Behind the Fiscal Cliff Compromise

At the eleventh hour on New Year's Eve, Washington negotiators reached a compromise to avoid the "fiscal cliff" – the looming combination of tax increases and spending cuts that threatened to throw the country back into recession.

One of the most important parts of that compromise has often been overlooked. The compromise made *permanent* changes to the tax code. For over the past decade, when Congress changed the tax law, it typically included a "sunset" date, when the changes would expire and the prior law would again take effect. These sunset dates made planning difficult, because taxpayers never knew if Congress in fact would allow a law to expire or instead would enact another temporary extension.

Now, for the first time in over a decade, changes to the tax law have been made permanent. Of course, Congress can still change the tax law in the future, but at least the changes do not have built-in expiration dates raising concerns about the new law expiring.

The fiscal cliff compromise made the following changes to income tax rates for 2013 and beyond:

- Permanently extended the existing tax rates (the "Bush tax cuts") for families with taxable income under $450K ($400K for individuals). For taxpayers with higher income, the lower tax rates in effect for the past decade have expired.

- Reinstated the "Pease" phase-out of itemized deductions for families with adjusted gross income over $300K ($250K for individuals). Under this provision, total itemized deductions are reduced by 3% of adjusted gross income above these income thresholds, but cannot be reduced by more than 80%. This phase-out is a horribly – and unnecessarily – complex provision that is in fact a disguised increase in the tax rate. The net effect of the deduction phase-out is to add about one percentage point to the tax rate for income over $300K ($250K for individuals).

- Leaves in place the implementation of the new 3.8% health care reform surtax on investment income for families with adjusted gross income over $250K ($200K for individuals).

- The 3.8% surtax applies only to *taxable* investment income. Thus, the tax does not apply to non-taxable income such as tax-exempt municipal bond interest or to life insurance death proceeds. Also, the tax does not apply to amounts withdrawn from qualified pension plans and IRAs.

- The 3.8% tax applies to taxable investment income only to the extent that income, plus all other adjusted gross income, exceeds $250,000 for a family ($200,000 for an individual). For instance, suppose a family has $200,000 of wage income and $80,000 of dividend income. Total adjusted gross income of $280,000 exceeds $250,000 by $30,000. Thus the 3.8% tax would apply to $30,000 of the dividend income.

Taken together, these changes create four sets of tax rates on investment income where before there was one:

Family income	*Ordinary income tax rate*[1]	*Cap gain / Dividend tax rate*
< $250K *(no change)*	35% max	15% max
$250K – $300K *(3.8% surtax)*	38.8%	18.8%
$300K - $450K *(Pease phase-out)*	39.8%	19.8%
> $450K *(Bush tax cuts expire)*	44.6%	25%

[1] "Ordinary income" is income that is taxed at an unreduced rate. Types of investment income taxed as ordinary income include interest (other than tax exempt interest), rents, and royalties. Dividends, capital gains, and tax exempt interest are not ordinary income as they are taxed at lower rates (or not at all).

Compensation income (income from a job) also is "ordinary income" because it is taxed at an unreduced rate. The 3.8% does not apply to compensation income. Instead, compensation income is subject to a new 0.9% surtax. The chart addresses only the taxation of investment income.

The fiscal cliff compromise makes other tax changes as well:

- Permanently extends the current estate, gift, and generation skipping tax exemptions and indexes these exemptions for inflation. In 2013, an individual can pass on during life or at death a total of $5.25 million in assets without gift or estate tax.
    - Permits "portability" of the exemption between spouses. For example, if husband dies with $2M, wife can pass on tax-free $8.25M (her $5.25 plus her husband's unused $3M).
    - Increases the estate tax rate to 40% (from 35%).
- Permanently "patches" the alternative minimum tax to keep it from affecting more taxpayers in later years.
- Extends through 2013 the ability of individuals over age 70-1/2 to make tax-free distributions of up to $100K from an IRA to a charity.

At the same time, there were a number of things the compromise did *not* do:

- Extend the lower payroll tax rate in effect in 2011 and 2012. Thus in 2013 the payroll tax rate reverts to 6.2% (from 4.2%).
- Reduce government spending. The compromise delays for two months the implementation of the "sequester" government spending cuts that were slated to begin in January 2013.
- Reduce the percentage of American families who pay no federal income tax (currently close to 50%).

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