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Swerving from the cliff
Tax provisions in the American Taxpayer Relief Act of 2012

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Introduction

As the nation grazed the edge of the so-called “fiscal cliff,” Congress approved and sent to President Obama legislation that among other provisions permanently extends the reduced Bush-era income tax rates for lower- and middle-income taxpayers, and allows the top rates on earned income, investment income, and estates and gifts to increase from their 2012 levels for more affluent taxpayers.

The American Taxpayer Relief Act of 2012 (the Act) became law on January 2, 2013, just one day after clearing the House of Representatives and the Senate. It is the product of a compromise forged between Senate Republicans and Vice President Joe Biden in the hours leading up to the expiration of the Bush tax cuts at midnight on December 31, 2012. (Negotiators were also working against the clock to avert a variety of spending cuts that were set to take effect on January 1 or shortly thereafter.)

In addition to addressing the Bush tax cuts, the Act also provides a permanent “patch” for the individual alternative minimum tax (AMT) and extends through 2013 dozens of temporary business and individual tax “extenders” provisions. The Act also includes provisions related to spending programs.

This publication examines the tax provisions in the new law and looks ahead to the tax policy challenges facing the president and the 113th Congress in the coming year.

Overview

Major provisions of the Act:

- Permanently extend most of the individual income tax relief provided in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) for unmarried taxpayers with income of $400,000 or less and married taxpayers with income of $450,000 or less;
- Permanently set the top marginal tax rate at 39.6 percent (up from 35 percent in 2012) for unmarried taxpayers with income over $400,000 and married taxpayers with income over $450,000;
- Permanently set the top rate on income from capital gains and qualified dividends at 20 percent (up from 15 percent in 2012) for unmarried taxpayers with income over $400,000 and married taxpayers with income over $450,000;
- Increase the individual AMT exemption to $50,600 for unmarried filers and $78,750 for married filers for 2012, permanently index those exemption amounts for inflation beginning in 2013, and allow nonrefundable personal credits against the AMT;
- Permanently reinstate the personal exemption phase-out (PEP) and limitation on itemized deductions (Pease) for single taxpayers with adjusted gross income (AGI) above $250,000 and joint filers with AGI over $300,000, with the thresholds indexed annually for inflation;
- Permanently set the top estate tax rate at 40 percent for estates worth more than $5 million (indexed for inflation); and
- Extend through 2013 an array of expired and expiring tax provisions such as the research and experimentation credit, the subpart F active financing exception, and the lookthrough rule for payments between related controlled foreign corporations (CFCs).

The new law does not extend the reduction in payroll taxes that was in effect in 2011 and 2012, nor does it reduce or delay new tax increases on earned and unearned income that were enacted under the Patient Protection and Affordable Care Act of 2010 and that took effect on January 1, 2013.

The Act is notable in several respects. First, it ends — at least for now — a debate between President Obama and congressional Republicans over the future of the Bush-era tax cuts that had been simmering since those provisions were last extended in 2010. Second, the inclusion of higher tax rates for upper-income taxpayers marks a significant concession on the part of many Republicans in Congress who have maintained that any increases in federal revenues should come primarily from economic growth generated by tax reform. Third, it is likely to set the stage for a larger debate on deficit reduction and fundamental tax reform that will continue to play out in 2013 and beyond.

Although the Act does not include specific instructions or call for expedited floor procedures that would allow lawmakers to quickly move tax reform legislation, the increased progressivity that the new law has built into the current tax code is likely to be a focus of discussion as Congress and the president consider what a reformed tax code should look like.

Deficit cutter or budget buster? – A note about baselines

Depending on who was talking, the Act was variously described as a large tax cut or a large tax increase. Some said it would reduce the deficit and others said the opposite. In a sense, they were all correct. Those who called it a massive tax cut and complained that it increased the deficit did so on the basis of official congressional scorekeeping rules, which assume that Congress will leave current law intact. Thus, with tax rates set to rise across the board on January 1, 2013 from the lapse of the Bush tax cuts, any action to extend some or all of them was determined by the Joint Committee on Taxation (JCT) — the official scorekeepers of tax legislation on Capitol Hill — to increase the deficit.

Others, including many members of Congress and the president, viewed tax policy through the lens of the "current policy baseline," meaning they assume that all current tax laws are extended permanently, so anything that results in higher revenue, relative to that baseline, is seen as reducing the deficit.

Thus, even though official budget scorekeeping says the Act adds almost $4 trillion to the deficit (not including further borrowing costs), some supporters cheered the bill as reducing the deficit because tax rates on upper-income individuals will be higher in 2013 than they were in 2012 (even though they are lower than what they would be had Congress taken no action at all). An official from the administration's Office of Management and Budget, for example, asserted in a January 1 blog post that the Act would reduce the deficit by $737 billion when compared to the current policy baseline.

Making this baseline discussion even more complex is the fact that the Act was not passed until January 1, meaning the higher taxes set to take effect at the end of 2012 did nominally take effect for at least a short time.

Individual income tax provisions

President Obama campaigned on a platform that called for allowing top Bush-era tax rates to return to their pre-2001 levels for taxpayers generally earning above $250,000 annually ($200,000 for single filers), while Republicans held firm in their position to extend the Bush tax cuts for all taxpayers. The Act achieves the president's goals of making the tax code more progressive and increasing the tax burden on high-income individuals — although not to the degree he had sought — by setting the top individual ordinary income tax rate at 39.6 percent, setting the top tax rate for investment income at 20 percent, and scaling back the benefit provided by deductions and personal exemptions, all beginning in 2013.

For low- and middle-income taxpayers, the Act permanently extends the majority of tax provisions that were originally enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001 and the Jobs and Growth Tax Relief Reconciliation Act of 2003 and extended two years ago by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010.

New health care taxes also effective in 2013

In addition to the new top rates on ordinary and investment income under the Act, married taxpayers generally earning in excess of $250,000 and unmarried taxpayers earning over $200,000 are subject beginning in 2013 to the following new taxes that were enacted in the Patient Protection and Affordable Care Act of 2010:

- An additional 0.9 percent Medicare Hospital Insurance tax on wages and self-employment income that exceeds these thresholds and
- A 3.8 percent net investment income tax on certain types of investment income. The tax applies to the lesser of the applicable individual's net investment income or modified adjusted gross income in excess of these threshold amounts.

Income tax rates

The Act permanently leaves in place the six individual income tax brackets ranging from 10 to 35 percent for married taxpayers earning taxable income below $450,000 and unmarried taxpayers earning below $400,000. For taxpayers earning annual taxable income above these thresholds, however, there is an additional bracket of 39.6 percent, equal to the top marginal rate in effect prior to 2001. The income thresholds are indexed annually for inflation.

The top tax rate on income from qualified dividends and long-term capital gains has similarly changed under the Act relative to 2012 law. The top rate on income from both sources increases to 20 percent (up from 15 percent) for married taxpayers with income above $450,000 ($400,000 for unmarried taxpayers). The 15 percent rate for both long-term capital gains and qualified dividends will remain in place for taxpayers with annual income below those thresholds.

Alternative minimum tax relief

The Act provides permanent relief from the individual AMT, thus ending what had become an almost annual ritual in Congress of adopting temporary "patches" to address the fact that the AMT was not previously indexed for inflation.

The last AMT patch expired at the end of 2011, allowing the AMT exemption amounts for 2012 to drop to $33,750 for single taxpayers and $45,000 for joint filers. The Act increases exemption amounts under the individual AMT to $50,600 for unmarried filers and $78,750 for married-joint filers for 2012, and indexes these amounts annually for inflation starting in 2013. The change provides greater protection from the AMT, particularly to taxpayers who claim large itemized deductions for state and local taxes and those who have a large number of dependents.

The Act also allows nonrefundable personal credits to be taken against the AMT starting in 2012.

Increasing the AMT exemption amounts will prevent roughly 28 million taxpayers from being swept into the AMT system for 2012 (though even at the higher exemption levels, it will still ensnare approximately 4 million taxpayers). Indexing the increased exemption amounts for inflation going forward will stem the growth of the AMT system in future years.

Permanent AMT relief, in lieu of the unpredictable annual patches, will provide added long-term certainty to taxpayers who either routinely owe AMT liabilities or may potentially be subject to the AMT regime because of certain types of income, deductions, or preferences.

PEP & Pease limitations

After being phased out completely in 2010 by the Bush tax cuts, two provisions that effectively increase marginal tax rates for higher-income individuals are now reinstated permanently for certain taxpayers. The PEP and Pease limitations generally require taxpayers with income above a certain threshold to reduce their personal exemptions and itemized deductions. Under the Act, both provisions will apply, beginning in 2013, to married taxpayers earning AGI in excess of $300,000 and unmarried taxpayers with AGI over $250,000. These threshold amounts are indexed annually for inflation. The Act permanently repeals PEP and the Pease limitations for taxpayers earning annual income below those thresholds.

Marriage penalty relief

In 2001, EGTRRA protected some two-earner couples from the so-called "marriage penalty" — the phenomenon of a married couple paying higher income taxes than they would have paid if they were not married and filed individual income tax returns — by (1) expanding the standard deduction for joint filers to twice the deduction for single filers and (2) expanding the 15 percent bracket for joint filers to twice the size of the corresponding rate bracket for single filers.

The Act permanently extends these provisions effective for taxable years beginning after December 31, 2012.

Child tax credit & other family tax benefits

The Act makes permanent the $1,000 child tax credit and expanded refundability as provided under EGTRRA, effective for taxable years beginning after December 31, 2012.

In contrast, the Act extends for five years (through 2017) the modifications to the credit enacted under the American Recovery and Reinvestment Act of 2009 (ARRA), the economic stimulus bill enacted in the early days of the Obama administration. The ARRA modifications include allowing earnings in excess of $3,000 to count toward the credit.

Other family-related tax benefits in the Act include:

- A permanent extension of the expanded 35 percent dependent care credit that applies to eligible child care expenses for children under age 13 and disabled dependents;
- A permanent extension of the $10,000 tax credit for qualified adoption expenses and the $10,000 income exclusion for employer-assistance programs;
- A permanent extension of the tax credit for employers who acquire, construct, rehabilitate, or expand property used for a child care facility; and
- A five-year extension (through 2017) of provisions in the ARRA that increased the earned income tax credit (EITC) for families with three or more children and increased the phase-out range for all married couples filing jointly.

Education tax incentives

Expansions of education tax incentives enacted as part of EGTRRA are extended permanently under the Act. These provisions, which are effective for taxable years beginning after December 31, 2012, include:

- The $5,250 annual employee exclusion for employer-provided educational assistance and its expansion to include graduate-level courses;
- The expansion of the student loan interest deduction beyond 60 months and increased income phase-out range;
- The increased Coverdell education savings account contribution limit (from $500 to $2,000) and the expansion of the definition of "qualified education expenses" to include expenses most frequently and directly related to elementary and secondary school education;

- The expansion of the scope of "qualified scholarships" to include awards under the National Health Service Corps Scholarship Program and the F. Edward Hebert Armed Forces Health Professions Scholarship and Financial Assistance Program; and
- Expanded tax preferences (including the arbitrage rebate exception) for certain bond-financing mechanisms for education facilities.

The modifications made by the ARRA to the American Opportunity Tax Credit are extended for five years (through 2017). These modifications include increasing the amount of the credit, extending it to cover four years of schooling, raising the income limits to determine eligibility for the credit, allowing up to 40 percent of the credit to be refunded, and expanding the expenses eligible for the credit.

Roth IRA conversions

To partially cover the cost of the two-month delay of the budget sequester that is a part of the Act, lawmakers included a tax revenue offset related to Roth conversions for retirement plans. Specifically, the revenue offset — which Joint Committee on Taxation staff estimated would raise $12.2 billion over 10 years — would allow individuals to convert any portion of their balance in an employer-sponsored tax-deferred retirement plan accounts into a Roth account under that plan. Under current law, taxpayers can convert a traditional IRA, rollover retirement plan distributions, or retirement plan accounts that are eligible for distribution, into a Roth account. The rollover amount is included in income, and there is no early withdrawal penalty.

The conversion option for retirement plans would only be available if employer plan sponsors include this feature in the plan. The amount converted, however, would be subject to regular income tax. The provision is effective for post-2012 transfers, in taxable years ending after December 31, 2012.

Similar to the temporary Roth IRA conversion opportunity in 2010-2011, this change creates both an opportunity for taxpayers and boosts revenues for the government. The JCT estimates that the provision will generally result in increased revenues as taxpayers make the conversions and pay related taxes.

Miscellaneous provisions from 2001 and 2003 tax laws

The Act permanently extends certain tax preferences applicable to Alaska Native Settlement Trusts for taxable years beginning after December 31, 2012. It also permanently disregards the refundable components of the EITC and child tax credit for purposes of means-tested benefit programs effective for any amount received after December 31, 2012.

Extensions of temporary individual tax provisions

In addition to addressing the Bush-era tax cuts, the Act also extends a number of expired and expiring temporary tax deductions, credits, and incentives for individuals. Among these so-called "extenders" are:

- **Deduction for state and local sales taxes** – The election for taxpayers to deduct state and local general sales taxes under section 164(b)(5) expired at the end of 2011. The Act retroactively extends the election through the end of 2013.
- **Above-the-line deduction for tuition** – Similarly, the above-the-line deduction for qualified tuition expenses under section 222 also expired at the end of 2011. The Act retroactively extends the deduction through 2013 and keeps the maximum deductions based on income thresholds the same as under prior law.
- **Distributions from individual retirement plans for charitable purposes** – Before its expiration at the end of 2011, section 408(d)(8) allowed tax-free distributions of up to $100,000 annually per taxpayer from an individual retirement arrangement held by an individual age 70 ½ or above. The Act retroactively extends this provision through 2013 and allows individuals who took a distribution in December 2012 to contribute the amount to charity and have it count as an eligible rollover.
- **Mortgage insurance premiums** – Section 163(h)(3) allowed taxpayers to deduct premiums for mortgage insurance as qualified residence interest. The provision expired at the end of 2011, but the Act retroactively extends it through 2013.
- **Mortgage debt relief** – The Act also extends through 2013 section 108(a)(1)(E), which allows a taxpayer to exclude from income up to $2 million in cancellation-of-indebtedness income from the forgiveness of mortgage debt on a principal residence.

Note: A discussion of notable business tax extenders begins on page 9; a complete list of extenders included in the Act is in the appendix on page 15.

Partial payroll tax holiday not extended

Despite early attempts by the Obama administration and some Democratic lawmakers, the Act does not extend the temporary partial payroll tax holiday that was in effect for 2011 and 2012. As a result, wage earners and self-employed individuals that are subject to Social Security tax will experience an increase in the Social Security payroll tax beginning in 2013 relative to what it was in 2011 and 2012. For those years, the 6.2 percent and 12.4 percent rates that were applicable under current law were reduced to 4.2 percent and 10.4 percent, respectively. The relief applied to all individuals subject to Social Security tax regardless of any limit on the amount of wages or other income they receive.

Complicating the code?

Economists often debate the impact of tax code complexity on taxpayer behavior and decision making. In a worst case scenario, a more complex tax system places an economic drag on the economy and makes the tax system more opaque, complicating and impeding economic and financial decisions.

By making permanent many expiring provisions of law, by some metrics the American Taxpayer Relief Act will reduce the complexity driven by uncertainty about future tax rates. In other ways, however, the Act can be seen as increasing the complexity of the code. To illustrate, long-term capital gains from the sale of typical appreciated stock and dividend income paid by a publicly traded company will now potentially be subject to four different tax rates:

- Zero percent for long-term capital gains or dividends for taxpayers in the first two tax brackets (10 and 15 percent);
- 15 percent for long-term capital gains or dividends of taxpayers taxed in other brackets up to the AGI thresholds ($200,000 and $250,000 for single and joint filers, respectively) used for determining the applicability of the 3.8 percent net investment income tax enacted in the Patient Protection and Affordable Care Act of 2010 that became effective on January 1 of this year;
- 18.8 percent for long-term capital gain and dividend income taxed between the net investment income tax thresholds and the new thresholds for defining high-income taxpayers for the top ordinary income tax bracket ($400,000 and $450,000 for single and joint filers, respectively); and
- 23.8 percent for long-term capital gains and dividends taxed above the top ordinary income tax bracket thresholds (the combination of the new top 20 percent tax rate on net capital gain and the 3.8 percent net investment income tax).

This range of tax rates does not take into consideration other types of capital gains transactions that have unique rates, for example, unrecaptured section 1250 gain and collectibles taxed at 25 percent and 28 percent, respectively.

It is little better for ordinary income. High-income taxpayers will face the new 39.6 percent tax bracket. However, they will also need to understand the effect of the additional 0.9 percent Medicare Hospital Insurance tax that is triggered when AGI exceeds $200,000 or $250,000 for single and joint filers, respectively. On top of that, the Act renews hidden marginal rate increases — the scaling back of itemized deductions (Pease limitation) and the phase-out of personal exemptions (PEP). These so-called “stealth” taxes kick in under the new law when the AGI of a single or joint filer exceeds $250,000 or $300,000, respectively, which is less than the entry point for the new highest marginal rate but above the entry point for the new 0.9 percent Medicare tax.

And of course for both ordinary and investment income there will be the application of “stacking rules” to determine which income is taxed at the lower rates and which at the higher.

Thus, while taxpayers may cheer the fact the Act makes permanent many unsettled areas of law, the added complexity it creates will no doubt also drive calls for Congress to consider fundamental tax reform sooner rather than later.

Individual income tax planning considerations

In general – Despite some alteration of the individual income tax landscape for 2013 and beyond, tax planning methods used by individuals during the past decade will largely go unchanged. Much of the planning will focus on the individual's specific fact pattern and objectives — for example, managing tax on income when realized and enhancing the benefit of deductions and exclusions — rather than issues related to changing income tax rates.

Investment income – Those who have substantial investment income can now make decisions about rebalancing investment portfolios with a sense of certainty about the tax impact of earning dividend income or capital appreciation. Other tax planning issues such as acceleration of income or deferral of deductions become less relevant in the short term.

Planning for net investment income tax – Taxpayers should also examine the effect of the new net investment income tax for high-income individuals enacted as part of the Patient Protection and Affordable Care Act that took effect at the start of 2013. This 3.8 percent tax applies to income traditionally considered "investment income" (interest, dividends, rents, royalties, capital gains), but also applies to "passive income" (typically, business income if the taxpayer does not participate in the business). Proper planning, especially with respect to passive income, may reduce this tax.

AMT planning – Individuals should examine their tax position every year to understand the possible effects of the AMT and how best to plan their taxes in that light. Someone who expects to be in AMT one year but not the next could consider accelerating ordinary income or deferring deductions that provide no AMT benefit. Conversely, a taxpayer who owes no AMT in the current year but expects to in the next could consider accelerating deductions that would not be allowable for AMT purposes next year into the current year or deferring ordinary income. A chronic AMT taxpayer would want to consider avoiding private activity bond investments, paying off home-equity debt that is not deductible for AMT purposes, or if possible, taking some deductions "above the line" — that is, taking a deduction prior to calculating adjusted gross income.

Roth conversions for deferred retirement accounts – The Act now expands opportunities for individuals to convert pre-tax balances in employer-sponsored retirement plans into designated Roth accounts. Individuals should consider the appropriateness of these conversions, recognizing that a conversion will be subject to current tax. A conversion can take place only if an employer plan sponsor makes this plan feature available.

Tax reform – If lawmakers and the president are successful in orchestrating comprehensive tax reform, individuals and their tax advisors will likely need to evaluate a wider range of tax benefits than those commonly considered in the past. For high-income individuals, certain tax benefits, such as deductions or exclusions, could be scaled back or eliminated as part of a tax reform process. The president, for example, has suggested limiting the tax benefit of itemized deductions and certain income exclusions as part of tax reform.

Transfer tax provisions

Estate & gift taxes

The Act permanently extends the unified estate and gift tax regime that was in effect in 2012, with the exception that a tax rate of 40 percent — rather than the 35 percent in effect for 2012 — will apply to all cumulative gift transfers and taxable estates in excess of the exemption amount. The estate and gift tax exemption amount will remain at $5 million. The inflation-adjusted exemption amount in 2012 was $5.12 million. The inflation-adjusted exemption for 2013 has yet to be announced.

A host of other taxpayer-friendly changes that were enacted in 2010 will also continue, including portability of a deceased spouse's unused estate and gift tax exemption amount.

The largest estates will shoulder the burden of the 40 percent tax rate, a change that makes the transfer tax regime going forward more progressive than it was in 2012, but nevertheless does not expand the scope of potential taxable estates.

By agreeing to a last-minute compromise, lawmakers averted automatically returning to the transfer tax regime that existed prior to the adoption of the Bush-era tax cuts in 2001. Had an agreement not been reached, taxpayers beginning in 2013 would have faced a top rate for taxable estates and gifts of 55 percent, along with an estate and gift tax exemption amount of $1 million. Had that occurred, the number of potential taxable estates would have increased dramatically compared to the number of taxable estates under the system made permanent under the Act.

Neither the president nor most members in Congress supported adopting the pre-2001 transfer tax regime. President Obama had sought to make permanent the 2009 estate and gift tax regime, which provided for a top rate of 45 percent, an estate tax exclusion of $3.5 million, and a gift tax exclusion of $1 million. For his part, House Speaker John Boehner, R-Ohio, during recent fiscal cliff negotiations, recommended extending the estate and gift tax regime that was in place for 2012. To some degree, the compromise is seen as a victory for those seeking permanent relief in the estate and gift tax area, especially for smaller estates falling under the $5 million exemption.

GST tax

The Act extends the current generation-skipping transfer (GST) tax effective for decedents dying and transfers made after December 31, 2012. The GST exemption in 2013 will also be $5 million indexed for inflation from 2012 — equal to the exclusion used for estate tax purposes. The GST tax rate for transfers made after 2012 is equal to the highest estate and gift tax rate in effect for such year — 40 percent. A range of taxpayer-friendly GST provisions that operate to reduce the risk of inadvertent missteps in applying the GST regime will also continue.

Transfer tax planning considerations

The Act now provides clarity and certainty in the estate tax area for the foreseeable future. The lack of congressional action on the estate and gift tax regime in 2012 had frustrated estate tax planners as well as individuals with large estates — a situation similar to 2010, when taxpayers wondered what rules would be in place once the temporary repeal of the estate and gift tax regime expired.

Estate tax planners will want to review estate plan documents to identify any revisions needed to reflect the changes made by the new law.

Significantly, the Act preserves a favorable tax environment for making gifts by preserving the $5 million gift tax exemption for the future; however, a 40 percent gift tax rate will apply to taxable gifts starting in 2013.

Taxpayers and estate planners alike should remain vigilant as the possibility of tax reform efforts resume in 2013. The possibility exists that Congress could adopt additional changes in the transfer tax area, including perceived estate and gift tax "loophole closers" previously proposed by the administration. These include a 10-year minimum term for grantor retained annuity trusts, restrictions limiting the use of discounts for transferred property, consistency in tax basis determinations for estate-taxed assets for income tax purposes, extending the disregard of transactions with grantor trusts to gifts and estates, and requiring the GST-exempt status of any trust to expire at the end of 90 years. Taxpayers and estate planners will need to keep abreast of tax legislative developments so they are in a position to react if more changes transpire.

Business tax provisions

The Act extends through 2013 several expired or expiring temporary business tax provisions, commonly referred to as "extenders." The provisions that expired at the end of 2011 are retroactively extended to the beginning of 2012. The extenders package in the Act is based largely on a pared-down extenders bill approved by the Senate Finance Committee on August 2, 2012.

Highlights of the major extenders provisions follow. A complete list of the extenders provisions in the Act is available in the appendix on page 15.

Research credit

The credit for research and experimentation expenses under section 41 expired at the end of 2011. The Act retroactively extends the credit through the end of 2013 and makes changes including:

- Modifications to the rules for calculating the credit when there is a change of ownership for a portion of the trade or business and
- Modifications to the rules for aggregation of research expenses within a controlled group.

Bonus depreciation

The Act extends for one year the 50 percent bonus depreciation for qualified property under section 168(k). The provision applies to qualified property placed in service before January 1, 2014 (before January 1, 2015 for certain longer-lived and transportation assets).

The provision makes some modifications, notably decoupling bonus depreciation from allocation of contract costs under the percentage of completion accounting method rules for assets with a depreciable life of seven years or less that are placed in service in 2013. And for regulated utilities, the provision clarifies that it is a violation of the normalization rules to assume a bonus depreciation benefit for ratemaking purposes when a utility has elected not to take bonus depreciation.

Generally, qualified property includes:

- Property with a MACRS recovery period of 20 years or less;
- Certain computer software;
- Water utility property; or
- Qualified leasehold improvement property.

AMT credit in lieu of bonus

In addition, the Act provides for another temporary election to accelerate some AMT credits in lieu of bonus depreciation for property placed in service in 2013. This election allows corporations to effectively "monetize" a portion of their AMT credits in lieu of claiming bonus depreciation.

Leasehold improvements

The Act retroactively extends the 15 year straight-line cost recovery for certain leasehold, restaurant, and retail improvements, and new restaurant buildings that are placed in service before January 1, 2014. The provision had originally expired at the end of 2011.

Section 179 expensing limitation

The Act increases the maximum amount and phase-out threshold in 2012 and 2013 for small business expensing under section 179 to the levels in effect in 2010 and 2011. For tax years beginning in 2013, the limitation is raised to $500,000 and would be reduced if the cost of section 179 property placed in service exceeds $2 million. Within those thresholds, the Act allows a taxpayer to expense up to $250,000 of the cost of qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property. Those limitation amounts will return to $25,000 and $200,000, respectively, after 2013.

Active financing income exception & CFC lookthrough

The exception in subpart F allowing deferral of the active financing income of a controlled foreign corporation engaged predominantly in banking, financing, or similar business activity expired at the end of 2011. The Act retroactively extends the exception through the end of 2013.

Similarly, the section 954(c)(6) lookthrough treatment for payments between related CFCs expired in 2011. The Act retroactively extends the treatment through 2013.

Energy provisions

The Act extends tax credits for construction of energy-efficient new homes, energy-efficiency improvements to existing homes, and the manufacture of energy-efficient appliances, as well as various incentives for biodiesel and renewable diesel, alternative fuel, and alternative fuel mixtures.

Incentives for biodiesel and renewable diesel and the extension and modification of the wind production tax credit are also included in the legislation.

Additionally, the Act extends the production tax credit for wind through 2013 and includes a modification to allow renewable energy facilities that begin construction before the end of 2013 to claim 10 years of credits—a substantial change from the prior placed in service rules that applied to such projects. It also disallows commonly recycled paper from qualifying for the section 45 production tax credit.

Other provisions

Other extended business provisions include the New Markets Tax Credit, the Work Opportunity Tax Credit, and the special exclusion rules for certain small business stock.

Financial statement impact

Enactment of the new law shortly after December 31 may create unique issues concerning the financial reporting impact. Absent the issuance of guidance by regulators or standard-setters providing for another alternative, the guidance in U.S. GAAP requires that the effect of a change in tax laws or rates be recognized at the date of enactment. The tax effect of a retroactive change in enacted tax laws or rates on current and deferred tax assets and liabilities shall be determined at the date of enactment using temporary differences and currently taxable income existing as of the date of enactment. When deferred tax accounts are adjusted for the effect of a change in tax laws or rates, the effect shall be included in income from continuing operations for the period that includes the enactment date. A company that has not yet issued its financial statements for the interim or annual period that ended prior to enactment cannot consider the enactment in preparing those financial statements; however, the company should consider whether current disclosure of the subsequent period financial statement impact of the enactment is appropriate.

State tax implications

It is important to remember that federal tax law changes will sometimes affect state taxes, but the impact will depend on whether the state conforms to federal tax law or has decoupled from it. Taxpayers operating in states that do not follow the federal bonus depreciation rules will face increases in the complexity of state tax returns and provisions and will have to maintain detailed recordkeeping so that state and federal differences can be reconciled.

Provisions left out in the cold

Leaders of the House and Senate taxwriting committees indicated throughout 2012 that the days of routine extension of expiring tax provisions may be coming to an end. This sentiment was, at least in small measure, reflected in the Act's extenders package.

The Act does not include Treasury 1603 grants for specified energy property in lieu of tax credits enacted in the American Recovery and Reinvestment Act of 2009. Several other provisions that typically have been part of tax extenders legislation — such as the enhanced charitable deduction for contributions of book inventories to public schools and for corporate contributions of computer inventory for educational purposes — also are excluded.

Conclusion: Looking ahead

While the fiscal cliff settlement resolves several of the most pressing tax and budget issues, it leaves a few items on the table that will need to be addressed in the near term. First, the settlement does not address the automatic spending cuts under the Budget Control Act's sequester; it only postpones the first round of cuts — which were scheduled to begin in early January — until March. Second, the United States reached its statutory debt ceiling at the end of 2012, and Treasury is taking what it calls "extraordinary measures" to keep from breaching the limit; but those measures probably cannot carry us beyond the end of February. Finally, federal government operations are only funded at FY2012 levels through March 27, requiring congressional action to prevent a government shutdown beginning March 28.

Failure to resolve these pressure points — and others that may surface as well — could have wide-reaching economic effects, and, in what is likely to be a replay of the fiscal cliff drama, the White House and Congress will have to come together again to work out a deal.

Looking further ahead – tax reform?

As the expected skirmishes related to these questions play out in the coming months, many in Washington will also want to turn the conversation to tax reform. The administration and members of Congress in both parties generally agree on the need to overhaul the federal tax code, and congressional taxwriters have already invested significant time and effort in tax reform, laying the groundwork that will be necessary to develop a detailed legislative proposal.

In his statement supporting the Act, House Ways and Means Committee Chairman Dave Camp, R-Mich., reiterated his intention to have his panel consider fundamental tax reform in 2013. Similarly, Senate Finance Committee Chairman Max Baucus, D-Mont., agreed that the Act will help make tax reform more likely in 2013.

"There are no tax expenditure provisions here, which make it easier to do tax reform — at least individual tax reform. And . . . there are virtually no corporate provisions in here so the road is clear to do corporate reform, which is also very important," Baucus said. "So does it help? I think it makes it easier."

In addition, by resolving — at least for now — the disagreement between the "current policy baseline" and the "current law baseline" (see box on page 2), the Act provides taxwriters with a clearer target for how much revenue a "revenue neutral" tax reform bill should generate.

That is not to say tax reform does not face real challenges going forward, including disagreements about the scope and distribution of income tax burdens, the size of the tax base, and what tax benefits in the form of tax expenditures could be targeted for repeal or modification to offset the cost of any reduction in tax rates.

But with House Republicans highly unlikely to agree to any legislation that increases tax rates and President Obama pledging in a statement delivered shortly after the Act passed the House that future efforts to reduce the deficit will not rely solely on spending cuts, the parties are likely to find tax reform one of the few ways to accommodate these competing priorities.

In the short term, the press will focus on what is likely to be another showdown between the executive and legislative branches over raising the debt limit. Any legislation emerging from that process could include an effort to jump-start tax reform, such as instructions to the taxwriting committees to produce legislation by a certain date and/or procedural protections to limit the ability of the Senate to delay or block action on tax reform. Such provisions in a debt limit deal would certainly enhance the prospects for tax reform, but even without them, it is likely fundamental tax reform will be at the top of the agenda for the 113th Congress, which convenes on January 3, 2013.

Given the expected focus on tax reform, taxpayers can take steps today to plan ahead including identifying key tax benefits, measuring and prioritizing the impact of those benefits, and communicating on a regular basis the status of tax reform efforts to key stakeholders.

Appendices

Overview of tax rates, credits, deductions, & exemptions

The table below compares various individual income tax rates, credits, deductions, and exemptions that were in effect for 2012 with the provisions that took effect for 2013 under the American Taxpayer Relief Act.

Provision	Rates and amounts in effect for 2012	Rates and amounts in effect for 2013
Ordinary income tax rates	– 35.0%[1] 33.0% 28.0% 25.0% 15.0% 10.0%	39.6%[2] 35.0% 33.0% 28.0% 25.0% 15.0% 10.0%
Capital gains top rate	15.0%	20.0%[3]
Dividends top rate	15.0%	20.0%[3]
Personal exemption phaseout (PEP) and itemized deductions limitation (Pease)	Repeal of PEP and Pease limitations in place	Restored for single and joint filers with AGI above $250,000 and $300,000, respectively (thresholds indexed annually for inflation)
Marriage penalty relief	• Standard deduction for married taxpayers is twice that for singles • 15% bracket expanded to twice that for single taxpayers	• Standard deduction for married taxpayers is twice that for singles • 15% bracket expanded to twice that for single taxpayers
Child credit	$1,000	$1,000
Estate and gift taxes	• Top rate: 35.0% • Exemption: $5 million (indexed for inflation)	• Top rate: 40.0% • Exemption: $5 million (indexed for inflation)
AMT exemption	• $33,750 (single filers)[4] • $45,000 (married filers)[4]	• $50,600, indexed for inflation (single filers)[5] • $78,750 indexed for inflation (joint filers)[5]

Notes

[1] To illustrate the 2012 income tax brackets for a single taxpayer: 10 percent bracket applies to taxable income from $0 to $8,700; 15 percent bracket from $8,701 to $35,350; 25 percent bracket from $35,351 to $85,650; 28 percent bracket from $85,651 to $178,650; 33 percent bracket from $178,651 to $388,350; and the 35 percent bracket for amounts in excess of $388,350.

[2] The 39.6% top rate applies only to joint filers earning income above $450,000 and single filers earning above $400,000. On top of these stated rates, joint filers generally earning in excess of $250,000 and single filers generally earning over $200,000 may be subject to an additional 0.9% Medicare Hospital Insurance tax on wages and self-employment income. This provision was enacted in the Patient Protection and Affordable Care Act of 2010 and became effective on January 1, 2013.

[3] The 20% top rate applies only to joint filers earning above $450,000 and single filers earning above $400,000. On top of these stated rates, joint filers generally earning in excess of $250,000 and single filers generally earning over $200,000 may be subject to a 3.8% net investment income tax on certain types of investment income. This provision was enacted in the Patient Protection and Affordable Care Act of 2010 and became effective on January 1, 2013.

[4] AMT exemption prior to the American Taxpayer Relief Act.

[5] AMT exemption under the American Taxpayer Relief Act.

Tax 'extenders' provisions

The Act extends the following temporary business and individual tax provisions—the so-called "extenders"—through 2013. Many of these provisions expired at the end of 2011; others expired at the end of 2012. Provisions marked with an asterisk (*) are effective retroactive to the beginning of 2012.

General business credits and incentives

- Tax credit for research and experimentation expenses (extending and modifying IRC section 41(h)(1)(B))*
- 50% Bonus depreciation for qualifying property purchased and placed in service before January 1, 2014 (2015 for certain property) (IRC section 168(k))
- Election to accelerate AMT credits in lieu of bonus depreciation (IRC section 168(k)(4))
- Exceptions under subpart F for active financing income (IRC sections 953(e)(10) and 954(h)(9))*
- Lookthrough treatment of payments between related controlled foreign corporations under the foreign personal holding company rules (IRC section 954(c)(6))*
- 15-year straight-line cost recovery for qualified leasehold improvements, qualified restaurant buildings and improvements, and qualified retail improvements (IRC sections 168(e)(3)(E)(iv), (v), (ix), 168(e)(7)(A)(i) and (e)(8))*
- Increased expensing limits ($500,000/$2 million) and expanded definition of section 179 property (IRC sections 179(b)(1) and (2) and 179(f))*
- Credit for certain expenditures for maintaining railroad tracks (IRC section 45G(f))*
- Mine rescue team training credit (IRC section 45N)*
- Employer wage credit for activated military reservists (IRC section 45P)*
- Seven-year recovery period for motorsports entertainment complexes (IRC section 168(i)(15) and 168(e)(3)(C)(ii))*
- Accelerated depreciation for business property on an Indian reservation (IRC section 168(j)(8))*
- Election to expense advanced mine safety equipment (IRC section 179E(a))*
- Special expensing rules for certain film and television productions (IRC section 181(f))*
- Deduction allowable with respect to income attributable to domestic production activities in Puerto Rico (IRC section 199(d)(8))*
- Treatment of certain dividends of regulated investment companies (RICs) (IRC sections 871(k)(1)(C) and (2)(C), and 881(e)(1)(A) and (2))*
- RIC qualified investment entity treatment under the Foreign Investment in Real Property Tax Act (FIRPTA) (IRC section 897(h)(4))*
- Special rules for qualified small business stock (IRC section 1202(a)(4))*
- Reduction in recognition period for S corporation built-in gains tax (IRC section 1374(d)(7))*
- Temporary increase in limit on cover over of rum excise tax revenues (from $10.50 to $13.25 per proof gallon) to Puerto Rico and the Virgin Islands (IRC section 7652(f))*
- Temporary minimum low-income tax credit rate for non-federally subsidized new buildings (IRC section 42(b)(2))
- Exclusion of military housing allowance for purposes of low-income housing tax credit (section 3005 of the Housing Assistance Tax Act of 2008) *

Energy tax incentives

- Placed-in-service date for wind facilities eligible to claim electricity production credit (extending and modifying IRC section 45(d) to allow a facility to be considered placed in service in 2013 so long as construction commences during the year)
- Election to claim the energy credit in lieu of the electricity production credit for wind facilities (IRC section 48(a)(5))
- Credit for construction of new energy-efficient homes (IRC section 45L(g))*
- Credit for energy-efficient appliances (IRC section 45M(b))*
- Credit for energy-efficiency improvements to existing homes (IRC section 25C(g))*
- Alternative fuel vehicle refueling property (nonhydrogen refueling property) (IRC section 30C(g)(2))*
- Incentives for biodiesel and renewable diesel*
  - Income tax credits for biodiesel fuel, biodiesel used to produce a qualified mixture, and small agribiodiesel producers (IRC section 40A)
  - Income tax credits for renewable diesel fuel and renewable diesel used to produce a qualified mixture (IRC section 40A)
  - Excise tax credits and outlay payments for biodiesel fuel mixtures (IRC sections 6426(c)(6) and 6427(e)(6)(B))
  - Excise tax credits and outlay payments for renewable diesel fuel mixtures (IRC sections 6426(c)(6) and 6427(e)(6)(B))

- Special rule for sales or dispositions to implement Federal Energy Regulatory Commission (FERC) or state electric restructuring policy (IRC section 451(i))*
- Incentives for alternative fuel and alternative fuel mixtures (other than liquefied hydrogen)*
  - Excise tax credits and outlay payments for alternative fuel (IRC sections 6426(d)(5) and 6427(e)(6)(C))
  - Excise tax credits and outlay payments for alternative fuel mixtures (IRC sections 6426(e)(3) and 6427(e)(6)(C))
- Cellulosic biofuel producer credit (IRC section 40(b)(6)(H)) (effective for fuel produced after date of enactment)
- Special depreciation allowance for cellulosic biofuel plant property (IRC section 168(l)) (effective for facilities placed in service after date of enactment)
- Credit for production of Indian coal (IRC section 45(e)(10)(A)(i))
- Credit for plug-in electric motorcycles and three-wheeled highway vehicles (modification and extension of IRC section 30D)*

Infrastructure, economic development, and community assistance provisions

- New markets tax credit (IRC section 45D(f)(1))*
- Work opportunity tax credit (IRC section 51(c)(4))*
- New York Liberty Zone tax-exempt bond financing*
- Qualified zone academy bonds: allocation of bond limitation (IRC section 54E(c)(1))*
- Empowerment zone tax incentives*
  - Designation of an empowerment zone and of additional empowerment zones (IRC sections 1391(d)(1)(A)(i) and (h)(2))
  - Increased exclusion of gain (attributable to periods through 12/31/16) on the sale of qualified business stock of an empowerment zone business (IRC sections 1202(a)(2) and 1391(d)(1)(A)(i))
  - Empowerment zone tax-exempt bonds (IRC sections 1394 and 1391(d)(1)(A)(i))
  - Empowerment zone employment credit (IRC sections 1396 and 1391(d)(1)(A)(i))
  - Increased expensing under section 179 (IRC sections 1397A and 1391(d)(1)(A)(i))
  - Nonrecognition of gain on rollover of empowerment zone investments (IRC sections 1397B and 1391(d)(1)(A)(i))
- Indian employment tax credit (IRC section 45A(f))*
- American Samoa economic development credit (section 119 of the Tax Relief and Health Care Act of 2006 as amended by section 756 of The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010)*

Individual tax incentives

- Deduction for state and local general sales taxes (IRC section 164(b)(5))*
- Above-the-line deduction for qualified tuition and related expenses (IRC section 222(e))*
- Parity for exclusion from income for employer-provided mass transit and parking benefits (IRC section 132(f))*
- Deduction for certain expenses of elementary and secondary school teachers (IRC section 62(a)(2)(D))*
- Discharge of indebtedness on principal residence excluded from gross income of individuals (IRC section 108(a)(1)(E))
- Premiums for mortgage insurance deductible as interest that is qualified residence interest (IRC section 163(h)(3))*
- Refunds disregarded in the administration of federal programs and federally assisted programs (IRC section 6409)
- Authorization to allow the IRS to disclose certain returns and return information to prison officials (modifying and making permanent IRC section 6103(k)(10))

Provisions governing charitable giving, tax-exempt entities

- Tax-free distributions from individual retirement plans by individuals age 70-1/2 and older for charitable purposes (IRC section 408(d)(8))*
- Special rules for contributions of capital gain real property made for conservation purposes (IRC sections 170(b)(1)(E) and 170(b)(2)(B))*
- Enhanced charitable deduction for contributions of food inventory (IRC section 170(e)(3)(C))*
- Modification of tax treatment of certain payments to controlling exempt organizations (IRC section 512(b)(13)(E))*
- Basis adjustment to stock of S corporations making charitable contributions of property (IRC section 1367(a))*

Estimated 10-year revenue effects of key tax provisions in the American Taxpayer Relief Act of 2012

Provision	Estimated revenue effect (in millions)[1]
Permanent extension of individual tax rates enacted in EGTRRA for taxable income under $400,000 ($450,000 joint)	-$762,352
Permanent extension of capital gains and dividend rates enacted in JGTRRA for taxable income under $400,000 ($450,000 joint)	-$289,920
Repeal of itemized deduction limitation and personal exemption phase-out for AGI under $250,000 ($300,000 joint)	-$10,514
Permanent AMT relief with increased exemption amount indexed for inflation	-$1,815,600
Permanent extension of $1,000 child credit including partial refundability; allow credit against AMT; repeal AMT offset of refundable credits	-$354,493
Permanent extension of marriage penalty relief including the 15% bracket and EITC modifications	-$84,630
Permanent extension of estate and gift tax regime with $5 million exemption (indexed) and 40% top rate	-$369,068
Education incentives including permanent extension of exclusion for employer-provided educational assistance and student loan interest deduction	-$23,149
Extension through 2017 of provisions enacted in 2009 including American Opportunity Tax Credit; $3,000 earnings threshold for refundable child credit; and EITC for larger families	-$134,244
Permanent extension of dependent care tax credit	-$1,791
Permanent extension of increased adoption tax credit and adoption assistance	-$5,580
Permanent extension of employer-provided child care credit	-$209
Permanent extension of Alaska settlement fund tax relief	-$46
Extension of individual tax extenders through 2013	-$12,016
Extension of business-related tax extenders through 2013	-$41,189
Extension of 50% bonus depreciation for 2013	-$4,673
Extension of election to accelerate AMT credits in lieu of bonus for 2013	-$283
Extension of energy-related tax extenders generally through 2013	-$18,146
Ability to convert applicable retirement plan amounts into Roth accounts	$12,186
Total 10-year revenue effect	**-$3,915,717**

Notes

[1] Source: Joint Committee on Taxation staff. Estimates include $276,534 million in outlay effects of tax provisions of the Act, particularly those related to the refundable child tax credit and the earned income tax credit.

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