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Over and Back from the Fiscal Cliff – The New Tax Law

On January 2, 2013, President Obama signed into law the American Taxpayer Relief Act of 2012 (the "Act"), averting the automatic across-the-board tax increases that would have otherwise gone into effect upon the expiration of the "Bush tax cuts." Other changes to the tax law that were scheduled to go into effect in 2013 have occurred as scheduled.

Individual and Payroll Tax Rates

Under the Act, capital gains and ordinary income tax rates for income below $400,000 ($450,000 for married taxpayers and $425,000 for heads of households) remain at their 2012 level. Ordinary income tax rates for income above these levels will be taxed at a 39.6% rate, while capital gains and qualified dividend income will be taxed at 20%. These threshold amounts are adjusted for inflation for calendar years after 2013.

However, the imposition of the new Medicare tax on investment income (which generally includes capital gains) also came into effect starting in 2013. This tax of 3.8% is imposed on investment income earned by taxpayers with income of more than $200,000 ($250,000 for married taxpayers). Thus, an unmarried taxpayer will be subject to a total income tax rate of 18.8% on capital gains above $200,000 and 23.8% on capital gains above $400,000.

With respect to payroll taxes, the employee portion of the social security tax reverts to the 6.2% rate that had been in effect prior to 2011. Also, the new additional Medicare tax of 0.9% on wages in excess of $200,000 ($250,000 for married taxpayers), went into effect starting January 2013. (Employers are only required to withhold this additional tax if the employer pays the employee an excess of $200,000 in wages.) These increases were also not affected by the Act.

Deduction Limitations

Under the Act, itemized deductions for high income individuals are reduced by 3% of the income above the threshold (adjusted gross income above $250,000 for individuals and $300,000 for married tax payers), but the total reduction is not to exceed 80% of the itemized deductions. Personal exemptions are also phased out for these high income individuals.

Permanent AMT Patch

Under the Act, the imposition of the alternative minimum tax (the "AMT") is now permanently indexed to inflation. Prior to the Act, Congress annually passed a "patch" to avoid the imposition of the AMT on middle class taxpayers. By permanently adjusting the threshold amounts for inflation, the annual political fight over the patch will no longer be necessary.

Individual and Business Extenders

The Act temporarily extends numerous tax credits and other provisions for both individuals and businesses. Among the extenders for individuals are the exclusion from gross income of discharge of indebtedness income of qualified principal residence indebtedness, as well as deductions for state and local general sales tax. A provision that established parity between fringe benefits for mass transit and for parking was also extended. For businesses, the Act extends the research credit and the work opportunity credit, as well bonus depreciation allowances, among other extenders. Numerous energy-related tax credits were also extended.

Additionally, by virtue of a blanket deletion of a sunset provision under prior law, the Act permanently extends several other tax provisions. Such provisions include (i) a provision allowing employers to exclude from the wages of employees amounts provided under an educational assistance program adoption assistance credit; (ii) the employer-provided child care credit; and (iii) provisions relating to the adoption assistance credit and amounts that can be provided by employers and excluded from employees' wages pursuant to adoption assistance programs.

Gift, Estate, and Generation-Skipping Transfer Taxes

Under the Act, the exemption amount for gift tax, estate tax, and generation-skipping transfer tax remains at $5,000,000, indexed from 2011 (approximately $5,250,000 for 2013). The maximum rate for gift, estate and generation-skipping transfer taxes was increased from 35% to 40%.

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