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The fiscal cliff and the dynamics of income

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At the end of 2012, certain income tax policies were set to end and others to become effective. Central among these was the planned expiration of the 2001 and 2003 tax cuts (the "Bush tax cuts"), which had been extended for two years in 2010.

How might corporations and individuals have acted to minimize the tax burden on themselves or their stakeholders?

The end of the Bush tax cuts would have meant an increase in marginal taxes on income for most individuals, an increase in tax rates on capital gains, and a change in the treatment of dividend income. Instead of being taxed at the same rate as capital gains, dividends were set to revert to being taxed at the higher ordinary income rates, as they had been until 2003. At the same time, the payroll tax holiday, originally implemented in 2011, that had cut the employee share of Social Security taxes from 6.2% to 4.2%, was set to end. Finally, two Medicare surtaxes were set to go into effect: a 3.8% surcharge on investment income for joint filers with incomes above $250,000 and an additional 0.9% withheld Medicare tax on wages. These tax-law changes along with legislated spending cuts were collectively known as the "fiscal cliff."

To avoid the fiscal cliff, the President signed the American Taxpayer Relief Act of 2012 (ATRA) on January 2, 2013. While payroll taxes, income taxes, capital gains taxes, and dividend taxes all increased for the highest earners, for most taxpayers increases were modest compared with what would have occurred in the absence of the ATRA (see figure 1).

In this *Chicago Fed Letter*, we explore how firms and individuals responded to the potential tax increases. We find that both acted to move income into 2012 so that it would be taxed at the lower rates. At the top of the income distribution, in the absence of legislative action, tax rates on ordinary income would have increased by 4.6 percentage points, long-term capital gains rates by 8.8 percentage points, and dividend rates by 28.4 percentage points. Thus, we would expect individuals and firms to have focused their tax reduction strategies on dividend income.

How might corporations and individuals have acted to minimize the tax burden on themselves or their stakeholders? To help employees receive more ordinary income under the friendlier tax regime, companies could have shifted bonuses from 2013:Q1 to 2012:Q4. To benefit shareholders, companies could have boosted dividend payments in 2012:Q4 through a special dividend, shifted dividends from 2013:Q1 to 2012:Q4, or ratcheted up share buybacks to facilitate capital gains realizations. Individuals could have responded to higher anticipated taxes by taking capital gains in 2012 rather than 2013, but most shareholders had little power to influence dividend policy.

Wages and salaries

With taxes expected to increase in 2013, we would expect to see higher earned income at the end of 2012 than would otherwise have occurred. Figure 2 depicts the year-over-year percentage

1. Tax rates on income, 2012 and 2013

	2012 tax rate	2013 tax rate without ATRA	2013 tax rate with ATRA
Marginal tax brackets[a]			
Income <$17,850	10	15	10
Income $17,851–60,350	15	15	15
Income $60,351–72,500	15	28	15
Income $72,501–146,400	25	28	25
Income $146,400–223,050	28	31	28
Income $223,051–398,350	33	36	33
Income $398,351–450,000	35	39.6	35
Income $450,001+	35	39.6	39.6
Capital gains tax rates			
Income <$72,500	0	10	0
Income $72,501–250,000	15	20	15
Income $250,001–450,000	15	23.8	18.8
Income $450,001+	15	23.8	23.8
Dividends			
Income <$72,500	0	15	0
Income $72,501–250,000	15	As ordinary income (28–39.6%) plus	15
Income $250,001–450,000	15	3.8% over $250K	18.8
Income $450,001+	15	43.4	23.8
Payroll taxes[b]	4.2	6.2	6.2
Medicare payroll tax			
Compensation $0–250,000	1.45	1.45	1.45
Compensation $250,000+	1.45	2.35	2.35

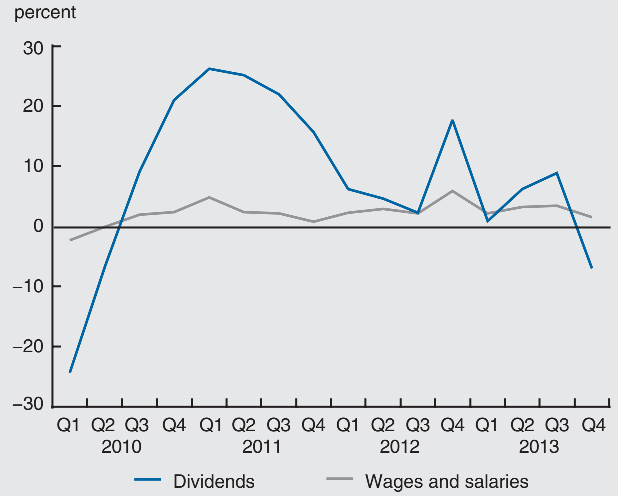
[a] Tax brackets in 2013, adjusted annually for inflation.

[b] Employee share payroll compensation up to Social Security wage base was $110,100 in 2012 and $113,700 in 2013.

Notes: Numbers are for tax units that are married filing jointly. There are different breakpoints for tax units with other filing statuses.

Sources: Authors' calculations based on Margot L. Crandall-Hollick, 2013, "An overview of the tax provisions in the American Taxpayer Relief Act of 2012," Congressional Research Service, January 10, available at www.fas.org/sgp/crs/misc/R42894.pdf, and Roberton Williams, Eric Toder, Donald Marron, and Hang Nguyen, 2012, "Toppling off the fiscal cliff: Whose taxes rise and how much?," Tax Policy Center, October 1, available at www.taxpolicycenter.org/UploadedPDF/412666-toppling-off-the-fiscal-cliff.pdf.

2. Year-over-year percent change in income (SAAR $2009)



Notes: SAAR is seasonally adjusted annual rate. Data based on 2009 dollars in real terms, using Personal Consumption Expenditures Price Index.

Source: U.S. Bureau of Economic Analysis, National Income and Product Accounts, via Haver Analytics.

change in private wage and salary disbursements from the National Income and Product Accounts (NIPAs). There is indeed a large spike in 2012:Q4. The sector that recorded the largest increase was bonus-heavy finance and insurance—specifically finance and insurance in Connecticut, New Jersey, and New York. Between 2012:Q4 and 2013:Q1, the largest decline in personal income was also in finance and insurance—suggesting that the increased earnings were not sustained.[1] Tax withholding also increased significantly in 2012:Q4, supporting the story that individual bonus payments were shifted to 2012:Q4 from 2013:Q1 (see figure 3).

Capital gains

Tax rates on realized capital gains were also expected to increase by between 5 and 10 percentage points, depending on income. Realized capital gains are not reported in the NIPAs and timely data are difficult to find. We look for evidence of increased capital gains realizations in two ways. First, if individuals were taking capital gains in anticipation of tax increases (rather than out of a desire to sell assets), they might have sold assets, booked the gains, and then purchased similar assets. We use stock market volumes to measure such asset churning. Volume on the last trading day of 2012 was unusually high—at nearly $225 billion, it was roughly double the volume on the last trading day of 2009, 2010, or 2011. Although the market had a very strong finish in 2013, the last day of trading was still shy of the 2012 figure. Overall, the numbers for 2012:Q4 do not suggest abnormally high trading volumes throughout the remainder of the quarter.

Second, we would expect high capital gains realizations at the end of 2012 to show up in high tax payments either in 2013:Q1, when the final estimated payment for 2012 are due, or in 2013:Q2 when final payments are made. Figure 3 shows high realizations of these "other" (non-withheld) tax payments in both of these quarters. These increases may also reflect higher dividends in 2012:Q4, which we discuss in the next section.[2]

Dividends

Companies routinely return cash to shareholders, whether in the form of share buybacks or dividends. Dividends are typically paid on a quarterly basis. Firms are reluctant to cut dividends, so a pattern of steady annual increases is the norm. Some firms supplement their regular distributions with special dividends, nonrecurring payments often made in the fiscal fourth quarter, which is also the calendar fourth quarter for most firms.

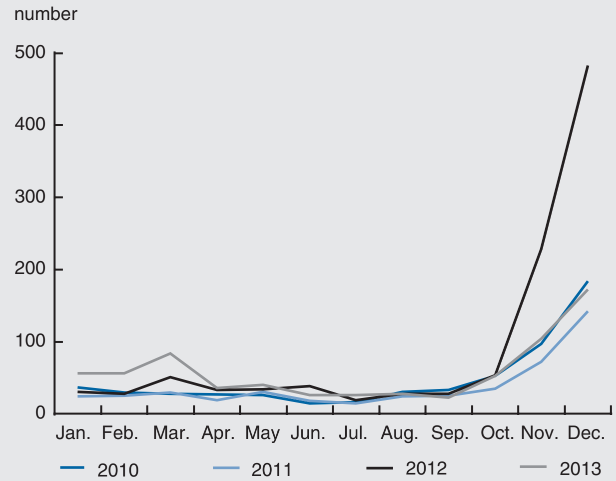
Examining data on the number of special dividends by month and total dividends and buybacks by quarter, we find there was a surge in the number of special dividends and the amounts paid in the fourth quarter of 2012, especially in December. November and December 2012 saw a total of 711 special dividend payments, compared with 214 and 276 in the same two-month period in 2011 and 2013, respectively (figure 4). Even more telling is the number of quarterly

3. Year-over-year percent change in income taxes withheld

NOTE: Data based on 2009 dollars in real terms, using Personal Consumption Expenditures Price Index.

SOURCE: U.S. Department of the Treasury data via Haver Analytics.

4. Extra or special dividends paid, 2009–13 (monthly)



SOURCE: http://us.spindices.com/.

dividends from 2013:Q1 that were paid out early in 2012:Q4. In 2010, there were 14 such cases, with payments totaling $247 million; and in 2011, there were two cases, totaling $45 million. However, in 2012, there were 179 such cases, with total payouts of more than $6 billion. Incidentally, 2010 was a miniature version of 2012, when the Bush tax cuts had originally been set to expire. Moreover, based on data from the Center for Research in Security Prices, the sum of special dividends in 2012:Q4 plus quarterly dividends shifted from 2013:Q1 was $34.01 billion in 2012 versus $5.62 billion in 2011 and $14.26 billion in 2010. By comparison, share repurchase activity, an alternative means of returning cash to shareholders but with different tax implications, in 2012:Q4 can be characterized as more or less normal.

It is interesting to consider which firms paid out the most in dividends. Were there factors beyond the impending tax law changes that drove these decisions? A cursory glance at the list of firms with the largest payouts suggests that it was primarily firms with substantial proportions of shares owned by high-ranking company executives (for example, Las Vegas Sands, Nike, Oracle, Tellabs, McGraw-Hill) rather than firms with the most cash on hand to distribute (for example, Apple, which had a cash hoard of $140-plus billion but little inside ownership). This makes some sense in the context of the anticipated tax changes as those with large stakes had the most to gain (or lose).

Conclusion

The data we have examined support the story that individuals and firms responded to the threatened increase in taxes in 2013 by moving income from 2013 into 2012. As a result, the federal government saw increases in revenues and a resulting trimming of deficits. State and local governments, in particular those with substantial income taxes, experienced the same pattern.

Although tax rates on dividends did not go up as much as feared, they did go up significantly, reducing the incentive for firms to increase payouts going forward. In any event, in 2013 cash balances grew at major U.S. corporations, with balances at nonfinancial corporations topping $1.5 trillion by the end of the year.

[1] See www.bea.gov/newsreleases/regional/spi/2013/pdf/spi0313.pdf, and www.bea.gov/newsreleases/regional/spi/2013/pdf/spi0613.pdf.

[2] The Congressional Budget Office also projected high capital gains realizations in 2012; see www.cbo.gov/sites/default/files/cbofiles/attachments/43907-BudgetOutlook.pdf.

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