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American Taxpayer Relief Act of 2012

The High Fiscal Cliff is Avoided -- Sort Of

Lawmakers passed legislation in the waning hours of the 112th Congress to avoid the much discussed “fiscal cliff,” but delayed resolving the issues of the national borrowing ceiling and federal spending cuts to deal with a huge federal deficit. This paper only deals with the key aspects of the tax deal.

Tax Rates

Tax rates from the so-called Bush era were left the same and made permanent in the US tax code for lower earning households. Marginal individual income tax rates for households making more than $450,000 were bumped from 35% up to 39.6%. ($400,000 for individuals)

The law makes permanent a capital gains tax rate of 20% for the higher earning households, and 15% for everyone earning below that level.

The alternative minimum tax (AMT) exemption has been added to the tax code and indexed for inflation. This removes the onus of a tax provision passed over 30 years ago, which had not been adjusted for inflation, from the backs of 30 million or more taxpayers. For 2012 taxpayers, the single exemption will be $50,600, and $78,750 for joint filers. Without the fix, the rates for taxpayers would have reverted to 1993 levels.

Estate taxes were modified to avoid a return to the $1 million exemption and 55% tax rate. Going forward, a 40% tax rate will apply to estates above a $5 million exemption (a 5% increase from the Bush-era tax levels), or $10 million exemption for a couple. This provision will be indexed for inflation.

Additionally, households earning more than $450,000 ($400,000 for individuals) will pay 23.8% tax on dividend income, rather than having dividends taxed at ordinary income rates. This is the sum of the 20% capital gains rate, plus the new 3.8% tax to fund health reform. For households under these income levels, the combined rate will be 18.8%.

Tax Limitations

Tax exemptions and deductions will be limited for higher income taxpayers. The personal exemption phase-out and itemized deductions limits are set at $250,000 for individuals and $300,000 for couples filing jointly.

401k Plans

The legislation permits an exemption from penalty prior to age 59.5 so that deposits within a 401k plan can be rolled over into a Roth IRA. Taxes will have to be paid on the deferred deposits, which suggests that this provision may appeal more to younger taxpayers with lower levels of contributions in their 401k plans.

Employment Taxes

The tax bill extends unemployment benefits for an additional year.

The reduction of 2% that had been applied to the employee portion of the last 2 years of FICA tax (social security portion) has been allowed to expire. Employees will now see a total of 6.2% withheld from their pre-tax salaries and wages.