Highlights of the American Taxpayer Relief Act of 2012

President Obama has signed the American Taxpayer Relief Act of 2012 (the "Act"). The Act partially averts the so-called "fiscal cliff," making permanent many Bush-era tax rate provisions while increasing taxes on upper-bracket individuals.

- Individual income tax rates. The Act reinstates a top marginal federal income tax rate of 39.6% for taxable income above $450,000 for married taxpayers filing jointly or $400,000 for single filers. The marginal tax rates on income below those thresholds remain the same as in 2012 for all taxpayers.

- Capital gains and qualified dividend income. Capital gains and qualified dividend income are subject to tax under the Act at a maximum rate of 20% for individual taxpayers in the 39.6% bracket described above. The Act retains 2012 tax rates on capital gains and qualified dividend income for other taxpayers, so that a 15% rate continues to apply to middle-bracket taxpayers. Without this legislation, taxes on qualified dividend income would have reverted to the applicable marginal ordinary income rates.

- Limitations on deductions for taxpayers with income above $250,000. The Act phases out certain itemized deductions and personal exemptions for married individuals filing jointly with adjusted gross income above $300,000 and single filers with adjusted gross income above $250,000. These limitations, which have received less attention in the popular press, effectively increase tax rates for affected taxpayers, including many who are not subject to the new 39.6% marginal rate.

- Roth conversions for retirement plans. The Act includes an unexpected amendment to the rules for Roth contributions to 401(k) and similar defined contribution plans, expanding the ability of such plans to allow participants to convert portions of their accounts to Roth accounts by removing the requirement that the participant be eligible to take a distribution of the portion that is selected for conversion.

- Permanent extension of certain employee benefits. By eliminating the sunset provisions of key 2001 tax legislation, the Act permanently extends certain popular tax-free employee benefits, such as employer-provided educational assistance.

- Individual and business extenders. The Act includes a package of individual and business "tax extenders," such as bonus depreciation deductions, certain exemptions from U.S. withholding taxes for foreign shareholders of regulated investment companies, and the research and development tax credit (which is also expanded in some cases).

- Estate, gift and generation-skipping transfer taxes. The estate tax exemption amount of $5 million, indexed from 2010, is made permanent, and the maximum estate tax rate is increased from 35% to 40% for decedents dying after December 31, 2012. The gift tax and the generation-skipping transfer tax (GST tax) are also permanently subject to the same exemption amount of $5 million (as indexed) and rate schedule. Importantly, the ability of the executor of a deceased spouse's estate to transfer any unused gift and estate tax exemption to a surviving spouse has also been made permanent.

The Act does not extend the 2011-2012 payroll tax holiday, and it leaves in place the new 0.9% additional Medicare tax on wages over $250,000 for married joint filers and $200,000 for single filers. The Act also does not affect the 3.8% surtax, effective January 1, 2013, on "net investment income" of certain individuals, estates, and trusts. The 3.8% surtax is described in more detail in our Alert of December 7, 2012.

For more information on the Act, please contact a member of the Ropes & Gray tax or employee benefits teams, or your regular Ropes & Gray attorney.

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