MEMORANDUM

TO: Interested Parties
FROM: Penn Hill Group
DATE: January 2, 2013
SUBJECT: Fiscal Cliff Update

This memorandum provides an overview of the deal reached on the so called "fiscal cliff" issues. The legislation passed by Congress and expected to be signed by the President delays the sequester for two months, extends expiring tax cuts for a large majority of taxpayers and for certain education-related purposes, permanently prevents the Alternative Minimum Tax from applying to additional taxpayers, and provides a one-year delay in lower fees for Medicare providers (the so-called doc-fix). This legislation did not extend the existing Federal debt limit. This will essentially link the debates around the sequester, extension of the Federal debt limit, and final FY 2013 appropriations. The current Continuing Resolution funds the Federal government through March 27, 2013. Without future action by Congress, sequestration and its corresponding cuts to non-defense discretionary programs (those that are funded through annual appropriations bills) in FY 2013 funding levels will take place beginning in March.

Fiscal Cliff Agreement Overview

The Senate (by a vote of 89-8) and the House (by a vote of 257-167) passed legislation that impacts the following issues related to the fiscal cliff:

- Sequestration: Delays sequestration for two months to March 1, 2013. Pays for the sequestration delay by reductions in discretionary spending caps for 2013 and 2014 and changes made to Roth IRA provisions.
- Personal Income Tax Rates: Reductions in income tax rates first passed in 2001 and later extended in 2010 will be extended for individuals making less than $400,000 a year and for married families filing jointly making less than $450,000 a year.
- Extends a number of education and related tax provisions, including the child care tax credit.
- Inheritance Taxes: Taxes estates over $5 million at a 40% tax rate.
- Unemployment Insurance: Unemployment benefits for the long-term unemployed will be continued through 2013.
- Extends the repeal of the "Pease" limitation on deductions for filers with income at or below $250,000 (individual filers), $275,000 (heads of households) and $300,000 (married filing jointly) for taxable years beginning after December 31, 2012. This limits the amount of itemized deductions that can be taken. This could have an impact on charitable giving by those with incomes over these thresholds.
- Alternative Minimum Tax: Will be modified, as it has been in past years, to prevent additional "middle class" taxpayers from being caught up in this tax.

- Medicare Provider Payment Rates: Reduction in these rates will be postponed (as they have been in past years). This is commonly referred to as the "doc fix."
- Extends the farm bill legislative authority for nine months, which, among other things, avoids the implementation of provisions that would have led to a doubling of the price of milk. The agreement cuts the nutrition education program by $110 million to pay for these changes.

Sequestration Delay Under the Agreement

The agreement delays sequestration for two months. This will essentially link the resolution (or not) of sequestration to the debate to extend the Federal debt limit. The Federal debt limit is presently $16.4 trillion. The Treasury Department has already notified Congress that it is bumping up against this limit.

This delay in sequestration is offset under the bill, essentially reducing the overall sequestration by $24 billion. The offsets are a combination of changes impacting Roth IRAs and reductions in the overall discretionary spending caps in FY 2013 and FY 2014[1]. These reductions in the caps, while small, will only increase the difficulty in passing future appropriations bills that meet these overall caps.

If sequestration cuts do take place beginning in March, then the reduction in the overall sequester amount due to this delay will slightly reduce the level of the across-the-board cuts required of defense and non-defense spending. Further information on the impact of sequestration, should it be implemented in March, is at the end of this memorandum.

Education and Related Tax Provisions in Fiscal Cliff Agreement

A number of education and related tax provisions were also extended under the agreement. These include:

- Permanent extension of expanded provisions made to the Coverdell Education Savings Accounts in 2001 (increased annual contribution limits to $2,000 and included K-12 expenses).
- Permanent extension of the $5,250 exclusion for employer-provided educational assistance for both undergraduate and graduate education.
- Permanent extension of the increased income thresholds and time periods for student loan interest deduction provisions made in 2001.
- Permanent extension of the exclusion from income of amounts received under certain scholarship programs (National Health Service Corps Scholarship and Armed Forces Health Professionals Scholarship).

[1] The Congressional Budget Office did not score the reduction in the non-defense cap as actual savings since the FY 2013 continuing resolution has provided appropriations that total approximately $3 billion less than the new cap established under the agreement.

- Permanent extension of the $15 million arbitrage rebate exception for school construction bonds to continue to ease the cost associated with calculation of excess interest.
- Permanent extension of tax-exempt private activity bonds for qualified education facilities.
- Extension of the American Opportunity Tax Credit for five years.
- Extension of the deduction for expenses of elementary and secondary school teachers for 2012 and 2013. Thus, the tax code will continue to allow a $250 above-the-line tax deduction for teachers and other school professionals for expenses paid or incurred for books and supplies used in the classroom.
- Extension of the above-the-line deduction for qualified higher education tuition-related expenses through 2013.
- Extension of the Qualified Zone Academy Bonds (QZABs) by providing allocations of $400 million in bond volume for 2012 and 2013.
- Extension of the tax credit for research and development expenses through 2013.
- Permanent extension of the expansion made to the child tax credit in 2001 ($1,000 credit and expanded refundability).

<u>Sequestration Impact Post-March</u>

As covered in earlier memorandums, the Budget Control Act of 2011 (BCA)[2] triggered $1.2 trillion in spending reductions (implemented through sequestration) over the next nine years (2013-2021) due to the failure of the "Super" Committee to recommend and the Congress to pass spending reductions in this amount. For FY 2013, this translates into slightly less than $110 billion in reductions in spending for both discretionary and mandatory spending programs[3]. The BCA requires these spending reductions to be divided equally between defense and non-defense spending. For non-defense discretionary programs this means a reduction of approximately 8.2% in FY 2013 spending levels. With some exceptions, for non-defense mandatory programs this means a reduction of approximately 7.6% in FY 2013 spending levels. <u>Both the 8.2 and 7.6 figures were calculated prior to the fiscal cliff agreement. These figures will need to be recalculated to reflect the two month delay to March for sequestration and other factors.</u>

<u>Programs That Are Exempt From Sequestration</u>

There are existing budgetary rules (as well as rules that the BCA adopted) that impact whether certain mandatory programs are subject to sequestration, and if they are subject to

[2]The sequestration process described in this memorandum is attributable to the lack of Super Committee action and is different from the sequestration process that would take place if the discretionary spending caps established in the Budget Control Act are breached in any of the fiscal years 2012 through 2021.

[3] The BCA also assumes slightly over $200 billion in interest savings due to reduced Federal spending ($110 billion x 9 years = 984 billion plus $216 billion in interest savings equals $1.2 trillion).

sequestration, how they are impacted. The chart below describes how some of the larger mandatory education, labor, and health-related programs would be impacted by sequestration.

Sequestration Rules for Major Mandatory Programs in Education, Labor, and Health

Program	Exempt or Applicable Rules
Pell Grants	Exempt (except see discussion of 2014-2021)
Federal Student Loans	Origination fees on loans are increased to match the sequester order
Child Nutrition	Exempt (except the Special Milk program)
Temporary Assistance for Needy Families (TANF)	Exempt
Advances to Unemployment Trust Funds	Exempt
Universal Service Fund	Exempt
Pension Benefit Guaranty Corporation Fund	Exempt
Medicaid	Exempt
Medicare	Provider fees can be cut by up to 2%

<u>How Sequestration Will Be Calculated For Different Types of Programs</u>
For FY 2013 programs for which funding has already been disbursed (or started to be disbursed), these cuts will result in a reduced rate of obligations in order to meet the required annual reduction. This may result in programs spending at a rate that is significantly lower compared to what they would have spent had the sequestration cut been implemented over the entire year, as the entire amount of the cut must be met over the remaining seven months of the fiscal year. Note, however, that few Department of Education programs operate in this manner (with funding spread out evenly over the course of the year); the major activities that may have to slow down because of sequestration are the Department's administrative accounts.

Student Loan Fees - Existing law (prior to the passage of the BCA) required that student loan fees rise under any sequestration situation. This means that sequestration will increase fees on Direct subsidized and unsubsidized loans as well as Parent Plus loans. As with current practice, these fees are collected from the overall amount of the loan that is provided to the student.

Formula programs - Under formula programs (Title I, IDEA, etc.) the recipients of the formula (states, school districts, etc.) will receive their FY 2012 amount minus the annual reduction due to sequestration. See the Department of Education section below for specific information on how forward-funded formula programs will be treated by the Department of Education under sequestration.

Competitive grant programs - Many agencies have not awarded FY 2013 funding under many competitive programs. More specifically, the Department of Education makes very few competitive grants during the first half of the fiscal year. While these programs will also see a reduction in their 2013 overall funding amount, agencies may make different determinations, including on a program-by-program basis, on the implementation of these cuts. Agencies could make fewer awards, or reduce the amount they would award grantees while maintaining the number of awards. These determinations will likely be made based on the purpose of specific programs and program structures and on whether FY 2013 is a year in which the agency will make new grants, or continuation grants, or both. If FY 2013 funds are being used to fund only continuation grants, then the agency might reduce each grant by the same percentage, or might take larger reductions from grantees that had more carry-over money or otherwise had less need for new funding. If FY 2013 funds are being used only for new awards, the agency would likely make fewer grants.

Agency-Specific Guidance on Sequestration

Department of Education - On July 20, 2012, Department of Education Deputy Secretary Tony Miller issued a memorandum describing how sequestration would impact programs that are forward-funded[4] at the Department. This memorandum stated that the reductions in funding due to sequestration for the vast majority of ED programs would not take place until July 2013, essentially exempting the 2012-2013 school year from the impact of sequestration. The major exception to this is the Impact Aid and Vocational Rehabilitation programs, which are not forward-funded.

Impact on Non-Defense Discretionary and Mandatory Spending in 2014-2021

In 2014 and beyond, the BCA actually lowers the discretionary spending caps adopted as part of the Act (after accounting for mandatory spending reductions) to meet the requirement to reduce approximately $110 billion each year in spending. In 2014 and beyond, the Appropriations Committees would determine the impact of these further-reduced discretionary spending caps, rather than each program facing a uniform reduction as in 2013. **Under this scenario, in 2014 through 2021 it is not possible to determine which programs would be cut or eliminated to produce the required savings**. It's important to note that while Pell Grant mandatory funding is exempt from sequestration (its mandatory spending stream would not be reduced in 2014-2021 through this process), overall Pell spending could be impacted because of lowered discretionary spending caps in 2014 and beyond.

[4]Forward-funded programs are programs for which appropriations become available in July of a fiscal year rather than at the start of the fiscal year. Many state-based formula programs, such as Title I, IDEA, and Career and Technical Education are forward funded. The availability of program funds in July of a fiscal year is done to coincide with the start of the school year.