APPLETON *PARTNERS*, INC.

THE AMERICAN TAXPAYER RELIEF ACT OF 2012
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The American Taxpayer Relief Act of 2012 which was passed on New Year's Day, addresses some of the goals on the revenue side of the balance sheet, but far from addresses the magnitude of sequestration and debt ceiling issues that are bearing down on us with, yet again, another deadline…approximately March 1st. According to a statement released by the Office of Management and Budget (OMB), this new legislation is estimated to produce a total benefit of $737 billion, largely made up of $618 billion in higher taxes on the wealthy, and an additional $104 billion benefit from lower interest payments on federal debt. To put this in perspective, our debt/GDP level is currently at approximately 73%, but we are on a trajectory to reach 90% by 2022 according to CBO estimates. Guaranteeing a debt/GDP ratio of approximately 75% in 2022 requires deficit reduction of approximately $3.7 trillion…a long way from where we are today.

Some key measures put forth in the bill that was agreed to yesterday:

Tax Measures:

- The Bush era tax cuts have been extended for individual filers earning below $400,000 and for families earning less than $450,000. For filers above these thresholds, *marginal tax rates increase from 35% to 39.6%*.

- Tax rates on dividends and capital gains remain unchanged for filers with income below $400,000 for individuals and $450,000 for families, but the *rate for both capital gains and dividends increases to 20%* for filers above the thresholds.

- The Payroll Tax Cut (a temporary reduction in Social Security withholding*) will NOT be extended,* and the rate will rise from 4.2% to 6.2% for all taxpayers with AGI >$113,700.

- The alternative minimum tax (AMT) will be *permanently indexed to inflation*. Until now, this has required an annual "override" to adjust the exemption. The bill increases the exemption amounts for 2012 and indexes the amounts going forward.

- The estate, gift, and generation skipping transfer tax continues under the new legislation to have a cap of $5 million, but *the top tax rate increases to 40%.*

Unemployment Benefits:

- Emergency unemployment benefits are *extended for one year* (through 12/31/2013).

Medicare and Health Extensions:

- The scheduled cuts in Medicare physician payment rates (at 26.5%) will NOT go into effect and *payments are guaranteed at the current level* for one year (through 12/31/2013).

Sequestration:

- Sequestration was postponed for 2 months to March 1st , and will be a big part of the debate as we approach the March deadlines.

Two features of the legislation address Municipal bond issuance. In both cases there are increases in exception caps that lower the burden on very small issuers who are issuing debt for qualified education facilities or who are benefiting from an investment arbitrage when temporarily investing tax exempt proceeds in higher yielding taxable securities. This is a very minor area of the market due to the qualifying size limitations.

This first step in budget reform can hardly be considered a "grand bargain." The clock is now counting down again to March 1st, and the prospects for major tax reform and massive entitlement and spending reform remain challenging. The initial reaction in global equity markets is to consider this major progress. The bond markets have a less sanguine view. We continue to see progress on the domestic economic front, but that progress is not even close to achieving the Federal Reserve's stated goals for employment growth in the context of price stability. Rates will stay low, and any expense cutting will act as a drag on the economy, further pushing the pendulum to the side of economic weakness in 2013.

At this point Municipal bonds, and Municipal bond issuers, have benefited tremendously by the increase in tax rates at the upper levels. Major tax reform could impact the level of tax exemption, but right now that does not appear to be an imminent threat. Additionally, let us not forget that as part of the Affordable Care Act passed in 2010, there is a mandatory 3.8% surtax on net investment income for filers with adjusted gross income of more than $200,000 for individuals and more than $250,000 for families. This will take capital gains and dividend rates to 23.8% for the highest earners and will affect most other forms of income. Municipal bonds are exempt from this surtax.

Without significant longer term progress on the spending side, US Treasury debt is at risk for downgrades by Moody's and Fitch, or at a minimum could be placed on "Negative Watch." As we approach March 1st, those rating agencies will be closely following progress, or lack thereof, being made in Washington. In the meantime, there will be no dearth of news, and news coverage, to keep us on the edge of our seats… earplugs anyone?

Appleton Partners, INC 45 Milk Street Boston, MA 02129 tel. 617.338.0700 www.AppletonPartners.com