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The Fiscal Cliff Deal - What does it mean for you and your business?

In the early morning hours of January 1, 2013, the Senate approved the American Taxpayer Relief Act of 2012 (the "Act") by a vote of 89-8. Less than 24 hours later, the House of Representatives also approved the Act by a vote of 257-167. Late in the evening on January 2, 2013, President Obama signed the Act into law remotely from his vacation in Hawaii bringing to a close, at least temporarily, the fiscal cliff debate.

After the Act, 2013 will bring about higher taxes for most, if not all, Americans. The wealthy will face higher tax rates and increased limitations on deductions, while all working taxpayers will face an increased payroll tax rate. While estate ***and gift*** tax exemptions will be set at $5,000,000 per spouse and will benefit from future indexing for inflation, the top estate and gift tax rate will rise from 35% to 40%. The Act also extends through 2013 many business friendly provisions including the current "bonus" depreciation rules, enhanced Section 179 business expensing, and popular credits such as the New Markets Tax Credit and the Work Opportunity Tax Credit.

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Overall, the Act will at least provide some certainty for taxpayers by making many permanent changes instead of temporary provisions that leave taxpayers and businesses unsure about how to plan for the future. This summary highlights many key provisions of the Act.

Income Tax Rates

In 2013, the top marginal income tax rate will increase from 35% to 39.6% for individuals with taxable income above $400,000; married taxpayers filing jointly and surviving spouses with taxable income above $450,000; heads of household with taxable income above $425,000; and married taxpayers filing separately with taxable income above $225,000. These amounts will be indexed for inflation for tax years beginning after 2013. The 2012 marginal tax rate brackets will be permanently extended for incomes below these amounts.

The Act raises the tax rate on long term capital gains (other than collectibles and recaptured section 1250 gain) and qualified dividends from 15% to 20% for individuals in the 39.6% tax bracket, while the long term capital gains and dividends tax rate will remain at 15% for most other taxpayers. However, due to the 3.8% Medicare surtax (which was unaffected by the Act), high income individuals will pay a 23.8% federal tax rate on many capital gains and dividends.

Limitations on Deductions

The "Pease provision", which limits itemized deductions for higher income taxpayers, will return in 2013. Taxpayers subject to the limitation will see their itemized deductions reduced by 3% of the amount by which their adjusted gross income ("AGI") exceeds the threshold amount,[1] with the reduction not to exceed 80% of the otherwise allowable itemized deductions. The threshold amount is $250,000 for individuals; $300,000 for married taxpayers filing jointly and surviving spouses; $275,000 for heads of household; and $150,000 for married taxpayers filing separately. These amounts are indexed for inflation for tax years after 2013.

Personal exemptions allow a certain amount per person to be exempt from tax. For 2012, this amount was $3,800. Individuals are entitled to claim personal exemptions for themselves, their spouses if married filing jointly, and any dependents they support. Starting in 2013, the Act reinstated the personal exemption phase-out formerly repealed by the Economic Growth and Tax Relief Reconciliation Act of 2001. The total amount of personal exemptions will be reduced by 2% for each $2,500 (or $1,250 in the case of married taxpayers filing separately) by which the taxpayer's AGI exceeds the applicable threshold. The threshold amount is $250,000 for individuals; $300,000 for married taxpayers filing jointly and surviving spouses; $275,000 for heads of household; and $150,000 for married taxpayers filing separately. These amounts are indexed for inflation for tax years after 2013.

Key Business Provisions

The Act extends through 2013 current "bonus" depreciation rules, which allow businesses to deduct up to 50% of the cost of a wide variety of property and equipment including real property improvements. The Act also extends through 2013 enhanced Section 179 business expensing up to $500,000. This amount is reduced dollar for dollar by the amount of Section 179 property placed into service during the year exceeding $2,000,000.

In addition, the Act extends through 2013 the New Markets Tax Credit and the Work Opportunity Tax Credit, which reward employers who hire individuals from targeted groups. The Act also extends through 2013 the provision allowing for 100% exclusion for gain on the sale of qualified small business stock.

Estate and Gift Tax

The unified federal estate and gift tax exemption amount will remain at $5,000,000 per person, indexed for inflation for tax years beginning after 2012. The Act makes portability permanent for decedents dying after December 31, 2012, which means that a spouse may use estate tax exemption remaining from his or her predeceased spouse's estate against his or her estate tax liability. The Act also permanently increases the top estate, gift, and generation-skipping transfer tax rate from 35% to 40%. Without the Act, the federal estate and gift tax exemptions would have fallen to $1,000,000 on January 1, 2013, and the top estate, gift, and generation-skipping transfer tax rate would have risen to 55%.

Payroll Taxes

The Act does not extend the two-percentage point reduction in the Old Age, Survivors, and Disability Insurance (OASDI) tax, commonly known as the Social Security Tax. The reduction, enacted in 2011, decreased that tax rate from 6.2% to 4.2%. In 2013, the tax rate will return to 6.2% on income up to $113,700.

Alternative Minimum Tax

The Alternative Minimum Tax (AMT) is imposed at 26% or 28% on certain tax preference items. The goal of the AMT was to prevent very wealthy taxpayers from investing in tax-advantaged investments and thus avoiding the payment of federal income tax altogether. However, the AMT exemptions have become so low that the AMT would apply to middle income taxpayers without frequent "patches" from Congress. The Act makes AMT relief permanent and increases the AMT exemption amount for 2012 to $50,600 for unmarried taxpayers, $78,750 for married taxpayers filing jointly and surviving spouses, and $39,275 for married taxpayers filing separately. Beginning in 2013, the AMT exemption amount, exemption phase-out threshold, and income bracket will be indexed for inflation.

Other Highlights

American Opportunity Tax Credit – The Act extends the American Opportunity Tax Credit for another 5 years, through 2017. The American Opportunity Tax Credit permits eligible taxpayers to claim a credit equal to 100% of the first $2,000 of qualified tuition and related expenses, and 25% of the next $2,000 of qualified tuition and related expenses (for a maximum credit of $2,500 for the first four years of post-secondary education).

Discharge of Indebtedness Income – The Act extends the exclusion of discharge of indebtedness income on a principal residence from gross income through the 2013 tax year. Taxpayers can exclude up to $2,000,000 of forgiven debt on their principal residence as long as the discharge of debt is directly related to a decline in the residence's value or the financial condition of the taxpayer.

401(k) Plans – The Act allows individuals to convert their existing 401(k) plan account to a Roth account, if their employer offers designated Roth accounts under the plan, regardless of whether the individual is allowed to take distributions from the plan. Under current law, taxpayers may only convert a 401(k) plan account to a Roth account if they are eligible to receive distributions from the plan (e.g., after age 59 ½).

Distributions to Charity – The Act extends through 2013 the provision allowing tax-free distributions from IRAs to public charities by individuals age 70 ½ or older, up to a maximum of $100,000 per taxpayer.

Contribution of Capital Gains Real Property for Conservation – The Act extends through 2013 the special rule allowing contributions of capital gain real property for conservation purposes to be taken against 50% of the contribution base.

State and Local Sales Taxes – The Act extends through 2013 the election to take an itemized deduction for State and local general sales taxes in lieu of the itemized deduction permitted for State and local income taxes.

[1] AGI is defined as gross income minus certain items including expenses of carrying on a trade or business (other than as an employee), certain moving expenses, allowable contributions to certain retirement arrangements, and alimony. Taxable income is AGI minus allowances for personal exemptions and standard or itemized deductions.

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