Preparing for the "Fiscal Cliff"

A phrase that has found its way into our daily lexicon this year is "fiscal cliff." It refers to a combination of Federal government spending cuts and expiring tax cuts that many fear could be a serious drag on the U.S. economy beginning at the start of 2013. These scheduled spending cuts and tax increases have many economists concerned that if nothing is done legislatively to change current plans and avoid the cliff, a recession could result due to consumers having less to spend just as government reduces its own spending.

Changes on the docket

The estimated impact on the economy comes from a combination of expiring tax cuts, new taxes and automatic spending cuts. The most direct effect on individuals has to do with tax changes. They include:

- The expiration of the "Bush era" tax cuts of 2001 and 2003. Most notably, this would raise income tax rates for most people to levels that were in place prior to 2001. It would also change other tax provisions, including an increase in taxes on dividends and capital gains, a decrease in the child tax credit, and a reinstatement of phasing out some itemized deductions and personal exemptions for higher income individuals.
- The end of the "payroll tax holiday" that reduced an individuals' Social Security taxes by two percent.
- Less benefit from the American Opportunity Tax Credit, which provided up to $2,500 per student in credits (a dollar-for-dollar reduction in taxes) to offset qualified higher education expenses. In 2013, income limits to qualify for the credit – which will revert back to its prior name, the Hope Scholarship Credit – are lowered and the maximum credit is reduced to a projected $1,950.
- The loss of the "patch" that allowed many middle income Americans to avoid exposure to the Alternative Minimum Tax (AMT).
- A drastic reduction in the exclusion amount for the estate tax from $5.12 million per person to $1 million, and an upturn in the highest maximum estate tax rate, from 35 percent to 55 percent.
- The implementation of a higher income threshold to qualify to deduct out-of-pocket medical costs as an itemized deduction. Currently, expenses valued at more than 7.5 percent of Adjusted Gross Income (AGI) can be deducted. The threshold rises to 10 percent in 2013 for most taxpayers. For those at least age 65, the higher threshold phases in through 2016.
- The addition of new taxes that will apply to individuals earning higher incomes as part of the new Patient Protection and Affordable Care Act.

The effect these changes would have on individuals over the next year could be dramatic, anywhere from several hundred dollars to several thousand dollars or more in increased taxes for 2013 depending on individual circumstances.

The other aspect of the fiscal cliff is scheduled federal government spending cuts that are due to take hold in 2013 – another potential blow to the economy. These include:

- $110 billion in spending cuts agreed to in the Budget Control Act of 2011
- $26 billion from the expiration of emergency unemployment benefits
- $11 billion in reduced Medicare reimbursements for physicians
- $105 billion in other scheduled changes to revenue or spending.

What should you plan for?

Nobody can be certain what policymakers in Washington may choose to do – or not do – to limit the potential economic shock created by the confluence of events that have led to the fiscal cliff. They could vote to alter the planned changes to tax laws and government outlays in order to temper the impact. However, any action in that regard may not occur before late this year or into 2013.

In the meantime, be prepared for what may come. It appears likely that the amount of taxes you pay in 2013 will be higher than what you paid in 2012. Whether it will be as severe as what exists under the currently scheduled changes remains to be seen. Despite this, changes to the national economy or your personal financial circumstances will not occur overnight.

The tax changes would take place all at once, but from a personal perspective, they would have a gradual effect. It could be dramatic over a year's time, but it will be applied in smaller increments such as through wage withholding. Even the government's spending cuts will be implemented gradually over the year. The situation will create challenges and should not be taken lightly. But it also offers the opportunity to carefully review your finances, everything from day-to-day spending to investment strategies and tax planning, to determine the best way to limit the impact on your own bottom line and move forward with your best financial strategies.

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