Tax legislation gets us past the fiscal cliff – for now

The *American Taxpayer Relief Act of 2012* approved by Congress just after we plunged over the "fiscal cliff" restores and modifies several expired tax breaks, but doesn't address other issues. Here are the highlights of the new law's provisions for individual taxpayers.

- **Individual income taxes.** Only the wealthiest taxpayers face an income tax increase in 2013. A new individual tax rate of 39.6% will apply to single filers with income above $400,000 and joint filers with income above $450,000. Otherwise, the 2012 tax rate structure is permanently extended. However, beginning in 2013, a new 3.8% Medicare surtax authorized by the 2010 health care law also applies to certain high-income investors.
- **Capital gains and dividends.** Under prior law, the maximum tax rate for net long-term capital gain would have been boosted to 20%, while qualified dividends were scheduled to be taxed at ordinary income rates, beginning in 2013. The new law extends the favorable 15% tax rate for most taxpayers and extends the zero tax rate for those in the 10% and 15% brackets for ordinary income. However, for single filers with income above $400,000 and joint filers with income above $450,000, the maximum tax rate on long-term gains and qualified dividends increases to 20%.
- **Alternative minimum tax.** Retroactive to January 1, 2012, the new tax law permanently revamps the alternative minimum tax (AMT) to avoid increased exposure to this "stealth tax." Without the latest fix, an estimated 30 million more filers would have been required to pay the AMT for the 2012 tax year.
- **Payroll tax holiday.** The 2% reduction in payroll taxes ends. Employees will pay a 6.2% social security tax instead of the 2012 rate of 4.2%. Similarly, the social security tax rate for self-employed individuals reverts to 12.4% from 10.4%.
- **Itemized deductions and personal exemptions.** Restrictions are imposed on high-income taxpayers with income above a specified threshold. For single filers with adjusted gross income (AGI) above $250,000 and joint filers with income above $300,000, certain itemized deductions are reduced by 3% above the threshold, but the overall reduction can't exceed 80%. Personal exemptions are phased out above the same AGI thresholds without the 80% cap.
- **Tax extensions.** The new law generally extends, for varying time periods and with certain modifications, several favorable provisions that had expired. The list includes the child, dependent care, adoption, and earned income credits; tax relief from the "marriage penalty"; the American Opportunity Tax Credit for higher education expenses; the deduction for tuition and related fees; the optional state sales tax deduction; the enhanced deduction for student loan interest; the $250 deduction for an educator's classroom expenses; energy credits for qualified home improvements; a conservation donation tax benefit; and the tax-free IRA-to-charity contribution of assets up to $100,000 for taxpayers age 70½ and older.
- **Estate and gift taxes.** The new law avoids drastic changes for several provisions that had officially ended after 2012. Significantly, the estate tax exemption, which had been scheduled to drop to $1 million from $5 million (inflation-indexed to $5.12 million in 2012) remains at $5 million with inflation indexing. Portability of exemptions between spouses is preserved. The top estate tax rate, which had been scheduled to increase from 35% to 55% in 2013, is bumped up to 40%. The estate and gift tax changes are permanent.
- **Other provisions.** The new law also temporarily preserves several tax breaks for businesses – including the research credit, the enhanced work opportunity tax credit, a higher Section 179 deduction, 50% bonus depreciation and faster write-offs for qualified leasehold improvements – as well as extending unemployment benefits and higher payments to Medicare providers.

This latest tax law is not likely to be the final word on taxes in 2013. Congress is once again talking about a complete revision of the tax code. Also, the spending side of the "fiscal cliff" issue is yet to be dealt with. Stay tuned for ongoing changes that could affect your personal and business tax planning.