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MEMORANDUM

To: Clients & Friends
From: The Ruchelman Law Firm
Re: Fiscal Cliff Averted – New Tax Changes
Date: January 2, 2013

On December 31, 2012, sources stated that an agreement was reached regarding the fiscal cliff and the expiration of the Bush era tax cuts.[1] The Senate passed the "American Taxpayer Relief Act of 2012" (the "Act"), early in the a.m. on January 1, 2013.[2] The same evening, the House of Representatives followed suit. This memorandum addresses the principal changes made by the new legislation, both headline items and items affecting U.S. taxation of certain cross border income flows.

Background

On January 1, 2013, the Bush era tax cuts were set to sunset, meaning such tax cuts would, in general, have reverted to the rates then in effect under the Clinton presidency of the 1990s. These tax increases include (but are not limited to) the following:

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1 As originally passed by the Economic Growth and Tax Relief Reconciliation Act of 2001 and Jobs Growth Tax Relief Reconciliation Act of 2003, and later extended by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010.

2 The text of the Senate bill, amending H.R. 8, as passed on January 1, 2013, is available here: http://www.gpo.gov/fdsys/pkg/BILLS-112hr8eas/pdf/BILLS-112hr8eas.pdf.

- The highest marginal income tax rate would have reverted to 39.6% from 35%.
- The rate on qualifying dividends would have reverted to 39.6% from the preferential rate of 15%.
- The maximum rate on capital gains would have reverted to 20% from the preferential rate of 15%.
- The maximum rates on the gift, estate, and generation-skipping transfer taxes would have reverted to 55% from 35%.
- The gift, estate, and generation-skipping transfer tax exemptions would have reverted from $5.12 million (as indexed for inflation) per decedent to $1 million (as indexed) per decedent or transferor.
- The exemption amount under the Alternative Minimum Tax ("A.M.T.") would have reverted from $75,450 for married individuals filing jointly and $48,450 for singles to $45,000 for married individuals filing jointly and $33,750 for unmarried individuals.[3] [4]
- The payroll tax cut, which was part of the 2010 Bush tax extension under the Obama presidency and reduced the payroll tax on the employee side by 2% from 6.2% to 4.2%, was also set to expire at the end of 2012, and revert to 6.2%.

In addition, several tax breaks and/or preferences had already expired and/or needed to be extended.

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3 See, *e.g.*, Margot L. Crandall-Hollick, *An Overview of Tax Provisions Expiring in 2012*, Congressional Research Service, September 24, 2012, available at http://www.fas.org/sgp/crs/misc/R42485.pdf.

4 For the A.M.T., it would affect the 2012 tax year. Thus, unless Congress acted, an estimated 60 million taxpayers would have been hit, and it would have been with their 2012 filing obligations, not 2013. The Congress has been patching the A.M.T. on an ad-hoc basis over the years, due to the fact that the A.M.T. as originally enacted was not indexed to inflation, and thus catching more and more taxpayers over time.

New Legislation

Under the Act:

- The marginal income tax rate for high-income earners has been raised to 39.6% from 35%. For these purposes high-income earners means, with respect to those taxpayers who are married filing jointly, those earning more than $450,000 and, with respect to single taxpayers, those earning more than $400,000. Thus the Bush era tax cuts are left intact for amounts earned up to $400,000. However, certain exemptions and deductions[5] will be limited for those with income greater than $300,000 (married filing jointly) or $250,000 (single taxpayers).[6]
- The maximum rates on qualifying dividends and capital gains have been raised to the rate of 20% from 15%. However, the increased rate would only affect high-income earners, as defined above.

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5 The personal exemption, which is indexed annually, is $3,800 for 2012. For the past three years, it was not subject to a phase-out, but was subject to a phase-out previously for high-income earners. The personal exemption phase-out has been reinstated for those high-income earners. Also, the Pease limitation on itemized deductions will also be reinstated for those high-income earners. The Pease limitation reduces most itemized deductions by 3 percent of the amount by which adjusted gross income exceeds a specified threshold, up to a maximum reduction of 80% of itemized deductions. However, this limitation was repealed for 2010, 2011, and 2012, under the Bush tax cuts (as extended under the Obama presidency). See, *e.g.*, Tax Policy Center, *Limitation on Itemized Deductions (Pease)*, available at http://www.taxpolicycenter.org/press/press-resources-pease.cfm (last accessed December 31, 2012).

6 This was a compromise, as Democrats initially set the threshold at $250,000 for married filing jointly and $200,000 for single taxpayers.

- The maximum gift, estate, and generation-skipping transfer tax rates has been raised from 35% to 40%. However, the transfer tax exemption amounts of $5 million (indexed) have been made permanent.
- The A.M.T. will be patched permanently. The exemption amount under the A.M.T. is $78,750 for married individuals filing joint returns and $50,600 for unmarried individuals. It will be indexed for inflation, which is a welcomed change.[7]

The Act also adopted a number of tax extenders affecting cross border cash flows, affecting both inbound investment and U.S. based multinationals. They include the following:

- Extension of the exemption from tax of certain interest-related dividends and short-term capital gain dividends of regulated investment companies ("R.I.C.s") for certain nonresident aliens and/or foreign corporations under Code § 871(k)(1) and (2). This provision had expired for tax years beginning after December 31, 2011. The Act extends these exemptions until December 31, 2013. This provision was initially enacted to enhance the global competitiveness of U.S. R.I.C.s., as a disparity existed between direct and indirect investments (through R.I.C.s) by foreign persons.[8]
- Extension of R.I.C. qualified investment entity treatment under the Foreign Investment Real Property Tax Act ("F.I.R.P.T.A."). Under F.I.R.P.T.A., net gains realized by foreign investors from the sale of U.S. real property interests are subject to U.S. taxation. Special withholding rules apply to collect the tax. U.S. real property interests include equity interests in U.S. real

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7 As noted above, Congress has been patching the A.M.T. on an ad-hoc basis, which is not an ideal way to run the fiscal side of the government.

8 See H Rept. No. 108-548, p. 163-164 (2004).

property holding corporations ("U.S.R.P.H.C.s") that hold predominantly U.S. real estate.[9] Under these rules, a foreign investor is subject to F.I.R.P.T.A. on the disposition of R.I.C. shares only if the R.I.C. itself is a U.S.R.P.H.C.[10] Legislation was previously enacted which provided a special exception for domestically controlled R.I.C.s and thus the sale of the shares of such a R.I.C. would not be subject to F.I.R.P.T.A.[11] This provision expired on December 31, 2011. The Act extends this exception until December 31, 2013.

- Extension of Subpart F exception for active financing income. Under the rules applicable to controlled foreign corporations, Subpart F income[12] is picked up on a current basis, whether or not the shareholder receives an actual distribution. Certain exceptions exist, including certain insurance income and active financing income from the active conduct of a banking, financing, insurance or similar business. These exceptions had expired for the 2012 tax year. The Act extends these exceptions for the 2012 and 2013 tax years.
- Extension of look-thru treatment of payments between related controlled foreign corporations under foreign personal holding company rules. Under Code § 954(c)(6), dividends, interest, rent, and royalties received or accrued from a controlled foreign corporation which is a related person is not treated as Subpart F income to the extent attributable or properly allocable to non-Subpart

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9 More specifically, a U.S.R.P.H.C. is a domestic corporation in which the fair market value of U.S. real property interests represent 50% or more of the fair market value of all real property and business assets, worldwide.

10 This is extremely rare, as R.I.C.s generally do not predominantly invest in U.S. real estate, and even if they did, the exception for stock that is regularly traded would generally apply (unless the individual owned more than 5% of such shares).

11 See Code § 871(h)(2). See also the American Jobs Creation Act of 2004 and the Tax Increase Prevention and Reconciliation Act of 2005. The provision was passed to provide domestically controlled R.I.C.s the same treatment as domestically controlled real estate investment trusts.

12 This is generally passive income, such as interest, dividends, rents and royalties, etc.

F income of the related payor and to income of the payor that is not treated as effectively connected income – income connected with a U.S. trade or business. This look-thru rule expired for the 2012 tax year. The Act extends this look-thru rule for the 2012 and 2013 tax years.

- Extension of temporary exclusion of 100% of gain on certain small business stock. Under Code § 1202, gain on the sale of certain qualified small business stock[13] is partially excluded from taxation.[14] However, pursuant to the Small Business Jobs Act of 2010 and the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, the excluded amount is 100% if the stock is acquired after September 27, 2010, and before January 1, 2012. The Act extends this 100% exclusion for another two years.

Discussion

Although the Act is welcomed, it is noteworthy for what it didn't do:

- It did not extend the payroll tax cut. Thus, despite promises by both parties not to hit the middle-class with a tax hike, the middle-class and all wage earners have been indeed hit with a tax hike of 2%.
- It did not affect the tax on net investment income as part of the healthcare overhaul. Thus, the tax on high-income earners with respect to qualifying dividends and capital gains will increase to as high as 23.8%. It should be noted that, with respect to the tax on net investment income, the definition of "high-income" earners is different than under the Act, having a reduced threshold of $250,000 (married filing jointly) and $200,000 (single taxpayers). The press had reported that Republicans had been hoping the tax on net investment income could be renegotiated during the fiscal cliff talks.

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[13] Generally, stock held for five years if the stock is issued by a qualified small business, which is, in general, a business with assets of no more than $50 million.

[14] The exclusion amount is 50% but has varied over the years. See Code § 1202(a)(1).

- It did not repeal the carried interest rules for partnerships having service partners receiving carried interests in future gains of the partnership. Under current law, the gain derived from the "carry"[15] is taxed at preferential rates.
- It did not affect corporate income tax rates. There has been much discussion by both parties in reducing the corporate income tax rates by reforming and simplifying the tax code (*e.g.*, by eliminating loopholes) in order to make the U.S. more competitive internationally.

<u>Conclusion</u>

The Act averted the so-called fiscal cliff by extending the Bush era tax cuts for most taxpayers. However, the Act is noteworthy for what it didn't do. It was not a 'grand bargain' addressing tax reform and budget deficits[16] as some had hoped. It did not reform corporate taxes nor eliminate many loopholes. More importantly, it did not raise the debt ceiling, which it has been reported that, once

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15 Hedge fund and private equity fund managers generally receive a 2% management fee and 20% profits interest as compensation for managing investments. The structure is a partnership for tax purposes. Under current law, the 20% profits interest is, in general, taxed at the preferential rates – for example, potentially eligible for the preferential long-term capital gains rate. Many consider this a loophole, as the fund manager is providing services and the profits interest can be considered compensation for those services rendered, thus under this analysis said profits interest should not be eligible for the preferential rates. Several bills have been introduced in Congress to repeal this rule over the years. See, *e.g.*, American Jobs and Closing Tax Loopholes Act of 2010 (H.R. 4123), *available at* http://waysandmeans.house.gov/media/pdf/111/america_jobs_summary.pdf.

16 Principally through spending cuts.

again, as of December 31, 2012, the debt ceiling limit has been reached.[17] Based on commentary by the President, Democrats, and Republicans, we expect many of these tax issues to be revisited early this year as the next debt ceiling debate progresses.

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If you have any questions about this alert, please contact any one of the following lawyers:

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[17] See, *e.g.*, Kasia Klimasinska, *Geithner Tells Congress U.S. Reaches Debt Limit*, Bloomberg, December 31, 2012, *available at* http://www.bloomberg.com/news/2012-12-31/geithner-tells-congress-u-s-reaches-debt-limit.html.