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Guest Article

Decoding The Fiscal Cliff

By Alvin D. Lurie
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Executive Summary

The waning days of 2012 and of President Obama's final days of his first Administration provide him and the Democratic and Republican leadership of the Congress a unique challenge to resolve what has become the most critical domestic problem of the Nation, averting the fiscal cliff. To do so will require them to achieve what they have been unable to accomplish in his entire initial term in office, namely, overcoming sharply contrasting philosophies of government regarding the issues that underlie the fiscal cliff, i.e. tax policy and government expenditures. Solving the problem is further compounded by what had become a mantra of the President in his bid for reelection, taxing the rich more heavily to minimize cuts in programs benefiting the middle and lower classes.

The argument of this article is that there are already enacted a considerable number of new tax measures that will begin to fall in 2013 only on the very taxpayers who are in the President's target area, thus accomplishing Obama's goal and greatly reducing the principal obstacle to the negotiators averting the fiscal cliff.

A Working Definition

"The Fiscal Cliff"—a term increasingly on the tongues of government leaders, TV talking heads and just plain Americans as this year-end draws nearer, the very sounds of whose words are foreboding—connotes for many something scary. But exactly why the term and what it portends many would be hard-pressed to state—albeit perhaps less so among viewers of this site. But even among such an elite group differences will abound, because the term, unlike the specific, often mathematical characteristics of terms employed by economists ("recession", "depression"), scientists ("climacteric", "photosynthesis"), anthropologists ("humanoid"), historians ("Luddites"), even meteorologists ("global warming")—although with sharp divisions in the ranks of the latter—is more a metaphor that has caught on only recently to describe a confluence of economic and political circumstances that are looming in this Country in these final months of this year, the cumulative effect of which can be likened to driving a vehicle (that is, the state of our economy) over a cliff.

Permit me then to define the term as I propose to use it here. I will confine it to particular tax increases and government spending decreases that are set in stone (i.e., foreordained in Federal statutes now on the books) to occur in CY 2013, which—it is almost universally agreed by rational and informed observers—will plunge the U.S. economy into deep recession unless Congress enacts and the President signs a legislative fix that ameliorates the cumulative effect of these laws so as to avert this dread eventuality. But, where the tax increases generally pointed to as drawing the U.S. closer to that cliff are limited to the Bush tax cuts, I would draw the lines much more broadly. Drawing the economy back from the cliff will be difficult under the best of circumstances for the government negotiators. It will be impossible if they look at only part of the picture.

Obstacles To A Solution

The problem is exacerbated by the backdrop against which this fix must occur, if at all:

i. The national debt is steadily rising to nose-bleeding heights, and in several months will require that the debt ceiling be raised if the U.S. is not to default on its obligations (a situation that was narrowly averted in 2011 when the Republicans and Democrats took opposing views on raising the debt limit until the impasse was resolved, but not before one of the rating agencies downgraded the U.S. credit standing).

ii. The debt problem can only be addressed by significantly raising taxes or lowering government spending, or a measured combination of each.

iii. Resort to such stratagems, while good for dealing with the debt crisis, is bad for stimulating the economy in the near term, because of sucking dollars out of the system.

iv. There is a push-pull in the respective philosophies of the two major political parties respecting taxes and spending, down for both by Republicans, the opposite for Democrats, such that each cancels the other out unless the Parties reach an accommodation permitting each of their philosophies to be respected as parts of a responsible compromise.

v. The rancor and hostility that characterized the dealings of the Parties for the past four years, leading to a dysfunctional Congress within its separate Houses and vis-a-vis the President, such that essential legislation could not be accomplished, show no signs of abating after the recent elections that have left the political leadership of all three governmental bodies exactly as they have been during the first Obama Administration.

It may be a triumph of hope over experience to anticipate that this looming "cliff" will be averted in the remaining weeks of this year. Perhaps the best thing that can realistically be hoped for in this abbreviated time span from the outgoing Congress is a band-aid that will just push C-Day down the road for the next Congress to grapple with. That can happen of course. It is within the power of the expiring Congress to postpone the effective dates that are now causing the calendar crunch before they kick in; or, failing that, the new Congress can accomplish a retroactive salvage action. But neither of those is ideal.

The uncertainty that has kept businesses sitting on the estimated trillions of dollars of working capital, which is already operating as a leash on the U.S. economy and a drag on the persistent unemployment figures, will only cause these conditions to worsen the longer inaction occurs. Even as Nature abhors a vacuum, so too do Wall Street and Main Street, whose reactions to the government stasis will compound the very matters at stake, by acting as if the cliff events had already occurred.

The cliff, of course, is merely the figurative image of the precipitous drop of the economy into recession from the billions of dollars that will be lost to it from the twin-barreled effects of laws now programmed to come into force on 1/1/2013. It is not that raising taxes or government pump-priming are inherently bad; rather that a fragile economy struggling to emerge from the deepest trough since the Great Depression, and showing only problematic early signs of growing out of the four-year recession, cannot but fail to stall if starved of working capital at this critical juncture in the recovery.

Sources of the Looming Cliff

As noted, the chief sources of the cash drain that are most often identified with the cliff are the statutorily scheduled expiration of the so-called "Bush (No. 2) tax cuts" of 2002 and 2003 and the deep cuts in Federal government spending all across the Federal budget that were mandated by the 2011 Budget Control Act to commence automatically next year (with the sacrosanct Department of Defense budget taking the biggest hit). Ironically, that law was crafted by its authors in both Parties to be so onerous as to cause it to be unthinkable that Congress would allow the cuts to go into effect. Many in Washington are reported to still be of that conviction; but despite some signs of activity after the recent election (a meeting of Congressional leaders at the White House with the President at his invitation, and reported follow-up meetings among the staffs of the leaders), there is no solid evidence at this writing that the necessary give-and-take has begun, out of which even the mere prospect of a "grand bargain" could emerge.

Indeed the only thing the President has stated publicly is that his mandate from the voters was to deliver on his campaign promises to raise taxes on the rich, which he defined as those making more than $250,000 dollars a year. Republican leaders have stated just as steadfastly that they will oppose that; although House Speaker Boehner has said that would not prevent raising revenue by loophole closings (unidentified) without raising tax brackets.

Very little has been said in public about the rates that would result from ending the Bush tax cuts. For example, taxes on dividends would actually go up from 15 percent on dividends to 24 percent, and capital gains taxes, from 15 percent, even more. In a statement calculated to gin up public support for the President's proposal to retain the Bush tax cuts for the middle class, the White House has projected that, without the cuts, the taxes of a married wage earner with two children, making in the $50,000- to-$80,000 range (presumably the President's target middle-class group) could see at least a $2,200 federal tax hike next year.

New Medicare Taxes

The end of the Bush cuts is reputedly the largest contributor to the cash drain from the economy, approaching $300 billion, compared with approximately $100 billion from the Budget Control spending cuts. But these are not the only components of the cliff.

A Medicare-related payroll tax cut of 2 percent of employees' portion of the tax (from 6.2 percent to 4.2 percent) that has obtained last year and this year, and a corresponding tax reduction of the self-employed Medicare tax, apparently are not going to be extended next year, which will cost taxpayers $125 billion.

And two other increases in the Medicare tax go into effect next year under the health care reform law (the Affordable Care Act, or "Obamacare" as it has come to be called) enacted in 2010 with unanimous Republican opposition. Nothing of these two appears to have been mentioned in the public prints or TV talk shows, or even in statements by the GOP leadership, in connection with the fiscal cliff issue; but these two tax increases properly should be included among the tax jumps in 2013 that build up the cliff just as certainly as the elimination of the Bush tax savings noted above and the Budget Control spending cuts:

1. A 0.9 percent rise in the Medicare portion of the self employment tax, from 2.9 percent to 3.8 percent on earnings in excess of $250,000 for married taxpayers filing jointly, $125,000 for married taxpayers filing separately, and $200,000 for all other taxpayers; and
2. A tax on what is termed in the law Net Investment Income ("NII").

(Technically part of the Health Care and Education Reconciliation Act of 2010, the NII tax was enacted one week after the Patient Protection and Affordable Care Act in March 2010, but together the two statutes are collectively called the Affordable Care Act, or "ACA.")

The NII tax provision imposes, effective January 1, 2013, for the first time since the Medicare tax came into the law, an entirely new tax regime applied to NII, equal to 3.8 percent of NII, but not more than 3.8 percent of "modified adjusted gross income" (essentially the same as "adjusted gross income") in excess of the $250k, $200k and $125k levels cited in the preceding paragraph.

Reach of the Net Investment Income Tax

NII is defined in the statute to include dividends, interest, rents and similar investment returns, and also gains from the disposition of property (presumably including sale of a residence). The tax will also reach the aforementioned items that pass through to the taxpayer from partnerships, LLCs and S corporations. The tax does not apply generally to income derived in the ordinary course of a trade or business, except if a passive activity with respect to the taxpayer.

Self-evidently, a lot of moving parts will enter into its calculation. Temporary Regulations from the IRS at an early date will be indispensable; but tax compliance will prove very difficult even with such preliminary guidance.

The NII tax reads like an income tax, from which it borrows heavily; and, it may be presumed, income tax law analysis and precedents generally will be applied to its interpretation—albeit by IRS specialists and agents in the payroll tax group, one would guess, whose fealty to income tax principles might be less than enthusiastic. It is completely separate from and in addition to the income tax, and is not creditable against the income tax. It is an even farther cry from health care reform, unless one includes within the parameters of "health" the health of tax advisers' bank accounts, for it is certain to become a growth industry for tax professionals.

One might have expected that in the arguments during the presidential campaign, and in the post-election comments as part of the preliminaries leading up to the impending fiscal cliff negotiations, someone might have mentioned that the President's call for raising taxes on the rich ("just a little bit," as Mr. Obama has put it in his recent utterances) has already been satisfied, at least partially, for many taxpayers by the 3.8% tax on NII, even to the point of approximately mirroring the $250,000 threshold level posited by the Administration for imposition of the tax. For the married taxpayer with AGI exceeding that threshold, who owns or has an interest in a business as to which he is "passive," every dollar he earns from that business above the threshold in 2013 and later years will be taxed at his regular income tax bracket plus 3.8 percent (if I have done the calculation correctly). The battle of passive versus non-passive may now be fought on a new battleground. At least, one might suppose, the extra Medicare tax should be credited against one's ordinary income tax.

ACA: A Mini-IRC

The ACA includes a variety of other taxes and fees, gathered together in titles and subtitles of the two acts headed "Revenue Provisions," dealing with particular kinds of products, providers, manufacturers and plan benefits, which are mostly too specialized to warrant mention here. But one in particular that is relevant to this discussion, entitled "Excise Tax On High Cost Employer-Sponsored Health Coverage," imposes a tax equal to 40 percent of the "excess benefit" of health coverage made available monthly to an employee, as determined by a formula spelled out in the statute. It has acquired the moniker "Cadillac Plan" for obvious reasons. It is one more levy on the "rich" that is already baked into our tax scheme; although, in a trade-off with the unions to win their support of the ACA, its effective date was moved from 2013 in the Patient Protection and Affordable Care Act to 2018 (yes, 2018!) by an amendment in the Health Care And Education Reconciliation Act.

It would be remiss not to mention that the ACA also includes a tax that comes into effect in 2013, the penalty imposed on individuals for failing to observe the now famous "individual mandate" of the ACA to obtain health insurance policies providing "essential health benefits," as defined in the statute. The law also includes a companion tax called 'Employer Responsibility Penalty' for employers with 50 or more employees failing to provide health insurance options satisfying minimum criteria. The law deliberately calls these "penalties" (presumably to immunize the ACA against charges of raising taxes on the middle class), but ironically the law was able to survive a challenge to its constitutionality in the Supreme Court because, writing for the slim 5-4 majority, Chief Justice Roberts, although not agreeing to the Administration's claimed Commerce Clause support for the law on which his colleagues in the majority were content to rest their decision, argued that, notwithstanding its "penalty" label, the penalty passed the test of a "tax" for constitutional purposes, and so was a proper exercise of the Congress' taxing power under the Constitution. His colleagues in the majority went along with that rationale, but not without a muscular concurring opinion by Madame Justice Ginsburg, taking her Chief to task for rejecting the Commerce Clause foundation.

The four justices in dissent vigorously objected to the "tax" treatment of the mandate, in the face of the statute's very deliberate and repeated designation of the impost as a penalty; but the Supreme Court speaks through its majority, and so, according to the law of the land, it is a tax. Penalty or tax, growing numbers of businesses are going to pay it starting in 2013, in preference to the costs of continuing employer-provided health insurance; and the numbers doing so will rise steadily in later years as the per-capita-measured amount rises steeply in each of such years. But, by whatever name one chooses to call it, to the extent it is paid by individuals and businesses it is an expense that adds to the cliff that is now causing growing concern in the Country. It is, therefore, surprising that it has not entered into the cliff debate.

The AMT "Patch" Is a Thing of the Past

There is still another tax increase that comes into effect in 2013, but not as part of the ACA, that has also not been mentioned in connection with the fiscal cliff. In the interest of presenting the full picture, it too must properly be counted in the toll of taxes that will drain cash from the economy, thus diverting funds that would otherwise add fuel to the growth of the economy. It is an inflation-indexed annual adjustment of the personal exemption for the individual Alternative Minimum Tax, which for many recent years has softened the impact of that tax by means of what is called the "patch." As the law presently stands, this indexed annual adjustment of the AMT exemption is not operative after 2012, so the potential reduction of the AMT taxable income will not occur.

The AMT has a particularly costly impact in states like New York with relatively high state income taxes, because state and local income taxes are not allowed as a deduction against taxable AMT income. It would not be unusual for the AMT to equal at least 50 percent of the ordinary tax. When Washington talks of the current top bracket under the Bush tax regime, it cites the 35% ordinary tax rate, which obviously distorts the true picture.

Higher Estate Tax Is a Thing of the Future

Finally, to the list can be added the radical estate and gift tax changes scheduled to take effect in 2013, to which no reference has apparently been made elsewhere in the context of the fiscal cliff, but which are likely to have considerable bearing on the issue. As the law now stands, the estate, gift and generation skipping transfer taxes will take an enormous leap at the stroke of midnight on December 31st, when, under present law, the exemptions for estate and gift taxes will drop to $1 million (approximately $1.4 million for the GST exemption), and the top rate will go back to its previous 55 percent bracket. Contrast these with the $5.12 million exemptions and 35 percent tax rates presently obtaining.

It is generally expected that either before January or, more likely, after it, Congress will adjust the numbers starting in 2013, and the "common wisdom" generally has pegged the 2013 numbers at $3.5 million and 35 percent, respectively. That is not to suggest that the common wisdom gets to vote; but, for what little it's worth, that would be this observer's vote too.

A lot of estate planning has been premised in the past few months on those numbers by advisers to "rich" people, so clearly a lot of taxpayers in that class have been building anticipated estate and gift tax increases in 2013 into their planning, perhaps more than they have planned around the income and other tax increases described above that this piece presupposes to be germane to dealing with the fiscal cliff.

Conclusion

Mr. Obama is about to enter into the fiscal cliff negotiations with Congressional leaders buoyed by the notion that he promised in his re-election campaign to raise taxes on the rich, and that a majority of Americans agreed with him; and that is therefore his precondition to satisfying the tax side of the equation. It is the burden of this paper that the goal has already been achieved, by a congeries of tax provisions that become effective in 2013 and that fall uniquely on the most affluent of taxpayers. This bundle of tax increases, coming into force at this very time, has already gone far beyond the President's characterization of his objective to effect a "little bit" of tax hike on the rich.

The Republicans could make the cheese more binding were they to put on the table a cap on deductions for high bracket taxpayers, as some have intimated. That would permit the negotiators to focus on the spending part of the fiscal cliff, something they do frequently in Congress, which would appear not to be a bridge too far. That could occur very quickly if the full burden of new tax increases about to fall on the top-bracket taxpayers—and only on them—were seen in their proper perspective. Wall Street would most certainly reward them and the entire country with a dramatic rise in all its indices were they to reach a rapid resolution of the fiscal cliff issue before the New Year. History might also erase the stigma of their having been participants in a dysfunctional government from 2009 to 2012.

As this article was 'going to press' (a term left over from the pre-digital age), the President sounded an optimistic note that even a pre-Christmas resolution of the fiscal cliff was within reach. Does he know something?

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