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Policy and Regulation

"Fiscal Cliff" Averted: The American Taxpayer Relief Act Enacted

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On January 1, 2013, Congress passed, and President Obama is expected to sign, H.R. 8, the American Taxpayer Relief Act of 2012, thereby averting the so-called "fiscal cliff" that would have occurred on January 1, 2013. The bill passed the Senate by a vote of 89-8 and the House by a vote of 257-167. This alert briefly describes the key components of the agreement as well as important policy issues that were not addressed.

KEY COMPONENTS

1. Top tax rate: The Bush tax cuts enacted in 2001 and 2003 are made permanent for taxpayers with incomes below $400,000 (individual)/$450,000 (joint). The top tax rate of 39.6 percent is reinstated for taxpayers with incomes above those levels.

2. Reinstatement of limitations on personal exemptions and itemized deductions: The phase-out of personal exemptions (PEP) and the limitation on itemized deductions (the "Pease" limitation) are reinstated on a permanent basis for taxpayers with incomes in excess of $250,000 (individual)/$300,000 (joint).

3. Capital gains and dividends: Tax rates on capital gains and dividends are permanently increased from 15 percent to 20 percent for taxpayers with incomes above $400,000 (individual) /$450,000 (joint). A 15-percent tax rate applies on a permanent basis for taxpayers below these income levels. (Note: the new 3.8 percent investment income tax, enacted in the Affordable Health Care Act of 2010, will be additive, resulting in a top rate of 23.8 percent on capital gains and dividends.)

4. Alternative Minimum Tax (AMT) relief: The AMT "patch" that prevents over 28 million taxpayers from having to pay the alternative minimum tax is increased and indexed on a permanent basis.

5. Federal estate tax relief: The top federal estate tax rate will be 40 percent, with a $5 million (inflation-indexed) exemption level, on a permanent basis.

6. Extension of 2009 tax relief: Several tax relief measures (the American Opportunity Tax Credit and modifications to the child tax credit and earned income tax credit), enacted as part of the 2009 American Recovery and Reinvestment Act, are extended for five years, through 2017.

7. Tax extenders: Nine individual tax extenders, 31 business extenders and 12 energy tax extenders are extended through 2013. This package is similar to the tax extender bill approved by the Senate Finance Committee in August 2012 and includes such items as bonus depreciation, section 179 small business expensing, the R&D tax credit, the new markets tax credit, the Subpart F active financing exception, the deduction for State and local sales taxes and the renewable energy production tax credit.

8. Medicare physician payment reimbursements: The so-called "doc fix," which prevents a 27 percent reduction in reimbursement rates to Medicare physicians, is extended through 2013.

9. Unemployment benefits: Emergency unemployment compensation benefits are extended through 2013.

10. Extension of the farm bill: The 2008 farm bill is extended through September 30, 2013.

11. Budget sequester: Enacted as part of the August 2011 debt ceiling statute, a $1.2 trillion "sequester" of federal spending, equally divided between defense and non-defense discretionary accounts, was scheduled to take effect on January 2, 2013. The budgetary effect of the scheduled sequester was estimated to be approximately $100 billion in the 2013 fiscal year. This fiscal cliff compromise postpones the sequester for two months to March 1, 2013, and compensates for the budget effects of the postponement with alternative proposals relating to (i) the 2013 and 2014 discretionary spending caps and (ii) Roth retirement plan conversions.

POLICY ISSUES NOT ADDRESSED IN THE AGREEMENT

1. Debt ceiling: Treasury Secretary Geithner has given official notice to Congress that the current $16.4 trillion debt ceiling was reached on December 31, 2012. Secretary Geithner has administrative authority to utilize "extraordinary measures" to avoid default, which is expected to postpone default by several months into 2013. However, a statutory increase in the debt ceiling will be required in the first quarter of 2013 to avoid an unprecedented default by the federal government.

2. Stimulus initiatives: The payroll tax relief, enacted in 2010 and extended in 2012, was allowed to expire on December 31, 2012. The fiscal cliff agreement also does not include the President's proposals for additional fiscal stimulus, such as increased infrastructure spending.

3. Deficit reduction, entitlement reform and tax reform: Negotiations on additional deficit reduction, entitlement reform and tax reform are anticipated in 2013.

THE NEW FISCAL CLIFF

Enactment of the American Taxpayer Relief Act of 2012 avoids one cliff and creates another. With the two-month postponement of the budget sequester to March 1, 2013 and the clear need to increase the statutory debt ceiling in that same time frame, a new fiscal cliff will fast approach. The convergence of these two significant fiscal events may provide motivation for a resumption of negotiations on a more expansive budget plan. In addition, expiration of the continuing resolution, which funds the federal government's operations through March 27, 2013, may provide an additional "action-forcing" event in early 2013.

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