January 2, 2013

In a process of decision-making that simply defies description, a deal on the "fiscal cliff" was reached late last evening. In terms of the priority tax issues that the New England Council supported during the fiscal cliff debate in December, we were pleased to see inclusion of almost all the elements for which we advocated. These included the renewal of the R & D tax credit retroactively for 2012 and prospectively for 2013; the extension of the active financing exception for a year and the maintenance of the current dividends and capital gains tax rates for most taxpayers. The bonus depreciation allowance was also extended through the end of 2013, and the Section 179 expensing provision for immediate write-offs was restored to higher levels retroactively for 2012, and prospectively for 2013. Thank you to all of you who helped identify priority tax measures and ensure focused and successful advocacy during this rather unpredictable process.

Beyond the market-calming effect of tax certainty in key areas and the positive impact on investment going forward, several provisions in the bill have implications for the financial services industry.

The final bill included a one-year extension of the Mortgage Forgiveness Debt Relief Act of 2007, which allows struggling homeowners to avoid paying taxes on forgiven mortgage debt from short sales or loan modifications. The tax break has been generally regarded as the catalyst behind the surge in short sales over the last year, which has helped the housing market improve to a measureable degree. Without this extension, there were concerns that the housing market would again destabilize, as distressed homeowners lost the incentive to use short sale process, and simply walked away from properties they could no longer afford. The advantageous tax treatment for forgiven mortgage debt in short sales expired on December 31st, but has now been extended though the end of 2013.

A major aspect of the final fiscal cliff deal was the decision to delay for two months the spending cuts through sequestration, at a cost of some $24 billion. To fund the delay, the final legislation included spending cuts of $12 billion (split between defense and non-defense in discretionary spending) and a provision that would generate another $12 billion in new revenue from allowing various retirement instruments, like 401Ks, to be converted into Roth IRAs. In that type of conversion, taxes would be paid up front at the time of conversion on previously tax-deferred gains, generating the short-term revenue that legislators sought. However, the future gains in the new Roth IRA would not be taxed upon distribution.

The carried interest tax rate, which drew considerable attention during the Presidential election, remained unchanged as these fiscal cliff discussions drew to a close. Carried interest will continue to be taxed as long-term capital gains for hedge fund and private equity managers. The top rate for capital gains has increased to 20% from 15%, but for the most part, the favorable tax treatment for carried interest was substantially maintained. As the new session of Congress convenes and begins to address the next fiscal deadline – the spending now cuts automatically scheduled for the beginning of March – some observers believe the carried interest tax rate may be in play again.