Law Averting Fiscal Cliff Revises Rates for Certain Taxpayers and Extends Various Business and Energy Tax Provisions

On January 2, 2013, President Obama signed the American Taxpayer Relief Act of 2012 (the Act), forestalling automatic tax increases and, temporarily, across-the-board spending cuts under the "fiscal cliff." This *Update* highlights various provisions of the Act affecting individual taxpayers and businesses, including several energy-related items.

Individuals

With respect to individual taxpayers, the Act:

- Raises the top US federal income tax rate from 35 percent to 39.6 percent on individuals whose taxable income exceeds $400,000 ($450,000 for joint filers and $425,000 for heads of households).
- Increases the top rate on qualified dividends and long-term capital gains from 15 percent to 20 percent. In addition, pursuant to the health care legislation enacted in 2010, "net investment income" of individuals, trusts and estates whose income exceeds certain thresholds is subject to a Medicare surtax of 3.8 percent, effective January 1, 2013.[1] Net investment income includes income from interest, dividends, annuities, royalties, rents and gains from certain dispositions of property not connected with the taxpayer's trade or business. The effective result for certain taxpayers is a combined rate of 23.8 percent on certain long-term capital gains and dividends and 43.4 percent on certain short-term capital gains and interest.
- Grants permanent alternative minimum tax (AMT) relief by increasing the AMT exemption amounts for 2012 (adjusted for inflation beginning in 2013) and allowing nonrefundable personal credits to be taken to the full extent of regular tax and AMT liability.
- Permanently repeals the personal exemption phase-out and the "Pease" limitation on itemized deductions, in each case for taxpayers under certain threshold levels of income.
- Provides for a top estate tax rate of 40 percent (up from the current 35 percent rate, but below the 55 percent rate to which it would otherwise have reverted) while permanently extending the inflation-adjusted $5 million exclusion from estate tax (which would have reverted to $1 million).
- Extends certain expiring unemployment benefits for one year.

The Act does not extend the payroll tax holiday that reduced the rate of Old Age, Survivors and Disability Insurance (OASDI) tax on wages up to the Social Security wage base. For 2013, the OASDI rate thus reverts from 4.2 percent to 6.2 percent on wages up to $113,700. Also effective January 1, 2013 is a payroll tax increase enacted as part of the health care legislation in 2010, imposing a 0.9 percent Medicare tax increase on wages and self-employment income over $250,000 for joint filers, $125,000 for married taxpayers filing separately and $200,000 for other taxpayers.[2]

Businesses

The Act extends numerous business tax provisions that were set to expire in the absence of this legislation or had previously expired. Among these, the Act:

- Retroactively extends through 2013 the research tax credit, which expired at the end of 2011.
- Extends through 2013 the Work Opportunity Tax Credit, which grants employers a credit generally equal to 40 percent of the first $6,000 of wages paid to new hires from certain targeted groups. The program expired after 2011 (2012 for qualified veterans). The extension is effective for individuals hired after 2011 and before 2014.
- Extends through 2013 the increased deduction limits for small business expensing under section 179 of the Internal Revenue Code of 1986, as amended (the Code), as well as 50 percent bonus depreciation under section 168(k) of the Code.
- Retroactively extends through 2013 the "active financing income" exception from taxation under Subpart F of the Code for income from the active conduct by a controlled foreign corporation (CFC) of a banking, financing or similar business or an insurance business or as a securities dealer. The exception had generally expired for most taxpayers at the end of 2011.
- Retroactively extends through 2013 the CFC look-through rule, which provides an exclusion from foreign personal holding company income for certain dividends, interest, rents and royalties received by a CFC from a related CFC. The exclusion had generally expired for most taxpayers at the end of 2011.
- Extends the exclusion of 100 percent of gain realized on the disposition of certain qualified small business stock, where the stock is acquired before 2014.[3]

Consistent with the long-term capital gains rate changes for individuals described above, the Act makes conforming changes to other federal tax law provisions referencing the former top 15 percent rate. These include the accumulated earnings tax under section 531 of the Code, the personal holding company tax under section 541 of the Code, withholding on certain dispositions of US real property interests under section 1445(e)(1) of the Code, and nonqualified withdrawals from capital construction funds for certain vessels under section 7518(g)(6)(A) of the Code and under section 53511 of title 46 of the United States Code.

Energy

The Act also extends a variety of energy-related credits and other provisions. Importantly, the Act:

- Extends the production tax credit (PTC) for qualified wind facilities, and the 30 percent investment tax credit (ITC) in lieu of the PTC, to otherwise qualifying wind facilities the construction of which begins before January 1, 2014.[4] Before this change, the PTC and ITC required a qualified wind facility not just to begin construction but to be placed in service before January 1, 2013. The January 1, 2014 construction start date rule also replaces an in-service date requirement for certain other qualified facilities, such as closed- and open-loop biomass, landfill gas, trash, qualified hydropower, geothermal, and marine and hydrokinetic renewable energy facilities.
- Retroactively extends a rule permitting certain qualified electric utilities to recognize gain from certain qualifying transmission transactions ratably over eight years, if the amount realized from the disposition is used within four years of the year of the transaction to purchase certain property used in generating, producing, transmitting, distributing or selling electricity or natural gas. Such dispositions, which previously had to occur before January 1, 2012, now must occur before January 1, 2014.

Endnotes

[1] *See* Latham & Watkins *Client Alert* Number 1008, "Significant Tax Provisions in Newly Enacted Health Care Reform Legislation," April 2, 2010.

[2] *See id*.

[3] *See* Latham & Watkins *Client Alert* Number 1111, "Extension of Favorable Legislation Relating to Qualified Small Business Stock," December 17, 2010.

[4] *See* Latham & Watkins *Client Alert* Number 811, "More Renewable Energy Tax Incentives in the American Recovery and Reinvestment Act of 2009," February 17, 2009; Latham & Watkins *Client Alert* Number 901, "Treasury Releases Guidance on Cash Grant Program for Renewable Energy Projects," July 14, 2009.

If you have questions about this *Update* or if you would like additional information, please contact David Raab at +1.212.906.1344, Samuel Weiner at +1.213.891.8298, Nicholas J. DeNovio at +1.202.637.1034, Knowledge Management Lawyer Thomas Halpern at +1.213.891.8684 or any member of the Latham & Watkins Tax Department listed below.

Abu Dhabi
Villiers Terblanche
+971.2.495.1700

Barcelona
Jordi Domínguez
+34.93.545.5000

Beijing
Allen C. Wang
+86.10.5965.7000

Boston
David O. Kahn
+1.617.948.6000

Brussels
Jean Paul Poitras
+32.2.788.6000

Chicago
Diana S. Doyle
+1.312.876.7700

Doha
Villiers Terblanche
+974.406.7700

Dubai
Villiers Terblanche
+971.4.704.6300

Frankfurt
Anders Kraft
+49.69.6062.6000

Hamburg
Tobias Klass
Götz T. Wiese
+49.40.4140.30

Hong Kong
Michael S. L. Liu
+852.2522.7886

Houston
C. Timothy Fenn
+1.713.546.5400

London
Sean Finn
Daniel Friel
+44.20.7710.1000

Los Angeles/Orange County
Samuel R. Weiner
Pardis Zomorodi
+1.213.485.1234

Madrid
Jordi Domínguez
+34.91.791.5000

Milan
Fabio Coppola
+39.02.3046.2000

Moscow
Christopher J. Allen
+7.495.785.1234

Munich
Thomas Fox
Stefan Süss
+49.89.2080.3.8000

New York/New Jersey
David S. Raab
Lisa G. Watts
+1.212.906.1200

Paris
Olivia Rauch-Ravisé
Xavier Renard
+33.1.4062.2000

Riyadh
Salman Al-Sudairi
+966.1.207.2500

Rome
Fabio Coppola
+39.06.98.95.6700

San Diego
Laurence J. Stein
+1.619.236.1234

San Francisco
Kirt Switzer
+1.415.391.0600

Shanghai
Rowland Cheng
+86.21.6101.6000

Silicon Valley
Kirt Switzer
+1.650.328.4600

Singapore
Stephen McWilliams
+65.6536.1161

Tokyo
Joseph Bevash
+81.3.6212.7800

Washington, D.C.
Nicholas J. DeNovio
Cheryl M. Coe
+1.202.637.2200

The information contained in this publication should not be construed as legal advice. Should further analysis or explanation of the subject matter be required, please contact any of the attorneys listed or the attorney with whom you normally consult.