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Temporary 'Fiscal Cliff' Solution Yields Important Tax Changes

On January 2, 2013, President Obama signed the American Taxpayer Relief Act of 2012 (the TRA of 2012), which permanently extends certain federal income tax rate reductions first enacted in 2001 that were scheduled to expire at the end of 2012, and extends and modifies certain other provisions relating to tax incentives for research and investments in renewable energy property. Because this legislation does not include an increase in the federal debt ceiling, and because the legislation postpones for two months the effects of the budget sequester provisions enacted in the Budget Control Act of 2010, it is likely that more significant tax legislation will be considered by the 113th Congress in the coming months.

Permanent Rate Changes for Individual Taxpayers

The TRA of 2012 permanently extends many of the tax rate reductions adopted during the administration of President George W. Bush, including:

- permanently extending the 10 percent individual income tax bracket (which otherwise would have increased to 15 percent for 2013);
- permanently extending the 25, 28 and 33 percent individual income tax brackets (which otherwise would have increased to 28, 31 and 36 percent for 2013);
- permanently extending the reduced tax rates applicable to dividend and capital gain income for individuals with income of $400,000 or less (or $450,000 or less for married taxpayers filing jointly). For taxpayers with income greater than those thresholds, the tax rate on dividend and capital gain income increases to 20 percent. In both cases, however, the additional 3.8 percent surtax enacted in the Patient Protection and Affordable Care Act of 2010 will result in a further tax burden on dividend and capital gain income; and
- permanently increasing the exemption amounts for the individual alternative minimum tax (AMT) to $50,600 for individual taxpayers and $78,750 for married taxpayers filing joint returns. In addition, those exemption amounts will be indexed for inflation, thereby avoiding uncertainty regarding application of the AMT on a going-forward basis.

Not all of the so-called "Bush tax cuts" were extended, however. For example:

- the 35 percent individual income tax bracket was not extended. Accordingly, for individuals with income of more than $400,000 (or $450,000 for married taxpayers filing joint returns), the top income tax bracket reverts to 39.6 percent for 2013; and
- the phaseouts of the personal exemptions (PEP) and the limitation on itemized deductions (Pease) are reinstated for individuals with income of more than $250,000 (or $300,000 for married taxpayers filing joint returns).

Three other noteworthy changes affecting individual taxpayers are:

- the extension of estate, gift and generation-skipping transfer tax relief through a permanent extension of the $5 million per person unified exemption amount, which will be indexed annually for inflation. However, the top tax rate is now set at 40 percent (increased from 35 percent) for estates of decedents dying after 2012;

- the legislation makes permanent the portability of the unified exemption amount, which allows the executor of a decedent's estate to transfer any unused exemption amount to the decedent's surviving spouse; and
- taxpayers participating in Section 401(k) or similar deferred retirement income plans can convert any amounts in such plans to designated "Roth" accounts within such plans. Although such conversions will be fully taxable at the current (increased) rates, all future distributions of principal and earnings will be tax free when distributed.

Extension of Bonus Depreciation and Research Credit

The TRA of 2012 extends for one year the "bonus" depreciation rule allowing the expensing of 50 percent of the cost of qualified property acquired and placed in service by the taxpayer before January 1, 2014 (or January 1, 2015, in the case of certain property eligible for a one-year extension of the placed-in-service date).

The legislation also extends for two years the research and experimentation credit, which had expired at the end of 2011. The credit is 20 percent of the amount by which a taxpayer's qualified research expenditures exceed its base amount for the year, or 14 percent lower than the simplified credit rules.

Key Energy Tax Incentives Extended

The TRA of 2012 extends certain noteworthy energy tax incentives that expired at the end of 2011 or were scheduled to expire at the end of 2012, including:

- *Extension of the Production Tax Credit (PTC) for Wind Facilities*. Prior to the TRA of 2012, with respect to wind facilities, the PTC only applied if the facility was placed in service before January 1, 2013. As a result of the TRA of 2012, the PTC now applies if the taxpayer begins construction of the wind facility before January 1, 2014, which effectively extends the PTC for facilities placed in service beyond the end of this year. The legislation does not provide guidance as to when construction begins; presumably rules similar to those applied for the recent Section 1603 grant program will apply in this context.
- *Extension of the PTC for Certain Other Renewable Energy Facilities*. The TRA of 2012 also extends the PTC for certain qualified facilities, the construction of which begins before January 1, 2014, that are closed-loop or open-loop biomass facilities, landfill gas facilities, trash facilities, qualified hydropower facilities, and marine and hydrokinetic renewable energy facilities.
- *Deferral of Gain on Qualifying Electric Transmission Transactions*. Under prior law, gain realized before January 1, 2012, by certain electric utilities from the sale of certain property used for providing electric transmission services could be realized ratably over an eight-year period. The TRA of 2012 extends this rule to apply to sales occurring after December 31, 2011, and before January 1, 2014.

The TRA of 2012 also includes two important technical corrections to previously enacted energy tax provisions. Specifically:

- *Election of Energy Credit Over PTC Only Applies to New Property*. The TRA of 2012 clarifies that elections under Section 48(a)(5) of the IRC to claim the Energy Credit in lieu of the PTC for certain property only applies if the property is constructed, reconstructed, erected or acquired by the taxpayer and the original use of such property commences with the taxpayer.

- *New Property Clarification Also Applies to the Section 1603 Grant Program*. The TRA of 2012 also modifies Section 1603 of Division B of the American Recovery and Reinvestment Act of 2009 to clarify that the Section 1603 grant program only applies to property originally placed in service by the grant applicant.

Observations

The TRA of 2012 provides important tax relief for many individual taxpayers. However, with the nation's fiscal crisis left largely unaddressed, it is likely that the Obama administration will pursue further tax increases on more affluent taxpayers when negotiations get underway for the next phase of the "fiscal cliff." Possible changes that may be part of that debate include a further limitation or cap on itemized deductions, adoption of the so-called "Buffett rule" for individuals earning more than $1 million, and changes to the tax treatment of "carried interests" in investment and real estate partnerships.

Even more significant changes may be in store for corporate taxpayers. With the exception of the extension of bonus depreciation and the energy tax provisions discussed above, the TRA of 2012 did little for corporate taxpayers. But with both the Obama administration and Congressional Republicans in support of significant corporate tax reform, and the President's recent statements that future agreements will require additional revenue, it is reasonable to expect that the debate might include renewed examination of proposals to reduce the corporate income tax rate in exchange for elimination of numerous tax deductions and credits, and to replace the existing "subpart F" regime for foreign income with a territorial system. Although these and other proposals designed to encourage corporate taxpayers to increase their domestic income activities have been the subject of numerous hearings in the Congressional tax-writing committees over the past few years, until negotiations in the next phase of the "fiscal cliff," it is uncertain which direction the President and Congressional leadership will take. Most observers agree that a long-term solution to the federal government's fiscal crisis will require additional revenue and/or spending cuts.