Fiscal Cliff Averted—Somewhat

On January 1, 2013, Congress approved H.R. 8, "the American Taxpayer Relief Act of 2012" (ATRA) to avert the "fiscal cliff," staving off widespread tax increases and deep spending cuts. President Obama signed the bill into law on January 2, 2013. The following is a brief review of what has changed, and what has not.

The so-called "fiscal cliff" has been at least partially averted by the eleventh-hour legislation signed by the president on Wednesday. For US taxpayers earning in excess of $400,000 (or $450,000 for joint filers), the tax rate on ordinary income will increase to 39.6 percent and the tax rate on dividends and long-term capital gains will increase to 20 percent, plus the Medicare tax of 3.8 percent. There was some concern that the preferential rate on dividends would be eliminated, but it remains. Furthermore, in a surprise move, the US estate and gift tax exemption remains at approximately $5 million, although the tax rate increases from 35 to 40 percent of value.

The major tax provisions of ATRA are as follows:

- The income tax brackets between 10 percent and 35 percent from the Bush tax cuts are retained, except with respect to certain high-income taxpayers.

- A new top tax bracket of 39.6 percent applies to individuals earning more than $400,000 a year ($450,000 for joint filers and $425,000 for heads of household).

- The exemption amount for "alternative minimum tax" on individuals has increased and will be permanently indexed for inflation.

- Dividends and capital gains are taxed at 20 percent (up from 15 percent) for individuals earning at least $400,000 ($450,000 for joint filers). Note, that this is in addition to the 3.8 percent Medicare tax.

- The "Personal Exemption Phase-Out" and the limitation on itemized deductions have been reinstated, with a threshold of $250,000 ($300,000 for joint filers).

- The following provisions have been extended (retroactively, where applicable) through December 31, 2013:

    - The 50 percent first-year bonus depreciation on certain depreciable property

    - The 15-year straight line cost recovery for qualified leasehold improvements, qualified restaurant buildings and improvements, and qualified retail improvements

    - The research tax credit (with certain modifications)

    - The increased expensing limitations ($500,000) and treatment of certain real property as "section 179 property"

    - Exclusion from a tax-exempt organization's "unrelated business taxable income" of certain "excess" interest, rent, royalties and annuities paid from a "controlled entity"

- The exceptions under the "subpart F" rules applicable to "controlled foreign corporations" (CFCs) for active financing income and for certain payments between related CFCs (the "look-through" rules) are retroactively extended through taxable years of non-US corporations beginning before January 1, 2014.

- The "production tax credit" and the alternative "investment tax credit" with respect to facilities producing energy from certain renewable resources are extended one year and modified such that a facility will be a "qualified facility" if construction begins before January 1, 2014, rather than requiring the facility to be up and running before that date. This modification eases pressure on sponsors to complete projects by the end of the year.
- For individuals dying, and gifts made, after 2012, steep increases in estate, gift and generation-skipping transfer (GST) tax that were slated to occur have been prevented by permanently retaining a $5,120,000 exemption (indexed for inflation).
- The top estate, gift and GST tax rate is permanently increased from 35 percent to 40 percent.
- The ability of a decedent's estate to transfer any unused estate tax exemption to a surviving spouse has been made permanent.

In addition to the above provisions, ATRA includes certain non-tax features such as (i) a one-year extension of emergency unemployment insurance and agricultural programs, (ii) a postponement of automatic cuts in Medicare payments to physicians, and (iii) a two-month postponement of automatic across-the-board spending cuts (i.e., sequestration) otherwise scheduled to begin January 1, 2013.

ATRA did not extend the temporary 4.2 percent rate for an employee's portion of the Social Security payroll tax, which reverts to 6.2 percent. ATRA also did not address the debt ceiling, pursuant to which the US reached its legal borrowing limit, giving Congress approximately two months before it must raise the debt ceiling or risk a default on its financial obligations.

A Small Piece of the Puzzle

ATRA is a stop-gap measure and, therefore, only a small piece of the puzzle. Various revenue shortfalls still need to be addressed. Thus, in connection with the negotiations relating to extending the debt ceiling, it is highly likely that additional tax legislation will be forthcoming this year. Presumably, this additional legislation will address many of the corporate tax loopholes and related corporate revenue raisers that are absent from ATRA and may include additional limitations on certain itemized deductions for individuals (e.g., mortgage interest and state and local taxes).

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