA"), there was a $675,000 exemption for combined transfers during life or at death for gifts and a top rate of 55%.
- Through 2010, EGTRRA gradually increased exemption amounts for transfers and decreased rates. For 2010, there was no estate tax and the gift tax rate decreased to 35%. The 2010 Tax Relief Act kept the no estate tax for 2010 but provided an option for electing to be taxed (without an election, carryover basis applied).
- For 2011, the estate and gift taxes were to revert to pre-EGTRRA levels. However, the 2010 Tax Relief Act provided temporary relief – a $5 million estate tax exemption adjusted for inflation and a top rate of 35% for 2011 and 2012.
- 2010 Tax Relief Act also added portability election to allow a deceased spouse's unused exemption to be shifted to the surviving spouse (Sec. 2010(c)(2)(B), (c)(4), (c)(5)).

Transfer Taxes – Estate and Gift

- ATRA permanently adopts the changes under the 2010 Tax Relief Act (including the exemption portability election) indexing the $5 million estate exemption amount for inflation (exemption $5.25 million for 2013) (Sec. 2010) and adopting a 40% maximum rate.
- Selected Unified Tax Rates (Sec. 2001(c), 2502(a)(2)):
  - Estate of $250,000 – $500,000: 34%
  - Estate of $500,000 – 750,000: 37%
  - Estate of $750,000 – 1,000,000: 39%
  - Estate in excess of $1,000,000: 40%

Expiration of Payroll Tax Holiday

- Prior to 2011, payroll taxes were as follows:
  - W-2 wages – FICA (Sec. 3101, 3111) – employer and employee subject to equal amounts consisting of:
    - *OASDI insurance (Social Security) tax of 6.2% up to a taxable wage base adjusted for inflation*
    - *Hospital Insurance (Medicare) tax of 1.45%*
  - Self-employment income – SECA (Sec. 1401):
    - *OASDI insurance (Social Security) tax of 12.4% up to a taxable wage base adjusted for inflation*
    - *Hospital Insurance (Medicare) tax of 2.9% (income tax deduction allowed for one-half of Medicare tax)*
- For 2011 and 2012, Congress instituted a "payroll tax holiday," decreasing OASDI social security payroll tax by 2% for both FICA and SECA purposes. Congress allowed these provisions to sunset for 2013.

Increased Medicare Tax on Wages & Self-Employment Income

- For 2013, an increased Medicare payroll tax becomes effective (enacted as part of the Patient Protection and Affordable Care Act). Individuals have to pay an additional 0.9% of Medicare tax on wages (Sec. 3101(b)(2)) and self-employment income (Sec. 1401(b)(2)) in excess of the threshold, for a total of a 3.8% tax.
  - W-2 employee: employee paying 2.35%; employer paying 1.45%.
  - Self-employed: additional 0.9% tax not eligible for deduction.
  - The threshold is $200,000 for single status filers and $250,000 for married filing jointly.
    - *First time in history that marital status has mattered to the collection of payroll tax. Each spouse may be under $200,000 threshold, but combined earnings may make them liable for 0.9% of their earnings in excess of the $250,000 threshold (e.g., $150,000 each).*
    - *Employers only need to withhold when employee's wages are in excess of $200,000. As a result, in the example above, the couple may need to file estimated taxes.*

Medicare Tax on Net Investment Income

- Effective January 1, 2013, higher-income U.S. individuals, trusts and estates are subject to a new 3.8% Medicare tax on “net investment income.”
- Enacted by the Health Care and Education Reconciliation Act of 2010, creating new Chapter 2A / Sec. 1411 of the Code.
- Net investment income tax is part of the calculation of determining estimated tax filing requirements.
- The government issued proposed regulations under Sec. 1411 in late 2012 that are anticipated to be finalized during 2013 (REG-130507-11). The regulations are proposed to be effective for taxable years beginning after 2013 (1 year after effective date of the tax), but taxpayers may rely on the proposed regulations until the effective date of the final regulations.

Medicare Tax on Net Investment Income

- "Net investment income" includes portfolio income and net gains from the disposition of property other than property held in an active trade or business.
  - Specifically includes "trade or business of trading in financial instruments or commodities." In other words, hedge fund income.
- Investment income does not include income from an active trade or business (other than a trading business or a business in which the taxpayer does not actively participate under Sec. 469 rules), distributions from qualified pension plans, nonqualified deferred compensation or municipal bond interest.
  - However this income is included in AGI, so may indirectly trigger the tax.
- Calculation of net investment income allows deductions that are "properly allocable" to such investment income.

Medicare Tax on Net Investment Income

Individuals

- Individuals are subject to the 3.8% tax on their "net investment income" for the year, but only to the extent their "modified adjusted gross income" exceeds a "threshold amount."
  - "Threshold amount"
    - *Single taxpayers – $200,000*
    - *Married taxpayers filing jointly (or a surviving spouse) – $250,000*
    - *Married taxpayers filing separately – $125,000*

Trusts & Estates

- Trusts and estates are subject to the 3.8% tax on their "undistributed net investment income," but only to the extent their adjusted gross income under Sec. 67(e) exceeds the highest Sec. 1(e) tax bracket amount ($11,950 for 2013).
  - "Undistributed net investment income" means net investment income reduced by distributions of net investment income to beneficiaries and amounts paid or permanently set aside for a charitable purpose.

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Medicare Tax on Net Investment Income

- Example (Prop. §1.1411-2(b)(2)): During Year 1, A, an unmarried U.S. citizen, has modified adjusted gross income of $190,000, which includes $50,000 of "net investment income." A has a zero tax imposed under Sec. 1411 because the threshold amount for a single individual is $200,000. If during Year 2, A has modified adjusted gross income of $220,000, which includes $50,000 of net investment income, then the individual has a Sec. 1411 tax of $760 (3.8 % multiplied by $20,000).

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“Pease” Overall Limitation on Itemized Deductions

- Under Sec. 68 “Pease limitation,” most itemized deductions of higher-income taxpayers are reduced by 3% of AGI above an inflation-adjusted figure, but the reduction can't exceed 80% of the amount of itemized deductions otherwise allowable for the tax year.
- EGTRRA gradually reduced this limitation until it was eliminated for 2010 (with subsequent legislation extending the repeal through 2012). The Pease limitation was allowed to return beginning in 2013.
- 2013 Pease limitation thresholds (which are to be indexed for inflation):
  - $300,000 for married taxpayers
  - $275,000 for a head of household
  - $250,000 for a single individual
  - $150,000 for a married individual filing a separate return

“Pease” Overall Limitation on Itemized Deductions

Example:

- *<u>Single filer with AGI = $275,000</u>:* AGI exceeds the phaseout threshold by $25,000 (= 275,000 - $250,000); 3% of $25,000 is $750. Itemized deductions may be reduced by $750, up to a maximum of 80% of itemized deductions.

Summary of 2013 Top Marginal Effective Tax Rates by Income Source

	Wages	Taxable Interest	Qualified Dividends	Long-Term Capital Gains
Top Marginal Rate	39.60%	39.60%	20.00%	20.00%
Medicare Tax	1.45%	N/A	N/A	N/A
New Medicare Surtaxes	0.90%	3.80%	3.80%	3.80%
Effect of Pease Limitation	1.18%	1.18%	1.18%	1.18%
Combined Effective Marginal Rate	**43.13%**	**44.58%**	**24.98%**	**24.98%**

Source: Gerald Prante and Austin John, Top Marginal Effective Tax Rates by State and by Source of Income, 2012 Tax Law vs. 2013 Tax Law (as enacted in ATRA) (February 3, 2012).

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AMT

- AMT (Sec. 55) was originally aimed at taxpayers that, absent the AMT, would have been able to claim a large number of deductions, exemptions, and credits. Goal was to have such taxpayers pay a certain minimum tax.
- Applies to non-corporate taxpayers (individuals, estates, and non-grantor trusts).
- Exemption from the AMT is phased out at higher income levels. Original exemption amount was not indexed for inflation causing more and more taxpayers to fall within its reach.

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AMT

- From 2001 through 2011 Congress repeatedly passed legislation (“AMT patches”) that increased the AMT exemption for one or two years in an attempt to reduce the number of individuals who otherwise would be subject to the AMT.
- AMT changes under ATRA:
  – AMT exemption amounts increased on a permanent basis.
  – Exemption amounts adjusted for inflation for tax years after 2012.
  – AMT exemption continues to be phased out for higher income taxpayers.

AMT

AMT Exemption Amounts

2012

Unmarried Individuals	$50,600
Married/Joint Returns	$78,750
Estates & Non-Grantor Trusts	$22,500

2013

Unmarried Individuals	$51,900
Married/Joint Returns	$80,750
Estates & Non-Grantor Trusts	$23,100

Phaseout of Personal Exemptions

- Under Sec. 151, each taxpayer may be entitled to an exemption for herself and her spouse, and may qualify for an additional exemption for each dependent.
- For 2013, Personal Exemption Phaseout (“PEP”) of Sec. 151(d) is reinstated (PEP, which was due to return in 2010, was suspended by the 2010 Tax Relief Act). Personal exemptions ($3,900 for 2013) are phased out at a rate of 2% for each $2,500 of AGI over specified thresholds (indexed for inflation after 2013 under ATRA). Thresholds are:
  - $250,000 for Single Filers (complete phaseout for AGI above $372,500);
  - $275,000 for Head of Household (complete phaseout for AGI above $397,500); and
  - $300,000 for Married Filing Jointly (complete phaseout for AGI above $422,500).

Additional Individual-Related Provisions under ATRA

- Accumulated earnings tax rate and personal holding company tax rate rises from 15% to 20% for 2013. (Sec. 532 and 541 respectively).
- Extension of the 100% gain exclusion for the sale of "qualified small business stock" acquired after Sep. 27, 2010, and before Jan. 1, 2014 (Sec. 1202).
- Standard deduction (Sec. 63(c)) marriage penalty relief made permanent (was scheduled to be 167% of the standard deduction for single taxpayers).
- Elimination of sunsetting provision that would have decreased Sec. 24 child credit from $1,000 to $500.
- Five-year extension of favorable rules for Sec. 32 earned income tax credit relating to 3 or more children and reduction of marriage penalty with respect to phaseout amount
- Five-year extension of Expanded American Opportunity Tax Credit (Sec. 25A(i)).
- Prevent sunsetting of favorable provisions for Sec. 21 credit for household and dependent care expenses.
- Employer-provided educational assistance exclusion under Sec. 127 made permanent.

Additional Business-Related Provisions under ATRA

- Shortened 5 year (rather than 10 year) "recognition period" for 2012 and 2013 for testing S corporation "built-in gains" tax under Sec. 1374.
- Extends Sec. 168(k) 50% first-year bonus depreciation so that it applies to qualified property acquired and placed in service before Jan. 1, 2014 (before Jan. 1, 2015 for certain longer-lived and transportation property).
- Increases the maximum expensing amount under Sec. 179 to $500,000 for 2012 and 2013. Also increases the investment-based phaseout amount for 2012 or 2013 to $2 million.
- The Work Opportunity Tax Credit of Sec. 51 extended with respect to eligible veterans and nonveterans that begin work before 2014.
- Permanent repeal of the collapsible corporation rules (former Sec. 341).

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Additional Business-Related Provisions under ATRA

- Active financing exception (Sec. 954(h) and (i)) extended through 2013 and made retroactive for 2012. The provision excludes from subpart F income certain income derived from the active conduct of a banking, financing, or similar business, and allows the shareholders of a CFC engaged in such business to defer U.S. tax on such income.
- Look-through rule (Sec. 954(c)(6)(C)) for FDAP-type payments between related CFCs that otherwise would be treated as foreign personal holding company income extended through 2013 and made retroactive for 2012. Payments not subpart F income to extent attributable to non-subpart F income or ECI of payor.
- FIRPTA withholding rate reduction for U.S. partnerships, trusts, or estates extended. A U.S. partnership, a trustee of a U.S. trust, or an executor of a U.S. estate is required to withhold 35% of the gain allocable to foreign persons. The Secretary was statutorily authorized to reduce the withholding rate in regulations, although none such regulations have been issued and the authority to promulgate them was set to expire after 2012. ATRA eliminated the sunset date by which such regulations had to be issued and allows the Secretary to issue regulations reducing the withholding rate to 20% (Sec. 1445(e)(1)).

Additional Business-Related Provisions under ATRA

- Reinstatement and/or extension (generally through 2013) of numerous credits including:
  - New Markets Tax Credit (Sec. 45D);
  - Research & Development Credit (Sec. 41);
  - Work Opportunity Tax Credit (Sec. 51);
  - Empowerment Zone Tax Incentives (Sec. 1391, 1396, 179, 1394 and 1397B); and
  - Low-income Housing Tax Credit (Sec. 42).

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Extension of Renewable Energy Tax Provisions under ATRA

- Extension of renewable energy production tax credit (Sec. 45) and investment tax credit (Sec. 48):
  - Wind facility – *the construction of which* begins before Jan. 1, 2014 (rather than *placed into service* before Jan. 1, 2013).
  - Other renewable facilities – generally, *the construction of which* begins before Jan. 1, 2014 (rather than *placed into service* before Jan. 1, 2014).

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Extension of Other Energy-Related Tax Provisions under ATRA

- Reinstatement from prior expiration in 2012 and extension through 2013:
  - Nonbusiness Energy Property Credit – Sec. 25C
  - New Energy Efficient Home Credit – Sec. 45L
  - Qualified Alternative Fuel Vehicle Refueling Property Credit – Sec. 30C
  - Plug-In Electric Vehicle Credit, but only for 2 or 3 wheeled vehicles – Sec. 30D
  - Manufacturer Energy Efficient Appliance Credits – Sec. 45M

Medical Device Excise Tax

- The medical device excise tax was enacted under the Health Care and Education Reconciliation Act of 2010.
- Effective for sales after Dec. 31, 2012, new Sec. 4191 imposes a 2.3% excise tax on the sale price associated with "the sale of any taxable medical device by the manufacturer, producer, or importer."
  - "Taxable medical device" – determined under FDA statute and regulations, unless specifically exempted (e.g., eyeglasses, contact lenses and hearing aids).
  - Sale for further manufacture, resale or export excepted from imposition of tax (Sec. 4221(a)(1), (2)).

FATCA

- Enacted as part of the Hiring Incentives to Restore Employment Act of 2010 (Pub. L. 111–147, 124 Stat. 71), FATCA (Chapter 4 / Sec. 1471-1474 of the Code) is an anti-tax avoidance regime designed to help the IRS identify U.S. taxpayers holding financial assets outside the U.S. It does this by using the threat of a withholding tax on certain U.S. source payments received by "foreign financial institutions" and certain other foreign entities to force information disclosure by such recipients.
- In general, FATCA requires U.S. withholding agents (e.g., persons who make payments potentially subject to FATCA withholding) and "participating" foreign financial institutions (or "FFIs") to document account holders and withhold 30% tax on "withholdable payments" to account holders/payees who fail to comply with information disclosure requests.

FATCA

- "Withholdable payment":
  - U.S. source fixed or determinable, annual or periodical (FDAP) income on or after January 1, 2014.
  - Gross proceeds from the disposition of property (occurring on or after January 1, 2017) that can produce interest or dividends that are U.S. source FDAP income (*i.e.*, sale of U.S. securities).
- No withholding applies with respect to payments under (or gross proceeds from the disposition of) "grandfathered obligations" (such as debt instruments) that are outstanding on Jan. 1, 2014.
- Government recently issued final regulations (T.D. 9610) and two model intergovernmental agreements (IGAs) implementing FATCA.

Other Recent Regulations Projects

- Prop. §1.83-3(c) – limits definition of "substantial risk of forfeiture"
- Temporary "repair regulations" under Sec. 162 and 263(a) for costs paid to acquire, produce or improve intangible property
- §1.108-8 – debt for partnership interest rules
- §1.721-2 – non-compensatory partnership options
- Final and temporary regulations under Sec. 367 – outbound stock and other outbound transfers
- Final and temporary regulations under Sec. 7874 – corporate inversions

Recent 3d Circuit Opinion – *Historic Boardwalk Hall*

- Involved establishment of marketed arrangement between N.J. tax-exempt state instrumentality ("NJSEA") and Pitney Bowles ("PB"), as the tax equity investor, to rehabilitate the Atlantic City venue that had held the Miss America pageant ("East Hall").
- NJSEA and PB entered into the arrangement through an LLC ("Historic Boardwalk Hall"), with 99.9% of tax items being allocated to PB (consisting principally of Sec. 47 historic rehabilitation tax credits).
- PB and NJSEA also entered into various put and call option agreements contemplating PB's divestiture of its interest in Historic Boardwalk Hall. NJSEA guaranteed PB's expected tax benefit from the tax credits.
- As part of the arrangement, PB was to receive a 3% preferred return. To the extent the preferred return was not paid, such amount would be payable as part of the purchase price under PB's put option. The put option purchase price was secured by the purchase of a guaranteed investment contract.

Recent 3d Circuit Opinion – *Historic Boardwalk Hall*

- At trial before the Tax Court (136 T.C. 1 (2011)), the government argued that PB's tax credits from Historic Boardwalk Hall should be disallowed under various theories. *The Tax Court held for petitioners as follows.*
  - Economic Substance/Sham Partnership – *Arrangement provided economic substance by virtue of the 3% preferred return plus the tax credit benefits and a legitimate business purpose of allowing PB to invest in the rehabilitation of East Hall. PB also had downside risk for environmental liabilities notwithstanding an insurance policy as well as risk that the rehabilitation would not be completed.*
  - PB not a bona fide partner in Historic Boardwalk Hall for tax purposes – *Under Culberston (337 U.S. 733 (1949)) facts and circumstances intent test, PB was bona fide partner in tax partnership, taking into account the stated purpose behind Historic Boardwalk's formation, the parties' investigation of the transaction, the transaction documents, and the parties' respective roles.*
  - Historic Boardwalk Hall did not own the East Hall under benefits and burdens test – *Weighing the benefits and burdens factors, NJSEA had transferred the East Hall to Historic Boardwalk Hall.*

Recent 3d Circuit Opinion – *Historic Boardwalk Hall*

- On appeal, the Third Circuit reversed and found that the partnership was simply a vehicle to transfer tax credits to PB based upon its *de novo* review under the bona fide partner/partnership theory (694 F.3d 425) .
  - Court accepted government's argument regarding the recent cases of *Castle Harbor*, 459 F.3d 220 (2d Cir. 2006), and *Virginia Historic Tax Credit Fund*, 639 F.3d 129 (4th Cir. 2011), as establishing "guideposts" for analyzing bona fide equity partner issues.
  - Court found under the substance of the arrangement, PB did not have meaningful downside risk or upside potential.
    - *Lack of investment risk because PB not required to contribute additional levels of capital until Historic Boardwalk Hall had reached the relevant rehabilitation benchmark sufficient to offset capital contributions with tax credits. Also, 3% preferred return in substance guaranteed through PB put option and purchase of guaranteed investment contract.*
    - *Lack of audit risk due to tax benefits guarantee.*
    - *Lack of project risk because the rehabilitation project was fully funded without PB's investment.*
    - *Lack of meaningful upside because operation of put and call options and lack of projected distributable cash flow in substance limited PB's upside in the investment.*

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