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The American Taxpayer Relief Act of 2012

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Introduction

As you no doubt have heard, the U.S. was set to plunge over the "fiscal cliff" on New Year's Day if Congress failed to act. In the early morning hours of New Year's Day, a deal was made that averted the crisis and made permanent the majority of the Bush-era tax cuts. The President signed the American Tax Relief Act of 2012 into law on Wednesday. The following highlights the new tax changes most likely to affect our clients.

Background

The fiscal cliff was the combination of several unrelated fiscal policy events all set to come into play on January 1, 2013. Numerous tax cuts were to expire on December 31, 2012, thereby raising taxes by $494 billion in 2013. Mandatory spending cuts of $1.2 trillion were to automatically go into effect January 3, 2013. Many worried that the double-whammy of increased taxes and spending cuts would further weaken our already injured economy.

On the income tax side, the "Bush tax cuts," some of which have been in effect since 2001, were set to expire on December 31, 2012. The 10% tax bracket would have been eliminated, and the rate of 15% would have been the lowest rate, with the rate of 25% increasing to 28%, 28% to 31%, 33% to 36%, and 35% to 39.6%. Dividends were to revert to being taxed as ordinary income (rather than taxed at the capital gains rate of 15%), which meant that in 2013 some individuals would have had their dividends taxed at nearly three times the amount they would have been taxed in 2012.

In the realm of estate and gift taxes, without Congressional action the current $5 million estate, gift, and generation-skipping transfer tax (GST) exemptions would have been reduced to a low $1 million per person in 2013. This would have exponentially increased the number of American households subject to the estate tax. For the past 12 years, the estate, gift, and GST tax exemptions and rates had been up in the air. The Economic Growth and Tax Relief Reconciliation Act of 2001 phased-out the estate and GST taxes completely in 2010, while the gift tax had a $1 million exemption and 35% rate for that year. In 2010, a new law set the exemption at $5 million per person with a 35% rate for all three taxes through December 31, 2012.

What the American Tax Relief Act of 2012 means

Tax Rate Hikes

The Act made the "Bush tax cuts" permanent for individuals whose income does not exceed the following thresholds: $400,000 for single filers, $425,000 for heads of household, $450,000 for those filing jointly, and $225,000 for those who are married filing separately. This means that the tax rates for individuals in these categories will remain the same as they were in 2012. For those taxpayers whose income exceeds the $400,000/425,000/450,000/225,000 threshold, their tax rates will permanently rise from a maximum rate of 35% to 39.6%. The maximum capital gains and dividends tax rate also increases for these individuals, rising from 15% to 20%. This rate is also permanent. The estate, gift, and generation-skipping transfer tax rates are now unified, and permanently rise to 40% on amounts over $5,000,000 (indexed to inflation), up from 35%. The Act also makes portability, where the second spouse can use the first spouse's unused estate tax exemption, permanent.

While not a part of the American Tax Relief Act of 2012, there are three additional tax increases in 2013 that should be noted. Congress chose not to extend the "payroll tax holiday" that expired at the end of 2012, so all individuals will now pay an additional 2% (for a total amount of 6.2%) in payroll taxes (Social Security taxes) on their income up to $113,700. The Affordable Care Act of 2010 instituted two new Medicare taxes. For taxpayers with incomes that cross the threshold of $250,000 (married filing jointly), $200,000 (single filers), or $125,000 (married filing separately), a .9% Medicare Hospital Insurance tax will be assessed on any wages or small business income that exceed the threshold. For individuals in these same categories, a new 3.8% Medicare surtax on the lesser of certain types of investment income or adjusted gross income will also be assessed.

Alternative Minimum Tax

The Act set permanent rates for the Alternative Minimum Tax (AMT), as well as indexed the AMT for inflation. The current rate, which is retroactive back to 2011, provides an exemption of $50,600 for single taxpayers, $78,750 for joint filers, and $39,375 for those who are married filing separately.

Deductions and Tax Credits

The Act reinstated both the Pease limitation on itemized deductions and the Personal Exemption Phaseout (PEP). These apply to those whose income reaches the following thresholds: $300,000 for those who are married filing jointly, $275,000 for heads of household, $250,000 for single filers, and $150,000 for married taxpayers filing separately. The PEP reduces the allowable exemption for individuals in these categories by 2% for every $2,500 over the threshold, and the Pease limitation reduces the allowed itemized deduction by 3% once an individual's income exceeds the threshold. The Earned Income Tax Credit, Child Tax Credit, and American Opportunity Tax Credit, aimed at individuals in low income brackets, were each extended for 5 years.

Other provisions

The Act keeps in place (through 2013) the following individual extenders:

- Deduction of certain expenses of elementary and secondary school teachers;
- Exclusion from gross income of discharge of qualified principal residence indebtedness;
- Parity for exclusion from income for employer-provided mass transit and parking benefits;
- Mortgage insurance premiums treated as qualified residence interest;
- Deduction of State and local general sales taxes;
- Special rule for contributions of capital gain real property made for conservation purposes;
- Above-the-line deduction for qualified tuition and related expenses;
- Tax-free distributions from individual retirement plans for charitable purposes; and
- Improve and make permanent the provision authorizing the IRS to disclose certain return and return information to certain prison officials.

The Act also extends certain business tax breaks (through 2013), depreciation modifications (through 2014), and energy-related extenders (through 2013). The Act extends federal unemployment provisions through 2013, and put a temporary hold on Medicare cuts for doctors (through 2013). A pay freeze for Congress is back in effect, and a temporary (9-month) extension for the farm bill was also included. Sequestration (the automatic spending and budget cuts that come into effect once the debt ceiling has been reached) is delayed for two months in order to give Congress more time to come to a decision on the debt ceiling issue.

What Happens Next

The Act averted the fiscal cliff, but it did nothing to deal with what is the next major political battle: debt ceiling negotiations. The debt ceiling is the federal government's authorized borrowing limit. This limit of $16.4 trillion was reached on December 31, 2012. Treasury Secretary Tim Geithner has implemented "extraordinary measures" to ensure the government does not default on its debts.

Republicans see the debt ceiling debate as an opportunity to demand cuts to entitlement programs by refusing to increase the debt limit. President Obama, on the other hand, has stated that he wants a balanced approach to deficit reduction that includes both increasing revenue and decreasing spending, and that the debt ceiling limit itself is nonnegotiable. Earlier this week he stated, "I will not have another debate with this Congress over whether or not they should pay the bills that they've already racked up through the laws that they passed."

The standoff over the debt limit will be compounded because of a confluence of events. By the end of February, the Treasury Department will most likely no longer be able to pay the government's bills, and on March 1 across the board cuts in spending will begin. On March 27 there exists the possibility of a government shutdown if Congress cannot agree on a government budget for the upcoming fiscal year. Thus, in the span of a few weeks, our nation's leaders will have to tackle difficult issues such as sequestration, Medicare and Medicaid spending, changing the inflation calculation for Social Security benefits, and tax reform.

Understandably, many in the business community are afraid of the looming debt ceiling fight because they remember the same debate in 2011 that caused Standard & Poor's to downgrade the United States' credit rating. Moreover, the debate is likely to fuel economic uncertainty, which could slow and possibly reduce hiring and investment in an already fragile recovery.

Because the Act did not include any tax reform measures, it is possible that tax reform akin to the 1986 tax code changes could be on the horizon. Congress also did not touch several estate planning and "revenue raising" items that were rumored, including a 10 year limit on Grantor Retained Annuity Trusts, limiting benefits of grantor trusts, curtailing the use of LLCs and other entity valuation discounts, and limiting the duration of allocation of GST exemptions. We will keep you apprised of any major tax law changes, and please reach out to us with any questions you might have.

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