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Tax Changes For Investment Funds And Their Investors In Fiscal Cliff Legislation

James R. Brown and
Joseph A. Riley

WILLKIE FARR & GALLAGHER LLP

James R. Brown

Joseph A. Riley

On January 2, 2013, President Obama signed into law the American Taxpayer Relief Act of 2012 (the "Act"). The Act addresses, among other things, provisions of the Internal Revenue Code that were scheduled to expire on December 31, 2012, or had expired previously, including many of the individual income tax rate provisions. This legislation does not affect the tax treatment of interests in partnership profits granted to a partner in exchange for services, referred to as "carried interest," but it is possible that future legislation may change the taxation of such interests.[1]

The following is a summary of provisions of the Act relevant to investment funds and their investors.

All changes described herein are effective for taxable years beginning after December 31, 2012, unless otherwise indicated.

Starting in 2013, ordinary income over $400,000 for individuals ($450,000 for married couples filing jointly) is taxed at a 39.6 percent federal income tax rate. The long-term capital gains tax rate is 15 percent for those whose income is below those same thresholds and 20 percent on any income above those thresholds that qualifies as long-term capital gain. The threshold amounts will be adjusted annually for inflation.

Qualified dividend income will continue to be taxed at the same rates as long-term capital gain, and using the same thresholds. Qualified dividend income generally includes dividends received from domestic corporations and certain foreign corporations, including foreign corporations that are incorporated in a possession of the United States, foreign corporations that are eligible for the benefits of a comprehensive income tax treaty with the United States that meets certain requirements, and foreign corporations whose stock is readily tradable on an established securities market in the United States.

The Act reinstates and makes permanent the limitation on the deductibility of certain itemized deductions, including deductions for investment expenses, such as management fees, but not including investment interest expense. Itemized deductions subject to this limitation will be reduced by the lesser of (i) 3 percent of the excess of an individual's adjusted gross income over a certain threshold (for 2013, $250,000 for unmarried individuals and $300,000 for married individuals filing jointly) indexed for inflation or (ii) 80 percent of the amount of certain itemized deductions otherwise allowable for the taxable year. This limitation is applied after application of the 2 percent floor on miscellaneous itemized deductions. The Act also reinstates and makes permanent the phase-out of personal exemptions, a reduction of which was previously scheduled to expire on December 31, 2012. Personal exemption amounts are reduced by 2 percent for each $2,500, or fraction thereof, by which a taxpayer's adjusted gross income exceeds the threshold amounts applicable to the limitation on itemized deductions above (but not by more than 100 percent).

The Act retroactively reinstates for taxable years beginning after December 31, 2011, and extends through taxable years ending before January 1, 2014, a provision permitting the tax-free distribution from an Individual Retirement Account to charitable organizations of up to $100,000 per taxpayer per taxable year. The Act makes permanent the so-called "patch" to the alternative minimum tax such that the exemption amount for taxable years beginning in 2012 is $50,600 ($78,750 for married couples filing jointly). The alternative minimum tax exemption amounts and phase-out thresholds will be adjusted annually for inflation starting in 2013. In addition, the Act makes permanent the backup withholding rate of 28 percent, which was scheduled to expire on December 31, 2012.

The Act extends the exclusion from gross income of the discharge of mortgage debt on a qualified principal residence occurring before January 1, 2014, which was scheduled to expire on December 31, 2012.

In addition, as part of previous legislation, starting in 2013, a 3.8 percent tax on net investment income is imposed on certain investment income for individuals with income over $200,000 ($250,000 for married couples filing jointly). For this purpose, net investment income includes, but is not limited to, interest, dividends, annuities, royalties, capital gains and income from a passive activity business

James R. Brown and Joseph A. Riley are Partners in the Tax Department of Willkie Farr & Gallagher LLP.

Please email the authors at jbrown@willkie.com or jriley@willkie.com with questions about this article.

or a business of trading in financial instruments or commodities. Starting in 2013, therefore, adjusted net capital gain, including qualified dividend income, is taxed to individuals with the highest incomes at an effective combined federal tax rate of 23.8 percent.

The Act retroactively reinstates for taxable years beginning after December 31, 2011, and extends through taxable years ending before January 1, 2014, certain provisions, relevant to investment funds organized as regulated investment companies ("RICs") and their investors, that had expired on December 31, 2011. Under one such provision, non-U.S. investors who receive dividends from RICs incur no tax liability on the portion of such dividend reported by the RIC as an "interest-related dividend" or as a "short-term capital gain dividend." Another such provision treats RICs whose interests in U.S. real property exceed certain levels as "qualified investment entities," which has the effect of requiring withholding on certain capital gains distributions attributable to the sale or exchange of U.S. real property and made to non-U.S. investors, and modifying when certain non-U.S. investors are subject to tax on the sale or exchange of their shares in a RIC.

The Act makes permanent the gift, estate and generation-skipping transfer tax exemption amount of $5,000,000, adjusted annually for inflation. The inflation-adjusted exemption amount is $5,120,000 for 2012 and $5,250,000 for 2013. The Act also makes permanent the current estate and gift tax rates, which were scheduled to expire at the end of 2012, but creates the following three new brackets: (i) 37 percent for taxable amounts (after adjusting for the exemption amount above) over $500,000 but not over $750,000; (ii) 39 percent for taxable amounts over $750,000 but not over $1,000,000; and (iii) 40 percent for taxable amounts over $1,000,000.

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1 For more information regarding proposals to change the taxation of carried interest, please refer to the Willkie Client Memorandum, "Preparing for the Possible Enactment of Carried Interest Legislation" (November 12, 2012), available at http://www.willkie.com/files/tbl_s29Publications/FileUpload5686/4245/Preparing_for_the_Possible_Enactment.pdf.