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American Taxpayer Relief Act of 2012 Finally Settles Individual Federal Income Tax Rates for 2013 and Beyond

On January 1, 2013, the Senate and the House of Representatives passed the American Taxpayer Relief Act of 2012 (“ATRA”), averting the so-called “fiscal cliff.” The legislation, which was signed by President Obama on January 2, 2013, includes several major changes to the Internal Revenue Code (the “Code”), the most important of which are outlined below.

The most contentious part of the year-end “fiscal cliff” negotiations involved whether individual tax rates would increase for “high-income taxpayers,” with both parties agreeing early that rates should not be increased for most taxpayers. The Obama administration initially would have defined “high income” for single taxpayers and married joint return filers at taxable incomes of $200,000 and $250,000 respectively. The compromise under ATRA defined high-income single and married taxpayers as those having taxable income above $400,000 and $450,000, respectively. As a result, the regular income tax rate for high-income taxpayers will increase from 35% to 39.6% on taxable income over these thresholds, while rates for other taxpayers will be unchanged. [1]

ATRA also made permanent the 2003 reductions in preferential tax rates applicable to qualified dividends and long-term capital gains, except for high-income taxpayers, so that the highest applicable rate on this type of income will remain at 15% for most taxpayers. For high income taxpayers with taxable income over the $400,000 or $450,000 threshold, the preferential rates for dividends and long-term capital gains will be 20% on the excess of such income over the threshold.

New Tax Rates and Other Changes for Individuals

The chart below shows the marginal rates for individual taxpayers.

Marginal Rates for Married Individuals Filing Jointly with Taxable Income:

Not over $17,400	10%
$17,400 - $70,700	15%
$70,701 - $142,700	25%
$142,701 - $217,450	28%
$217,451 - $388,350	33%

[1] In addition to the rate increases applicable to items of income generally, the new Medicare tax that took effect on January 1, 2013 (which is not part of ATRA) imposes on individuals a 3.8% tax on the lesser of net investment income or modified adjusted gross income over $200,000 (in the case of an unmarried taxpayer) or $250,000 (for couples filing jointly).

$388,351 - $450,000	35%
Over $450,000	39.6%

Maximum Dividend and Capital Gain Rates for Married Individuals Filing Jointly with Taxable Income:

Up to $450,000	15%
Above $450,000	20%

Marginal Rates for Unmarried Individuals with Taxable Income:

Not over $8,700	10%
$8,701 - $35,350	15%
$35,351 - $85,650	25%
$85,651 - $178,650	28%
$178,651 - $388,350	33%
$388,351 - $400,000	35%
Over $400,000	39.6%

Maximum Dividend and Capital Gain Rates for Unmarried Individuals with Taxable Income:

Up to $400,000	15%
Above $400,000	20%

Before 2010, certain itemized deductions, including deductions for mortgage interest, state and local taxes, and charitable gifts, were reduced based on adjusted gross income in excess of a specified threshold. ATRA revives these deduction phase-outs for single taxpayers with adjusted gross incomes above $250,000 and couples with adjusted gross incomes above $300,000. Similar rules apply to the phase-out of personal exemptions. The total amount of itemized deductions for each such taxpayer is reduced by 3% of the amount by which the taxpayer’s adjusted gross income exceeds the threshold amount, with the reduction not to exceed 80% of the otherwise allowable itemized deductions. These limitations do not apply to the deductions for medical expenses, investment interest, non-business casualty and theft losses, and gambling losses.

ATRA does not extend the 2% payroll tax holiday that has been in effect for the two years ending December 31, 2012, and payroll tax rates therefore will immediately increase to 6.2% (up from 4.2%).

ATRA permanently adjusts the individual alternative minimum tax ("AMT") exemption amount to take into account the effects of inflation. The AMT previously was not automatically adjusted for inflation and therefore had the potential each year to affect more taxpayers who were never intended to be covered by the AMT. ATRA is designed to eliminate the need for periodic "AMT patches" that increased the exemption amount for inflation since its original enactment. The changes to the AMT are effective retroactively to taxable years beginning after December 31, 2011.

Also, under ATRA, cancellation of indebtedness income that is from "qualified principal residence indebtedness" will be excluded from income so long as the debt is discharged before January 1, 2014. This represents a one-year extension of prior law. Additionally, taxpayers will continue to be able to deduct state and local sales taxes for taxable years beginning before January 1, 2014, a two-year extension.

Taxpayers ages 70 ½ or older will continue to be able to make tax-free distributions from individual retirement plans directly to charitable organizations until December 31, 2013. Additionally, ATRA makes it much easier for taxpayers to convert their existing retirement savings into Roth IRAs.

ATRA makes permanent the unified estate and gift tax exemption that applied during 2012. As a result, taxpayers can make up to $5 million (which will be indexed for inflation, currently $5.12 million) of total gifts during their lifetime and at death without being subject to estate or gift tax. ATRA also increases the top rate on estates that exceed the exemption amount, from 35% to 40%.

ATRA also extends several tax credits for individuals. In particular, the child tax credit and the earned income tax credit were extended for five years.

The exclusion from gross income for gains on qualified small business stock was 50% for investments made up until February 17, 2009, 75% for investments made from February 17, 2009 through September 27, 2010, and 100% for investments made from September 28, 2010 through December 31, 2011. ATRA extends the 100% exclusion to gains on all investments in qualified small business stock made through the end of 2013 (provided that the minimum 5-year holding period requirement is satisfied at the time of the sale).

Corporations converting to S corporation status are subject to a corporate level tax on certain gains that economically accrued before the conversion to S status ("built-in gains"). This tax is generally imposed if the built-in gain is recognized by the corporation during a subchapter S year that begins during the 10-year period following the effective date of the S election. This 10-year "recognition period" was reduced to seven years for taxable years beginning in 2009 and 2010, and then was reduced to five years for taxable years beginning in 2011. The recognition period was scheduled to revert to the full 10-year period for taxable years beginning in 2012. ATRA extends the application of the five-year recognition period for two more years so that it will apply to taxable years beginning in 2012 and 2013. The shortened recognition period rule also prevents imposition of a built-in gain tax on installment sale gains in later years, provided that the installment sale itself occurred during a taxable year in which the shortened recognition period would have otherwise prevented imposition of a built-in gains tax.

Changes for Businesses

In addition to changes in the taxation of individuals, ATRA contains a number of important business tax provisions. Thus, foreign shareholders in regulated investment companies are now allowed to continue to exempt "interest-related dividends" through taxable years ending in 2013. This represents a two-year extension compared to prior law. ATRA also extends exclusions from Subpart F income for “exempt interest income” and “qualified banking or financing income.”

In another important development, ATRA reinstates the Subpart F “lookthrough rule” that excludes same-country dividends and interest from Subpart F income. This will facilitate tax planning for multinationals.

Businesses will be able to take advantage of an extension of the research credit under section 41, as well as several energy credits. Most notably, the production tax credit was extended for all wind energy projects that “begin construction” by the end of 2013. In addition to extending the production tax credit, other credits, including those for biodiesel, cellulosic ethanol, electric vehicles, and energy efficient homes and appliances, were also extended.

Significantly more favorable limitations on deductions under section 179 were extended for another year, and were also made applicable retroactively to taxable years beginning in 2012. Whereas prior law limited the amount of bonus depreciation to $25,000 for taxable years beginning after 2012, ATRA extends the $500,000 limitation to taxable years beginning in 2012 and in 2013. In addition, the applicability of “bonus depreciation” under section 168(k) has been extended for another year. “Bonus depreciation” allows taxpayers to immediately deduct 50% of the adjusted basis of certain types of property. Under prior law, certain types of property would no longer have been eligible for this deduction as of January 1, 2013.

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