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Fiscal Cliff Legislation – A Quick Rundown of What Happened to Taxes Over the Holiday

In the early morning hours of January 1, 2013 the Senate passed the "American Taxpayer Relief Act of 2012" by a vote of 89-8. Late that same day, after plans to amend the bill to include spending cuts were abandoned, the House of Representatives approved the same bill by a vote of 257-167. The bill now goes to President Obama for his signature. The bill provides greater certainty with regard to income tax rates, which hopefully will allow business owners and individuals an opportunity to plan for the future. In many respects the deal is not a temporary fix, as many thought might happen at the last minute. Changes to tax rates on ordinary income, estate tax, dividends, capital gains, and the AMT patch, are intended to be permanent in nature.

- Rate increases:
    - The top ordinary income tax bracket will increase from 35% to 39.6% at taxable income levels in excess of $400,000 for single filers and $450,000 for married couples filing jointly.
    - The top rate for capital gains and dividends will increase from 15% to 20%, for taxpayers in excess of the same $400,000/$450,000 taxable income levels.
    - These rate increases are in addition to the new Medicare tax increases on adjusted gross incomes in excess of $200,000/$250,000 that are already set to begin in 2013 as a result of healthcare legislation enacted in 2010. After adding in this Medicare surtax, the overall tax rate on investment-type income and gains will be 23.8% for higher income taxpayers.

- Reinstating phase-outs for personal exemptions and itemized deductions, which were eliminated over a number of years by the Bush-era tax cuts. These phase-outs are effectively hidden marginal tax rate increases for single taxpayers with adjusted gross incomes of $250,000 (and married taxpayers filing jointly at $300,000) or more. For example, the 3% reduction to itemized deductions effectively adds 1.2% to the tax rate of those individuals in the 39.6% rate bracket.

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- The AMT exemptions and phase-outs have been addressed, retroactive for the 2012 tax year. Because AMT exemptions and phase-out levels will be indexed for inflation going forward, the bill is generally viewed as a permanent AMT patch and should eliminate the need for a last-minute changes to exemption levels, as has happened for the last several years.

- Estate, gift and generation skipping transfer tax changes, all of which are intended by Congress to be permanent:
    - Retains the $5 million per person exemption, indexed for inflation.
    - Increases the top rate from 35% to 40%.
    - Retains the concept of portability, which allows married taxpayers to take advantage of both spouses' lifetime exemptions without potentially complex planning.
    - The estate and gift tax remains "unified," allowing individuals to take advantage of the $5 million exemption during their lifetime or at their death.

- Extension of selected favorable business provisions through 2013:
    - The research & development credit was extended through 2013 and made retroactive for 2012.
    - The Work Opportunity Tax Credit was extended through 2013 and was also made retroactive for 2012.
    - Section 179 expense stays in place at the 2010/2011 levels, with a maximum deduction of $500,000 and a $2 million phase-out for 2012 and 2013.
    - Bonus depreciation continues through 2013, which allows 50% expensing for qualifying property placed in service before 1/1/14.

The bill also extended the current Medicare reimbursement rates for physicians, and federal emergency unemployment benefits, through 2013. The bill did not extend the 2% employee payroll tax cut that was in effect for 2011 and 2012. To the ire of House Republicans, the agreement delays the onset of sequestration spending cuts for 2 months, and does not address the federal debt ceiling. So, Congress still has more work to do between now and the end of February.

As additional details become available we will be providing more in-depth information. In the meantime, please contact your GBQ tax representative if you have questions or would like to discuss the impact this legislation may have on you and your business.