Inside the Fiscal Cliff Tax Bill

In another down-to-the-wire scenario Congress moved on New Year's Day to avoid the tax side of the fiscal cliff by passing legislation aimed primarily at raising taxes on high-earners, but virtually all Americans will feel a bigger tax bite in 2013.

In the weeks and months to come Washington lawmakers must begin to address the contentious issues of spending cuts and deficit reduction.

Key Provisions

The American Taxpayer Relief Act of 2012 includes many provisions targeted at high-earning taxpayers:

Return to top income tax rate of 39.6% -- Marginal income tax rates remain the same for all taxpayers in 2013 and beyond except for those individuals with taxable incomes above $400,000 ($450,000 for married couples filing joint tax returns). Income above these levels will be taxed at the reinstated top rate of 39.6%, up from 35% in 2012.

20% top rate on capital gains and dividends -- The same taxable income thresholds of $400,000/$450,000 apply when determining the rate investors will pay on long-term capital gains and dividends. Those with incomes that exceed the new limit will pay a higher 20% rate; most others will continue to pay the lower 15% rate. While this provision represents an investment tax increase for high earners, it comes in the form of a flat tax, which is far more favorable than the White House's original plan to tax dividends at the same rate as ordinary income.

Maximum 40% estate tax rate -- The bill sets a new maximum estate tax rate of 40% (up from 35%) on estates that exceed $5.12 million. Going forward, the exclusion amount will be adjusted for inflation each year.

Revival of personal exemption and itemized deduction limits -- Less obvious tax increases reintroduced by the bill are meant to restrict or eliminate personal exemptions and itemized deductions on high-earning Americans. Under the new law, eligibility to claim the personal exemption ($3,800 for individuals in 2012) will begin to phase out for couples with incomes of $300,000 or individuals with incomes of $250,000. The same thresholds apply to itemized deductions, such as charitable donations and mortgage interest.

Other Notable Provisions

End to Payroll Tax Holiday -- Despite the partisan political posturing about avoiding tax increases for the middle class, the bill put an end to the payroll tax cut that had for two years reduced Social Security payroll tax for most working Americans by 2% -- from 6.2% to 4.2%. As a result, it is estimated that the average household earning $50,000 annually, roughly the national median, will pay an extra $1,000 in taxes in 2013.[1]

Permanent AMT "Patch"-- The bill included a permanent "patch" for the alternative minimum tax (AMT). In the past Congress has acted each year to adjust the AMT exemption amount to avoid exposing more middle-income taxpayers to the tax. The new law retroactively increases the 2012 exemption amounts to $50,600 for individuals and $78,750 for couples, while the 2013 exemption amounts are expected to be $51,900 for singles and $80,750 for couples.[2] Importantly, the new law provides for an annual inflation adjustment going forward.

Retirement Accounts -- The bill grants IRA holders a two-year extension (through December 31, 2013) for making tax-free distributions of up to $100,000 annually from an IRA to public charities provided the account holder is age 70½ or older. In order to take full advantage of the two-year extension, account holders can recharacterize distributions made in January 2013 as made on December 31, 2012. Additionally, individuals are allowed to treat a normal distribution from an IRA made in December 2012 as a charitable distribution if the monies are transferred to the charity by February 1, 2013.[2]

In a separate rule, participants in 401(k), 403(b), and 457(b) plans will be able to convert their accounts to Roth-style accounts absent the required "qualifying event." This provision is optional and was included by lawmakers as a way to raise additional revenue on the funds transferred.

Extensions Galore -- In addition to the tax changes outlined above, the new law extends permanently, or at least through 2017, a number of valuable tax credits and education incentives aimed at providing financial relief to low- and middle-income Americans, students, and businesses. Included among them are:

- Marriage Penalty Relief
- The Child Tax Credit
- Coverdell Education Savings Accounts
- The Earned Income Credit
- Code Sec. 179 Small Business Expensing
- The Child and Dependent Care Credit
- Bonus Depreciation
- The American Opportunity Tax Credit
- Research Tax Credit
- Student Loan Interest Deduction
- The Work Opportunity Tax Credit

While this legislation represents a stop-gap measure to prevent the brunt of the expiring Bush-era tax cuts from falling on the shoulders of the American middle-class, it is by no means the end of the story. In the weeks and months to come Washington lawmakers must begin to address the contentious issues of spending cuts and deficit reduction, and strive to restore much needed fiscal stability to the nation.

[1]Source: *The New York Times*, "Bigger Tax Bite for Most Under Fiscal Pact," January 1, 2013.

[2]Source: CCH Tax Briefing, "American Taxpayer Relief Act of 2012," January 2, 2013.

Other Sources:

The Wall Street Journal, "High Earners Facing First Major Tax Increase in Years," January 1, 2013.

The Washington Post, "Wonkbook: Everything you need to know about the fiscal cliff deal," January 1, 2013.