



NATaT Special Report: The Fiscal Cliff Deal

Executive Summary

On January 1, 2013, the House and Senate passed H.R. 8, the American Taxpayer Relief Act of 2012, which represents a deal brokered by Congress and the White House to avert the so-called “fiscal cliff”. The deal includes a number of tax provisions, a delay of automatic spending cuts, and other specific extensions.



H.R. 8 permanently extends Bush-era income and other tax cuts for taxable income up to \$400,000 for individuals and \$450,000 for families - but allows tax rates to rise from 35% to 39.6% on income over that level. It increases tax rates for capital gains and dividends on such income from 15% to 20%, and increases the estate tax from 35% to 40%. It also includes a permanent “patch” for the Alternative Minimum Tax (AMT) - permanently indexing it to inflation.

The bill postpones for two months the sequestration of FY 2013 spending, originally scheduled to occur this month, replacing it with a combination of other spending cuts and revenue increases. It extends for another year long-term unemployment benefits, prevents a 27% cut in Medicare reimbursement rates, and extends through FY 2013 most federal farm programs and policies, including dairy policies in order to prevent a spike in milk prices.

But H.R. 8 fails to address many issues that divided the 112th Congress over the last few months, including avoiding the automatic spending cuts, raising the debt ceiling and addressing a long-term fix to the nation’s fiscal issues. When the 113th Congress convenes tomorrow, January 3, returning and new members will certainly have their work cut out for them.

Individual Earned Income Taxes

Extension of Income Tax Brackets

The 2001 tax law changed the five tax rate brackets: 15%, 28%, 31%, 36% and 39.6%, into five new brackets: 10%, 25%, 28%, 33% and 35%. H.R. 8 permanently extends the current 10%, 25%, 28%, 33% and 35% brackets. Under the measure, the permanently extended 35% bracket would apply only for taxable income below \$400,000 for individuals and \$450,000 for families. For head of household filers, it would apply to taxable income below \$425,000. Those that earn above these thresholds will be taxed at the 39.6% rate.

Personal Exemption Phaseout (PEP) and Limitation on Itemized Deductions (Pease)

The 2001 tax law scheduled a gradual phased elimination of personal exemptions and itemized deductions beginning in 2006 with complete elimination in 2010. The 2010 tax act extended the elimination through 2012, after which, the reductions return to original levels. H.R. 8 allows both reductions to resume in 2013 but only for high-income taxpayers - single filers with taxable income over \$200,000, joint filers with taxable income over \$250,000, and \$275,000 for head of household filers.

Other Income Tax Credits and Deductions

H.R. 8 also included the following income tax credits and deductions:

- ❖ The measure permanently extends modifications to the child tax credit that were included in the 2001 tax law, and extends for five years the changes made by the 2009 economic stimulus law. Specifically, it permanently retains the \$1,000 credit level, the ability of the credit to be claimed against the alternative minimum tax (AMT), and the ability to refund the credit for up to 15% of the taxpayer's earned income in excess of \$10,000 (adjusted for inflation).
- ❖ Through 2017, the measure extends provisions from the stimulus law that reduced the "floor" to \$3,000, also known as the earned income formula. In addition, the 2009 law permitted families with three or more qualifying children to determine the additional child tax credit through an "alternative formula" that can result in a larger tax credit than the earned income formula.
- ❖ The bill also permanently extends certain adjustments to the Earned Income Tax Credit (EITC) included in the 2001 tax law, and extends for five years those included in the 2009 economic stimulus law that increased the beginning point of the phase-out range for all married couples and extended it for larger families. The EITC is a refundable tax credit designed to ease the tax burden on certain low-income workers and is phased out as income exceeds certain levels.
- ❖ H.R. 8 maintains marriage penalty relief, continuing inflation provisions that prevent the marriage penalty. It permanently extends the basic standard deductions for married couples (which are twice that of the standard deductions for single individuals) and continues the size of the 15% regular income tax bracket for married couples (which is twice that of the corresponding bracket for individuals).
- ❖ The measure also extends several other education-related credits and deductions that were enacted in 2009, including provisions related to Coverdell Education Savings Accounts, employer-provided educational assistance, the student-loan interest deduction, elimination of taxes on certain awards, increased arbitrage rebate exception for school construction governmental bonds and issuance of tax-exempt private activity bonds for qualified education facilities. It includes family-related provisions covering dependent care tax credits, adoption credits, and employer-provided child care credits.
- ❖ H.R. 8 extends through 2017 a provision from the 2009 stimulus law that provided a credit for 100% of the first \$2,000 in qualifying tuition and related expenses, and 25% for the second \$2,000 in such expenses, for a maximum credit of \$2,500. As much as 40% of the credit is refundable. Known as the American Opportunity Tax Credit, it is subject to a phase-out for taxpayers with adjusted gross income in excess of \$80,000, or \$160,000 for married couples filing jointly.

Capital Gains and Dividend Taxes

H.R. 8 permanently extends reduced rates on capital gains and dividend income for income levels up to \$400,000 for individuals and \$450,000 for families. For those earning more than these thresholds, tax rates for capital gains and dividends on such income are increased from 15% to 20%.

Estate Tax

H.R. 8 permanently exempts estates up to \$5.12 million from the estate tax (\$5 million indexed for inflation for years after 2011). However, it increases the maximum rate from 35% to 40% for estate values above the exemption amount.

The 2010 tax law, which set the current rate and exemption level, also reunified the gift tax with the estate tax. Therefore, the measure also extends gift tax levels of a \$5.12 million (\$5 million indexed for inflation) exemption and a 40% top rate. In addition, it extends portability rules related to the passing of an exemption amount onto a surviving spouse.

Alternative Minimum Tax

The alternative minimum tax (AMT) was created by the Tax Reform Act of 1986 to prevent higher-income taxpayers from using credits and deductions to completely offset their federal income tax liability. The 2010 tax law included an AMT patch for 2010 and 2011 intended to shield some 25 million taxpayers from the AMT by increasing the exemption amounts. H.R. 8 includes a permanent "patch" to prevent millions of middle class taxpayers from being subject to the AMT, starting with the 2012 tax year.

Specifically, the measure sets the exemption amounts (i.e., the income not subject to taxes under the AMT) at \$50,600 for individuals and \$78,750 for couples filing jointly, and adjusts these amounts yearly for inflation. It also allows various non-refundable personal credits to be claimed against the AMT (see child tax credit above).

Tax-Free Municipal Bonds

In the weeks and months leading up to this deal to avert the "fiscal cliff", there were proposals to eliminate or reduce the tax deductibility of interest paid on municipal debt. Fortunately, there are no changes to the treatment of municipal bonds in H.R. 8. However, the municipal bond interest exemption issue could be targeted when the 113th Congress considers legislation to offset federal spending. Proposals will most likely be developed over the next two months as debate over automatic spending cuts and sequestration continues.

Tax Extenders

Congress routinely extends expiring tax provisions. Many of those included in H.R. 8 were last extended in the 2010 tax law and would be extended for the 2012 and 2013 tax years.

Credits for Individuals

H.R. 8 includes the following tax credits for individuals:

- ❖ The deduction for state and local sales taxes in lieu of state income taxes.

- ❖ The deduction for qualified tuition and other related expenses, worth up to \$4,000.
- ❖ A rule that would allow individuals to exclude from gross income the discharge of indebtedness on a principal residence (to be extended for one year, as the provision expired at the beginning of 2013).
- ❖ A provision of the economic stimulus law that equalizes the tax-free benefits employers can provide for transit and parking.
- ❖ The deduction for teachers for up to \$250 in out-of-pocket classroom expenses.
- ❖ The deduction for private mortgage insurance premiums as qualified residence interest.
- ❖ A rule that allows those age 70-and-a-half or older to make up to \$100,000 in tax-free distributions to charities from their individual retirement accounts.

Credits for Businesses

H.R. 8 extends 31 provisions that are aimed primarily at businesses. A sample is included below:

- ❖ The "new markets tax credit," which is provided to businesses that make certain investments in community development entities, as well as a maximum annual amount of \$3.5 billion in qualified investments in 2012 and 2013.
- ❖ The temporary minimum low-income housing tax credit rate of 9% for non-federally subsidized new buildings (to be extended for one year, as the provision expired at the beginning of 2013).
- ❖ The exclusion of military housing allowances for determining area median gross income for qualified residential rental project exempt facility bonds.
- ❖ The work opportunity tax credit for qualified wages paid to members of targeted groups, such as food stamp recipients or individuals receiving supplemental security income benefits, as well as an employer wage credit for activated military reservists equal to 20% of the sum of differential wage payments to reservists.
- ❖ A credit for 50% of certain maintenance expenses on railroad tracks owned or leased by Class II and Class III railroads.
- ❖ A credit of up to \$10,000 for training mine rescue teams, as well as rules allowing businesses to expense mine safety equipment.
- ❖ The qualified zone academy bond tax credit program that provides a source of funding that may be used for renovating school buildings, purchasing equipment, developing curricula, and/or training school personnel.
- ❖ A provision that allows businesses to recover the cost of certain leasehold improvements and restaurant and retail property over a 15-year period, rather than over 39 years.
- ❖ A seven-year recovery period for motor sports racetrack property, instead of the 15-year period that would otherwise apply.
- ❖ Special expensing rules for film and television productions, which can currently expense the first \$15 million in production costs, or \$20 million in distressed areas, no matter the total production costs.
- ❖ Various provisions concerning charitable donations, such as enhanced deductions for certain food donations and basis adjustments for S-corporations that donate property.
- ❖ Rules related to development, such as special tax incentives for businesses and individual residents within economically depressed census tracts known as Empowerment Zones and tax-exempt bond financing for the area in lower Manhattan around the World Trade Center known as the New York Liberty Zone.

In addition, H.R. 8 includes the following bonus depreciation rules and other major credits for businesses:

- ❖ Extends 50% bonus depreciation rules for property placed in service before the end of 2013 (and through 2014 for certain transportation property, as well as certain longer-lived items). H.R. 8 allows businesses to deduct from their taxes 50% of the value of that property in addition to amounts that they could otherwise claim under depreciation rules.
- ❖ Bonus depreciation is allowed against both the regular tax system and the AMT. In addition, businesses can elect to accelerate the AMT credit in lieu of bonus depreciation.
- ❖ Extends the ability of financial services companies and manufacturers with financing arms to defer taxes on income earned overseas from active financing operations.
- ❖ Extends the research and experimentation credit for businesses.
- ❖ Gives small-business taxpayers the option to deduct from their taxes, (i.e., "to expense") the cost of certain capital expenses/purchases, up to specified limits, in the year items are acquired, rather than recovering the costs of the items over time through depreciation.
- ❖ Increases for 2012 and 2013 the expensing limit to \$500,000, with the phase-out beginning when investments exceed \$2 million.

Energy Tax Incentives

H.R. 8 extends the following energy incentives for the 2012 and 2013 tax years:

- ❖ The requirements for exterior windows, doors and skylights to be eligible for the non-business energy property tax credit.
- ❖ The credit for alternative fuel vehicle refueling property.
- ❖ The credit for two-wheeled or three-wheeled plug-in electric vehicles.
- ❖ Certain credits for renewable energy, such as extension of the expiration date for renewable electricity production credit construction through 2013, including for wind facilities, exclusion of paper that is commonly recycled from the definition of municipal solid waste for purposes of the renewable energy production credit, and the election to claim the energy credit in lieu of the electricity production credit.
- ❖ The credit for construction of energy-efficient new homes and energy-efficient appliances.

Sequestration Delay

H.R. 8 extends the deadline for the across-the-board budget cuts to March 1, 2013, replacing them with lower discretionary spending caps and \$12 billion in new revenue related to retirement accounts.

The 2011 budget law provided for \$2.1 trillion in deficit reduction by setting 10-year caps on discretionary spending (for a savings of \$917 billion) and, after Congress was unable to enact another \$1.2 trillion in savings, the backup sequester mechanism for automatic cuts to discretionary and mandatory spending for nine years, beginning in January 2013, with half to come from defense.

Under H.R. 8, the sequester for FY 2013 would be implemented on March 27, the same day that the current six-month continuing resolution funding the government expires; the White House would be required to release its sequester report and order the cuts on March 1. The total automatic cut for FY 2013, currently estimated at \$109 billion, would be reduced by \$24 billion, thereby reducing to \$85 billion the required sequester of discretionary and mandatory spending for FY 2013.

The bill offsets that \$24 billion reduction by decreasing the current statutory caps on discretionary spending set for FY 2013 and FY 2014 by a total of \$12 billion (\$4 billion from FY 2013 and \$8 billion from FY 2014, split evenly each year between security and non-security spending), and by raising \$12.2 billion in revenue over 10 years by making it easier for individuals with certain tax-deferred retirement accounts to transfer those funds to a Roth IRA. (Individuals switching from traditional tax-deferred IRAs to a Roth IRA must pay tax on the funds transferred since eventual distributions from Roth IRAs are not taxable, unlike distributions from traditional IRAs. By allowing individuals with tax-deferred IRAs to switch to a Roth IRA at any time, rather than in limited circumstances as under current law, more people are expected to make such taxable transactions.)

Farm Bill Extension

The 2008 farm bill expired on September 30, 2012. H.R. 8 extended the farm bill to September 30, 2012, preventing farm policy from reverting to underlying permanent 1949 farm policy law. The bill's authority will be retroactive to September 30, 2012, as most agriculture policy and programs under the 2008 farm bill expired on or before that date (while dairy programs expired December 31, 2012). The measure ends mandatory funding for a number of programs that used to be entirely mandatory or a combination of discretionary and mandatory; instead, funding for those programs would instead be entirely discretionary. Those programs include certain food stamp-related programs, agricultural research, energy, horticulture and organic agriculture, and assistance for socially disadvantaged farmers or ranchers programs.

H.R. 8 authorizes funding for certain agricultural disaster assistance programs from the 2008 farm bill that had expired at the end of FY 2011, a year before the rest of the farm policy law.

Specifically, it authorizes for both FY 2012 and FY 2013:

- ❖ \$80 million a year for livestock indemnity payments.
- ❖ \$400 million a year for the livestock forage disaster program.
- ❖ \$50 million a year for emergency assistance for livestock, honeybees and farm-raised fish.
- ❖ \$20 million a year for the tree assistance program.

Unemployment Insurance

H.R. 8 extends for one year, through December 31, 2103, the federal unemployment insurance benefits for laid-off workers. The measure retains the benefit tiers enacted in 2012, which reduced the maximum number of weeks an individual could receive benefits from 99 to 73 week: 47 weeks of federal benefits in addition to 26 weeks of state benefits. H.R. 8 also retains the job search requirement on beneficiaries and authorizes states to drug-test beneficiaries in cases where their employment was terminated for unlawful drug use. The measure also extends the current authorization of appropriations for federal aid to help states carry out re-employment services through FY 2014, at a rate of \$85 per individual receiving such services.

Medicare “Doc Fix” and Health Care Provisions

H.R. 8 prevents for one year a scheduled 27% cut in Medicare reimbursement rates to physicians and extends several expiring health care programs. It also includes a number of offsets related to health care,

and repeals or modifies provisions of the health care overhaul law. For more detailed information on these health care provisions, please contact NATaT Federal Director Jennifer Imo.

Issues NOT Addressed in H.R. 8

Although H.R. 8 will avert many of the year-end tax hikes and spending cuts that were set to kick in, it failed to address some of the major issues that have divided Congress in recent months. Here's what was left out:

- ❖ **An agreement to raise the debt ceiling:** The nation reached its borrowing limit on December 31, 2012, and the Treasury Department has said it will use “extraordinary measures” to avert default as long as it can - likely into February. Then Congress will have to once again take up the contentious issue of raising the country's so-called debt ceiling. Last time, the negotiations resulted in a downgrade of the U.S. credit rating.
- ❖ **Extension of the payroll-tax cut:** A temporary, 2% cut to the payroll tax expired at midnight on December 31, 2012, and was not renewed. If a person makes \$50,000 or more, that is an extra \$1,000 in taxes over the next year.
- ❖ **A grand bargain:** Lawmakers did not address the country's long-term fiscal issues in this bill -- namely, a complicated tax code and rising entitlement spending. Tax reform and costly spending decisions will keep the 113th Congress very busy.
- ❖ **Tax-free municipal bonds safe for now:** Again, there is no change in the status of tax-exempt municipal bonds in H.R. 8. However, the issue will likely arise again as Congress works on tax reform in the coming months.

What to Expect

The 112th Congress officially adjourned yesterday, January 2, and the first session of the 113th Congress is scheduled to convene tomorrow, January 3. Not only is this one of the narrowest breaks between Congresses, but, as mentioned earlier, many issues from the 112th will spill over into the new Congress and demand immediate attention. Over the next few months, we expect to see movement and action on the following issues:

- ❖ **FY 2013 Appropriations:** The current six-month continuing resolution (P.L. 112-175) is set to expire on March 27. Congress will need to either reintroduce and finalize the FY 2013 spending bills or approve another short-term continuing resolution before that date.
- ❖ **Sequestration:** H.R. 8 merely extended the sequestration trigger until March 1, setting up further debate on automatic spending cuts in the 113th Congress. Members will be charged with coming up with a more permanent solution before that date.
- ❖ **Supplemental Spending Bill:** The 112th Congress failed to come to agreement on a supplemental spending measure for disaster relief, mainly targeting the victims of Hurricane Sandy. Putting together a disaster relief package will be a top priority of the 113th Congress.
- ❖ **Debt Ceiling Increase:** The Treasury Department is working hard to ensure that the nation does not default on its debt. The 113th Congress will most certainly need to address the issue of raising the nation's debt ceiling before mid-February.