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The American Taxpayer Relief Act of 2012

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On January 1, 2013, Congress passed the American Taxpayer Relief Act of 2012 (the "**Act**"), which averted the "fiscal cliff." The Act:

- Extends the "Bush-era tax cuts" for individuals with taxable income below $400,000 (and for married individuals filing jointly with incomes below $450,000), but allows ordinary income rates to increase to 39.6%, and long-term capital gains and dividend rates to increase to 20%, for taxpayers with taxable income above these levels,
- Delays mandatory across-the-board spending cuts,
- Permanently "patches" the alternative minimum tax for individuals by increasing the exemption amounts applicable to individuals and indexing these amounts for inflation,
- Permanently raises the top gift and estate tax rate to 40% (from 35%) and provides a $5.12 million exemption amount (indexed for inflation), and
- Temporarily extends or reinstates a number of tax credits and other tax provisions that had expired or were scheduled to expire.

The Act does not extend the 2% "payroll tax holiday" that reduced Social Security taxes from 6.2% to 4.2% in 2012.

This memorandum summarizes some of the more significant provisions of the Act. Section I discusses the provisions that apply to individuals, and section II discusses the provisions that apply to businesses.

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I. Individuals.

Income Tax Rates. The Act permanently extends the existing tax rate structure for incomes up to $400,000 ($450,000 for married individuals filing jointly), and increases the marginal tax rate to 39.6% for ordinary income and 20% for long-term capital gains and dividends for individuals with income in excess of $400,000 and for married individuals filing jointly with income in excess of $450,000.[1]

Alternative Minimum Tax. The Act permanently "patches" the alternative minimum tax for individuals by increasing the exemption amounts applicable to individuals and indexing these amounts for inflation.[2]

Reinstatement of Pease Limitation. The Act permanently reinstates the "Pease" deduction limitations.[3] Under section 68 of the Internal Revenue Code,[4] certain itemized deductions (including deductions for mortgage interest, charitable gifts, and state and local taxes) are reduced by 3% of the excess of a taxpayer's adjusted gross income over an "applicable threshold amount" that is adjusted annually for inflation, up to a maximum reduction of 80% of the taxpayer's itemized deductions.[5] The Pease limitation was repealed temporarily for tax years beginning in 2010, 2011, and 2012. The Act reinstates the Pease limitation, but increases the applicable threshold amounts from $178,150 for married individuals filing jointly (or $89,075 for married individuals filing

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[1] The increase in the capital gains and dividends rate is in addition to the 3.8% "Medicare tax" on net investment income that takes effect in 2013. Very generally, the 3.8% Medicare tax is imposed on a taxpayer's interest, dividends, capital gains, and other "net investment income" to the extent that this income, when added to the taxpayer's other modified adjusted gross income, exceeds $200,000 in the case of unmarried individuals, $250,000 in the case of married individuals filing jointly, and $125,000 in the case of married individuals filing separately.

[2] The alternative minimum tax is an alternative tax. Each year, taxpayers must pay either their regular income tax or their alternative minimum tax liability, whichever is greater. The alternative minimum tax is imposed at a maximum marginal rate of 28%, but because the regime denies a number of the exclusions, deductions, and credits permitted under the regular income tax, it may produce a higher tax liability than the regular income tax. In general, an individual's tentative alternative minimum tax liability is based on the extent to which the individual's alternative minimum taxable income exceeds a prescribed "exemption amount." The Act increases the 2012 exemption amounts to $50,600 for unmarried individuals (up from $33,750), $78,750 for married individuals filing jointly and surviving spouses (up from $45,000), and $39,375 for married individuals filing separately (up from $22,500).

[3] The limitation was originally introduced by Representative Donald J. Pease (D-Ohio).

[4] All references to section numbers are to the Internal Revenue Code of 1986, as amended (the "**Code**"), or to Treasury regulations promulgated thereunder.

[5] For example, if an unmarried taxpayer earns $1,000,000 of wages, incurs $130,000 of state and local income taxes, and has no other income or deductions for the tax year, and the applicable threshold amount for unmarried individuals is $250,000, then the taxpayer's deduction for state and local taxes will be reduced by $22,500 (which is 3% of the $750,000 excess of the taxpayer's income over the applicable threshold amount), to $107,500, and the taxpayer's taxable income for the year will be $892,500 (which is $1,000,000 minus the $107,500 allowable deduction).

The Pease limitation generally does not apply to deductions for medical expenses, investment interest, casualty or theft losses, or losses from wagering transactions.

separately) to $300,000 for married individuals filing jointly, $275,000 for heads of households, $250,000 for unmarried individuals, and $150,000 for married individuals filing separately.

Reinstatement of Personal Exemption Phase-Out. The Act reinstates the personal exemption phase-out. Under section 151(d), deductions for personal exemptions are reduced by 2% of the excess of a taxpayer's adjusted gross income over an "applicable threshold amount" that is adjusted annually for inflation. The personal exemption phase-out was repealed temporarily for tax years beginning in 2010, 2011, and 2012. The Act reinstates the personal exemption phase-out, but increases the applicable threshold amounts from $178,150 for single taxpayers (or $267,200 for married individuals filing jointly) to $300,000 for married individuals filing jointly, $275,000 for heads of households, $250,000 for unmarried individuals, and $150,000 for married individuals filing separately.

Transfer of Traditional 401(k) Plan to a Roth 401(k). The Act permits participants in a traditional 401(k) plan to elect to pay current tax on the value of the 401(k) plan and convert it into a Roth 401(k) plan without incurring an early withdrawal penalty. Distributions from a traditional 401(k) plan are subject to tax at ordinary income rates, but amounts contributed to a traditional 401(k) plan are not subject to current taxation. Distributions from a Roth 401(k) plan are not subject to tax, but contributions to a Roth 401(k) plan are taxed currently at ordinary income rates.

Gift, Estate and Generation-Skipping Transfer Tax. The Act permanently extends the federal gift, estate and generation-skipping transfer ("GST") tax provisions that were in effect during 2011 and 2012. These provisions (i) exempt up to $5.12 million (indexed for inflation) in gratuitous transfers made by an individual during lifetime and at death from gift, estate and GST tax and (ii) increase the amount of a surviving spouse's gift and estate tax exemption (but not GST tax exemption) by the unused portion of his or her deceased spouse's gift and estate tax exemption. In addition, the Act increases the gift and estate tax rate in excess of the applicable exemption amount from 35% to 40%.[6]

II. Businesses.

Reinstatement of "Look-Through" Rule for Payments Between Related Controlled Foreign Corporations. The Act extends the look-through rule of section 954(c)(6). Under subpart F of the Internal Revenue Code, as originally enacted, if a "controlled foreign corporation" (a "CFC") made a payment of interest, dividends, rents, or royalties to a related CFC (i.e., one with the same 10% United States shareholder), the payment generally was treated as "subpart F income" and currently taxable to the 10% United States shareholder, unless both CFCs were

[6] The top rate was 35% in 2012. The top rate had been scheduled to increase to 55% in 2013.

organized in the same country.[7] In 2006, Congress enacted section 954(c)(6), which "looks through" any dividend, interest, rent, or royalty paid by a CFC to a related CFC and treats the payment as subpart F income only to the extent that the payment was allocable to subpart F income (or to income that was effectively connected with a U.S. trade or business) of the payer. Section 954(c)(6) expired at the end of 2011. The Act reinstates the look-through rule of section 954(c)(6) retroactively for tax years beginning in 2012 and extends the rule through 2013.

Reinstatement of "Active Banking or Financing Income" Exception from Subpart F Income. The Act extends the "active banking or financing income" exception from subpart F income. Very generally, under section 954(h), income generated directly by a CFC's transactions with non-U.S. customers in the active conduct of a banking, financing, or similar business is not treated as subpart F income (and therefore is not currently taxable to the 10% United States shareholders of the CFC) if the CFC is a licensed bank or a registered broker or dealer, or if more than 70% of the CFC's gross income is derived from the active conduct of a lending or finance business from transactions with unrelated customers. Section 954(h) expired at the end of 2011. The Act reinstates section 954(h) retroactively for tax years beginning in 2012 and extends it through 2013.

Extension of Bonus Depreciation. The Act extends "bonus depreciation" under section 168(k). Very generally, under section 168(k), a taxpayer can take a first-year bonus depreciation deduction equal to 50% of the basis of any depreciable property that the taxpayer puts into service that year if the taxpayer is the first user of the property and the property has a recovery period of 20 years or less.[8] Section 168(k) expired at the end of 2012 (and is scheduled to expire at the end of 2013 for certain property). The Act reinstates section 168(k) and extends it through 2013 (and through 2014 for certain property).

Reinstatement of Withholding Tax Exemption for Dividends Attributable to Interest Paid by Regulated Investment Companies. The Act extends the withholding exemption for regulated investment company ("RIC") dividends attributable to interest for one year. In general, under sections 871 and 881, dividends paid by a U.S. corporation to a non-U.S. person are subject to 30% withholding tax, except to the extent the tax is reduced by an applicable income tax treaty. However, section 871(k) generally exempts dividends paid by a RIC (e.g., a mutual or money market fund) in tax years beginning in 2011 to the extent that the dividends are attributable to

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[7] See section 951; Treasury regulations section 1.954-2(b)(4). Very generally, a foreign corporation is a "controlled foreign corporation" if more than 50% of the combined voting power or value of all classes of the corporation's stock is owned (directly or through attribution) by United States persons that each own (directly or through attribution) stock representing at least 10% of the corporation's voting power (any such owner, a "10% United States shareholder").

[8] Bonus depreciation also applies to certain water utility property, which has a recovery period of 25 years.

interest received by the RIC from persons unrelated to the RIC, or to short-term capital gains.[9] The Act reinstates section 871(k) retroactively for tax years beginning in 2012 and extends it through 2013.

Reinstatement of Research Tax Credit. The Act extends the research tax credit. Under section 41, a credit of as much as 20% of research expenses above a base amount is available for tax years beginning before 2012 to taxpayers conducting research. Alternatively, a taxpayer may elect a credit of as much as 14% of research expenses that exceed 50% of the average of those expenses for the three prior taxable years. The Act reinstates the research tax credit retroactively for 2012 and extends the credit through 2013.

Extension of Production Tax Credit for Wind Facilities. Taxpayers that placed a wind facility in service in 2012 may claim either a production tax credit or an investment tax credit.[10] The Act extends these tax credits to wind facilities whose construction begins before 2014.

Extension of Production Tax Credit for Energy Producers. Taxpayers that place certain renewable energy facilities into service before 2014 can claim either a production tax credit or an investment tax credit.[11] The Act extends these tax credits to renewable energy facilities whose construction begins before 2014 (even if the facilities are not placed in service before 2014).[12]

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If you have any questions about the foregoing, please contact any member of the Cadwalader Tax Department or the Cadwalader Private Client Department.

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[9] Dividends attributable to long-term capital gains of a regulated investment company generally are exempt from withholding under Treasury regulations section 1.1441-3(c)(2)(i)(D).

[10] See section 45; section 48.

[11] See section 45; section 48.

[12] The Act does not renew the cash grant program under section 1603 that permits taxpayers to elect to receive cash in lieu of an investment tax credit with respect to the construction of certain renewable energy projects. The Act also does not extend the ability of taxpayers to use percentage depletion in excess of income with respect to oil and gas wells; as a result, beginning in 2013, percentage depletion for oil and gas wells will be limited to the amount of the taxpayer's income from the property.