Understanding the new tax law: A preliminary view

Prepared by:

Don Susswein, *Principal*, *Washington National Tax*, McGladrey LLP

Despite the passage of the American Taxpayer Relief Act of 2012 (the Act or the fiscal cliff legislation), almost everyone's federal taxes will go up in 2013. Although an unpleasant reality, it is largely irrelevant as an indicator of the overall direction of federal tax policy because so many of the tax rates in effect in 2012 resulted from avowedly "temporary" tax cuts that no one should have reasonably assumed would continue. An appropriate "baseline"–other than the temporary rules in effect in 2012–must be established to determine whether the new tax structure represents a move forward, backwards or sideways.

To be sure, a major goal and focus of the Obama administration was to increase taxes on higher-income taxpayers, and not to raise taxes on lower- and middle-income taxpayers. To measure the extent to which the administration accomplished these goals, this article reviews the major changes that establish the new, "permanent" levels of payroll taxes, income taxes, and wealth transfer taxes, suggests an appropriate baseline for comparison, and then analyzes the new rules against the pertinent baseline.

Payroll tax changes and associated entitlement spending

Foremost among the tax increases that most Americans will experience in 2013 is the expiration of an avowedly temporary "payroll tax holiday" that had reduced the worker's share of social security taxes by 2 percentage points. The holiday applied only to the first $110,000 of wages or self-employment income. The increased annual tax burden to an individual from the expiration of this holiday could thus be as much as $2,200. Many would agree, however, that it would be unfair to criticize Congress and the president for "raising taxes" by this amount. There are two reasons for this.

First, the expiration of a temporary tax cut or tax holiday intended to provide only temporary tax relief or economic stimulus should not be viewed as a tax hike. Otherwise, Congress could never grant any short-term benefit without being wrongfully accused of being a Scrooge rather than a Santa because the benefit is only temporary. Even Santa grants his presents one year at a time and has been known to be more generous in certain years than others.

Second, even according to the progressive Urban Institute,[1] most lower- and middle-income individuals actually receive much greater lifetime benefits from social security and Medicare than the sum total of the taxes paid by both workers and their employers over their working lifetimes. FICA taxes are called “insurance contributions” to reflect the theory that these programs were intended to be viewed as mandatory insurance programs and not "welfare" programs, which is the reason many beneficiaries continue to argue that they have “paid for” their benefits.

According to the Urban Institute, this is true in many cases for a good portion of the benefits. Yet, the Urban Institute figures also demonstrate persuasively that social security and Medicare taxes and benefits represent a *net federal subsidy* to most workers–not a net contribution to the cost of government. That is, the taxes or required “contributions” do not even fully pay for the cost of program benefits.

Of course, Congress clearly intended this result for the generation that lived through the Great Depression. These individuals received benefits even though they had not contributed during their working years when the programs simply did not exist, and no one would begrudge them that. However, for baby boomers who have been paying social security and Medicare taxes their entire working lives, it is a different matter.

Individuals born in 1945 or later who began working after 1965, when Medicare was added to the social security system, are generally thought to be contributing to an insurance program that is supposed to be actuarially sound–even if mandatory. That is why so many beneficiaries believe they have “paid for” their benefits and thus argue that they have a moral claim that should prevent any reduction or modification of these benefits.

In fact, according to the Urban Institute study, the net subsidy represented by social security and Medicare for a middle-income, two-earner couple born after World War II is roughly equivalent to receiving a $250,000 cash grant at retirement, in today’s

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[1] Urban Institute, *Social Security and Medicare Taxes and Benefits over a Lifetime: 2012 Update*, C. Eugene Steuerle and Caleb Quakenbush.

dollars. This is the approximate difference, in today's dollars for a couple retiring today, between the present value of the total lifetime taxes and fees paid by workers and employers (assuming a reasonable rate of return on funds credited to the social security and health insurance trust funds) and the market cost of obtaining a retirement annuity, disability insurance policy, and health insurance policy comparable to the benefits such workers are "entitled" to receive. Because taxes or contributions from employers and employees fund only around 80 percent of the total costs of the programs,[2] some call the program "unsustainable"–meaning unsustainable as a self-supporting social insurance program, without additional subsidies from other sources.

To make these programs actuarially sound (i.e., supported by the taxes that many believe "pay for" these programs), benefit costs would need to be curtailed somehow, or payroll taxes levied on the first $110,000 of wages would have to *increase* by several percentage points. The math is relatively easy. If a combined employer and employee tax rate of 15.30 percent only pays for 80 percent of the program costs, the combined employer and employee rate would have to increase from 15.30 percent to slightly over 19 percent of taxable wages to make the program solvent as a form of mandatory insurance. That would mean a payroll tax increase on the employee's share alone of about 2 percentage points. In other words, even after suffering the expiration of a 2 percentage point tax holiday and paying the full 7.65 percent tax applicable in 2013, employees would have to bear a payroll tax *increase* of another 2 percentage points to 9.65 percent (with a similar increase on the employer) to make the programs actuarially solvent as insurance programs. The Congressional Budget Office estimates on this point are similar.

Notably, if this were an income tax, we would call this deficit between the payroll tax rate needed to cover program costs and the benefits the taxes supposedly "pay for" a *tax expenditure.* For some reason, that concept has never been applied to payroll taxes and their associated benefits–only to income taxes.

In fairness, of course, this problem cannot be laid at the foot of the current administration or the current Congress. Medicare was created in 1965 under the leadership of President Lyndon B. Johnson and substantially expanded under President George W. Bush to cover pharmaceuticals. Regardless of who is to be blamed or credited for the existing program design, the dire financial condition of Medicare is at the heart of the question of what should be done on the federal spending side. Changes to the current Medicare system were not part of the debate

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[2] *Id.*

surrounding the fiscal cliff legislation and must await future legislation on the spending and entitlement side.

Income tax changes–Complex interactions as gross income rises from $300,000 to $575,000

Searching for an appropriate baseline is difficult when it comes to the new law's changes to income taxes. It should be noted that there were three major changes to the income tax structure. Taken together, they amount to a phase-out of the benefits of the Bush-era income tax cuts as adjusted gross income (AGI) increases from $300,000 to $575,000, at which point the income tax rules and rates largely conform to where they were in 2000 under President Bill Clinton.

1. First, as is well-known, the "temporary" income tax cuts first enacted under the leadership of President George W. Bush were set to expire at the end of 2012 for all Americans. The fiscal cliff legislation retained those rates for the first $450,000 of taxable income for a married couple ($400,000 for single individuals).

2. Second, for amounts of taxable income over $450,000 (or $400,000 for singles), ordinary tax rates were *increased* by 4.6 percent (from 35 to 39.6 percent), reverting back to the rates that applied under President Bill Clinton.

3. Third, in the somewhat confusing guise of a cutback on itemized deductions and personal exemptions, an effective tax rate increase of slightly over 1 percent was imposed on the AGI of married couples over $300,000 (or $250,000 for single individuals).[3] A similar cutback existed before the Bush

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[3] These rules are confusing, some might say misleading, because the added tax largely is a function of one's AGI and only in extreme cases a function of the amount of itemized deductions or personal exemptions. For example, consider a married couple with $500,000 of AGI, $60,000 of deductions, and $440,000 of taxable income but for this provision. The cutback in itemized deductions will equal 3 percent of the amount of their AGI that exceeds $300,000 (i.e., 3 percent of $200,000, or $6,000). Thus, their deductions are reduced from $60,000 to $54,000, and their taxable income rises by $6,000 to $446,000. At a 35 percent tax rate, that amounts to added taxes of $2,100. However, even dramatically reducing their deductions–say, from $60,000 to $20,000–would not reduce the tax hit. In that case, the $20,000 of otherwise allowable deductions would still be reduced by $6,000. The cutback is proportional to AGI, not to the total amount of deductions. In the case of personal exemptions, the cutback works in a similar way–proportional to AGI and not proportional to the amount of exemptions. However, the total amount potentially subject to cutback is obviously limited the number of dependents multiplied by $3,800. Thus, a similarly situated family of four will, at most, suffer an exemption cutback of $15,200, costing them $6,019 at a 39.6 percent tax rate.

Combined, these two cutbacks cost our hypothetical family approximately $8,200 because their AGI exceeds $300,000 by $200,000. That tax represents approximately 4 percent of their AGI over $300,000, but once the $15,200 of exemptions have been fully cut back to zero, the continuing drag–in the form of a cutback of itemized deductions–amounts to a tax of only 1.2 percent on each dollar of AGI.

tax cuts suspended its application. Had it remained in effect without intervening changes, the previous cutback actually would have applied at an even lower level of AGI (adjusted for inflation).

Under these three provisions working together, the benefits of the Bush-era income tax cuts are gradually phased out for married couples with AGI between $300,000 and approximately $575,000, and for single individuals at comparable levels. Again, this occurs through a combination of (1) explicit rate increases (on taxable income above $450,000 for married couples, or $400,000 for singles) and (2) rate increases in the forms of a phase-out of personal exemptions and a limitation on itemized deductions, both of which are roughly proportional to the amount of AGI over $300,000 (or $250,000 for singles).

For example, assume an AGI of $500,000 for a married couple with two children and otherwise allowable itemized deductions and deductions for personal exemptions that total $60,000, which would otherwise produce taxable income of $440,000. Under the rate changes alone, the continuing benefits of the Bush rate cuts on the first $450,000 of taxable income (roughly $12,000 of tax savings) are unaffected. Only as taxable income increases above $450,000 do the Clinton-era tax rates apply. However, the cutbacks in personal exemptions and itemized deductions, which are roughly proportional to the amount of AGI above the threshold, would cost this hypothetical couple approximately $7,500.

For our hypothetical couple earning $500,000 of AGI, that still leaves approximately $4,500 of Bush-era income tax benefits intact. With a little more income, approximately $75,000, that $4,500 of benefits would be fully wiped out. This occurs because the marginal tax on each additional dollar of AGI after $500,000 is increased by 5.8 percentage points–1.2 percentage points from the cutback in deductions and 4.6 percentage points from the restoration of the Clinton-era top tax rate on high earners. Thus, at approximately $575,000 of AGI, the income tax benefits of the Bush tax cuts have essentially been eliminated, and any incremental income is subject to a tax on taxable income of 39.6 percent plus an effective tax on AGI of 1.2 percent, for a total marginal rate of 40.8 percent.

Of course, entirely separate from the fiscal cliff legislation are the provisions of Obamacare that impose a new, 3.8 percent tax on “net investment income” as total income exceeds approximately $250,000.

Who won the battle of the fiscal cliff?

Many political observers have been focused on the political gamesmanship that led up to the adoption of this new rate structure and whether one side “won” or “lost.”

As explained below, that appears to depend on what one uses as the “baseline” or assumed starting point. Does one assume or project that the law would have reverted to the law in effect in 2000? In that event, almost everyone received a tax cut under the new law–including many with incomes above $250,000.

Or, does one view *any* diminution of the tax benefits available during the twelve years of George W. Bush and the first Obama administration as a “victory” for the Democrats and a “loss” for the Republicans? If so, how “wonderfully progressive” or “horribly anti-growth” does one view the tax structure in effect under Bill Clinton, to which there has been a partial return?

Compared to the flat 28 percent tax rate on all types of income that applied when Ronald Reagan left office in 1989, the prospect of paying a combined top rate of 43 percent on wages, salaries, and ordinary investment income seems to be a truly dramatic shift in the fortunes of the top earners. That shift largely happened during the years of President Bill Clinton and President George H.W. Bush. A partial and temporary reprieve occurred in the form of the President George W. Bush tax cuts, which were extended through the end of 2012 with the blessing of President Obama. As explained above, the new law preserves that reprieve for those with AGI below $300,000 but gradually phases it out as AGI increases from $300,000 to $575,000.

How significant is the complete elimination of the Bush-era income tax cuts? For a married couple earning AGI of $3 million per year in the form of wages and salaries, the Bush-era tax benefits are eliminated by the time their AGI reaches approximately $575,000. Then, their incremental income tax burden amounts to an additional 5.8 percent tax on the $2,425,000 of AGI between $575,000 and $3 million. That equates to a total of $140,000 of new taxes, plus the elimination of around $12,000 of tax benefits on the first $575,000 or so of AGI. This increases their actual tax burden from approximately $850,000 to $1 million–from approximately 33 percent to approximately 37.5 percent of AGI. While substantial, many have observed that this is little more than a return to Clinton-era income tax policies.

Treatment of capital gains and qualified dividends

The new law also restored the capital gains rates of the Clinton era–at least for those with taxable incomes over $450,000 (or $400,000 for an unmarried taxpayer). That is, the general rate is 15 percent, but higher-income taxpayers will incur a 20 percent rate. This five-percentage-point increase is almost identical in magnitude to the increase of the top ordinary income rate from 35 percent to 39.6 percent. However, individuals earning their income largely from long-term capital gains (or qualified dividends) continue to have a much lower absolute tax burden, even after the new legislation.

In that regard, it is noteworthy that the legislation did not include a “Buffett Rule” requiring those who make their income from capital gains to pay taxes at ordinary income rates. This is particularly important because only a relatively small number of taxpayers with AGI above $575,000 earn their income predominantly from wages and salaries and ordinary investment income. Whether one feels that “the rich” are not paying enough taxes because of their capital gains benefits, or that this incentive for capital formation is crucial to our country's economic future, this is arguably "the dog that didn't bark."

Estate and gift tax rates and exclusions

Whatever baseline one assumes, it is essential to take into account the major permanent changes in the estate and gift tax laws. The laws are permanent, at least in the sense that they are not set to expire at any time. Positive legislation would be needed to alter them.

Many of the most economically successful Americans have the potential to *save and invest* some of their income (after income taxes) and build up a substantial estate. Thus, the effects of being fully exposed to the brunt of Clinton-era income tax policies by the elimination of the Bush-Obama income tax cuts have to be viewed in combination with the substantial benefits of the Bush-Obama era estate and gift tax changes made “permanent” by the new law.

Before the Bush tax cuts, the lifetime exclusion (adjusted for inflation to today’s dollars) was the equivalent of $2.3 million for a married couple using both of their exclusions. Today, it is $10.5 million, and that amount will continue to be adjusted for inflation. In addition, the marginal rate applicable to amounts in excess of the exclusion has been reduced from the 55 percent rate effective in 1990 to the 40 percent rate applicable for 2013 and future years. Thus, it would be fair to say that, of the combined income and estate tax benefits of the Bush tax cuts for high earners, only the income tax cuts have been eliminated. In some cases, the importance of the estate tax benefits far outweighs that of the income tax benefits.

For example, one can certainly imagine a frugal and savvy couple making $1 million per year (in 2013 dollars) and living in a low-cost state with no income tax suffering an annual, fiscal cliff income tax increase of $40,000 (in 2013 dollars). Over a working life with 30 years of peak earnings, that would amount to a lifetime added tax cost of $1.2 million in 2013 dollars. Nevertheless, the couple may still be able to accumulate an estate of $10.5 million (in 2013 dollars). This would only require them to save and prudently invest, in each of their 30 peak earning years, approximately $300,000 (in 2013 dollars). This should be feasible in many cases. For example, the couple might incur federal income taxes of approximately $200,000 (in 2013 dollars) and consume only $500,000 of the remaining $800,000 of post-income-tax disposable income. This includes the effects of approximately $40,000 of tax hikes attributable to the new legislation and its elimination of the Bush-era income tax cuts.

Again, for a couple at the beginning of their working lives today, one might multiply that $40,000 tax hike by 30 peak earning years–from 2013 to 2043–in which the repeal of the Bush-era income tax cuts would affect the couple. That would sum to a total of $1.2 million of lifetime added income tax burdens from the repeal of the Bush-era income tax cuts. However, they will continue to enjoy a Bush-era estate tax cut compared to the tax rules in effect when President George W. Bush took office. For example, assume the couple has an estate worth $10.5 million in 2013 dollars, which would be completely exempt from estate taxes under the new legislation. If the Clinton-era tax policies had continued in effect through the year of the couple's demise, that couple would have been subject to estate taxes costing the equivalent of approximately $4.7 million in 2013 dollars. That burden is eliminated by the fiscal cliff legislation.

How much has been lost and how much preserved for this hypothetical couple making $1 million annually for 30 years? If the combined lifetime income and estate tax benefits of the Bush-era tax cuts totaled $1.2 million (income taxes) and $4.7 million (estate taxes), the couple will continue to enjoy 4.7/5.9ths, or roughly 80 percent of the prior benefits.

As income levels increase, the ratio may change. Much may also depend on whether any particular couple decides to live in a high-cost or low-cost state or a high-tax or low-tax state, how frugal they are, and even whether they decide to avoid marriage, or to get divorced, in order to avoid the very substantial marriage penalty imposed by the new tax structure.

Conclusions

No matter how this Act is viewed, it is hard to see these results as a transformational shift in the tax burden towards the rich. Depending on the precise interaction of income and estate taxes, local cost of living, state tax rates, personal savings and investment decisions, and marriage or divorce decisions, many upper-income taxpayers will be able to conclude that they are still far better off than they were 13 years ago under the Clinton-era policies that President Obama argued should return. In other words, if President Obama or Congress were trying to fully turn the clock back to the Clinton-era tax policies, that has not been accomplished. At the same time, the behavior one must engage in to fully enjoy the new tax structure has changed, along with the amount of tax planning required.

For example, the new legislation is much less harsh if one is a saver, living in a low-cost area, and not married (if both halves of a couple earn similar amounts). Arguably, the balance between the cost of the lost income tax benefits and the benefits of the preserved estate tax benefits is even more favorable for builders or developer of a business, who can still enjoy the lion’s share of the substantial capital formation incentives in effect even during the Clinton era. The marginal income tax rate on long-term capital gains is still no higher than 20 percent, although the new Obamacare tax of 3.8 percent of net investment income could raise the overall rate to 23.8 percent. Although capital gains rates rise under the new legislation by approximately the same amount as ordinary income tax rates, the absolute level of capital gains taxes makes it easier to accumulate a substantial estate and utilize the full estate tax benefits of the Act.

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