The Lowdown on The Fiscal Cliff Legislation

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If nothing else, you can certainly say that the U.S. Congress has a flair for the dramatic. After letting the country technically fall over the fiscal cliff, Congress finally passed a compromise bill, the American Taxpayer Relief Act, on New Year's Day. President Obama quickly signed the bill into law, thus averting a potentially damaging (to the economy) tax increase on virtually every American.

The good news: The Act makes tax brackets that were established as part of tax legislation passed in 2001 and 2003 (the so-called Bush tax cuts) permanent. It also permanently maintains the $5 million per person (or $10 million per married couple) gift and estate tax exemption and permanently patches the AMT with a $50,600 per person (or $78,750 per married couple) exemption, both of which will be indexed annually for inflation.

The bad news: The Act creates a new top marginal tax bracket of 39.6 percent that will apply to individual income above $400,000 per year (or annual income above $450,000 for married couples filing jointly). It also increases the top capital gains and dividend tax rate from 15 to 20 percent and reinstates the personal exemption phase-out (or PEP) and limits on itemized deductions for individuals earning more than $250,000 (or married couples earning more than $300,000).

The Pros and Cons

Many economists believe that the uncertainty presented by the pending expiration of the Bush tax cuts—first scheduled to occur at the end of 2010 and then delayed until the end of 2012—has been a major drag on the economy the past few years. The legislation reduces some of this uncertainty by making the 10, 15, 25, 28, 33 and 35 percent tax brackets permanent, in addition to adding the new top bracket of 39.6 percent. Indexing the AMT exemption for inflation is also welcome news that helps reduce uncertainty. Until now, Congress had to set new exemption amounts every year in order to keep millions of taxpayers out of AMT's clutches.

But while this reduced uncertainty may help the economy, the higher taxes that will now be paid by upper-income individuals may do just the opposite. Many small business owners' income is taxed at the individual, not corporate, level, so they will be subject to the higher rates on income above $400,000 or $450,000. Some experts believe this could suppress hiring and other business growth and expansion activity.

High earners are now also subject to a new 3.8 percent investment surtax, thanks to the Patient Protection and Affordable Care Act (or Obamacare). This surtax applies to passively earned income, including dividends and capital gains, pushing these effective rates up to 23.8 percent for individuals earning more than $200,000 and married couples earning more than $250,000. Also, the threshold for deducting unreimbursed medical expenses has been raised from 7.5 percent to 10 percent of adjusted gross income (AGI).

Business Extenders

There is some good news in the legislation for business owners, however. The Act includes a number of temporary business extenders, including:

The R&D tax credit — This popular tax credit was extended through the end of this year and made retroactive for 2012 (since it actually expired at the end of 2011). It applies to excess qualified research expenditures for the tax year over and above the average annual qualified research expenditures over the previous four years.

Section 179 expensing — Small businesses can deduct up to $500,000 of the cost of many types of equipment through the end of this year (up to a $2 million investment) rather than have to depreciate the equipment. Without legislation, the expensing limit would have dropped to just $25,000 this year.

Bonus depreciation — Small businesses also receive a 50 percent bonus depreciation amount this year of the cost of most equipment and real estate. This bonus depreciation applies to property placed in service before January 1, 2014, or January 1, 2015, for certain transportation and longer period production property.

Energy tax credits — A wide range of business energy tax credits has been extended through the end of this year. These include a production tax credit for facilities that produce energy from wind facilities and credits for alternative fuel vehicle refueling property.

Work Opportunity Tax Credit — This credit of 40 percent of first-year wages (up to $6,000) is available through the end of this year to companies that hire otherwise hard-to-employ workers.

Concluding Thoughts

It appears that the American Taxpayer Relief Act is a mixed bag, at best, for most Los Angeles and Southern California CEOs and CFOs. And don't look now, but the battles in Washington will start heating up again very soon: The sequestration and debt ceiling issues are not addressed by the Act but were simply put off by Congress until March—less than two months away.

About CFO Edge

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