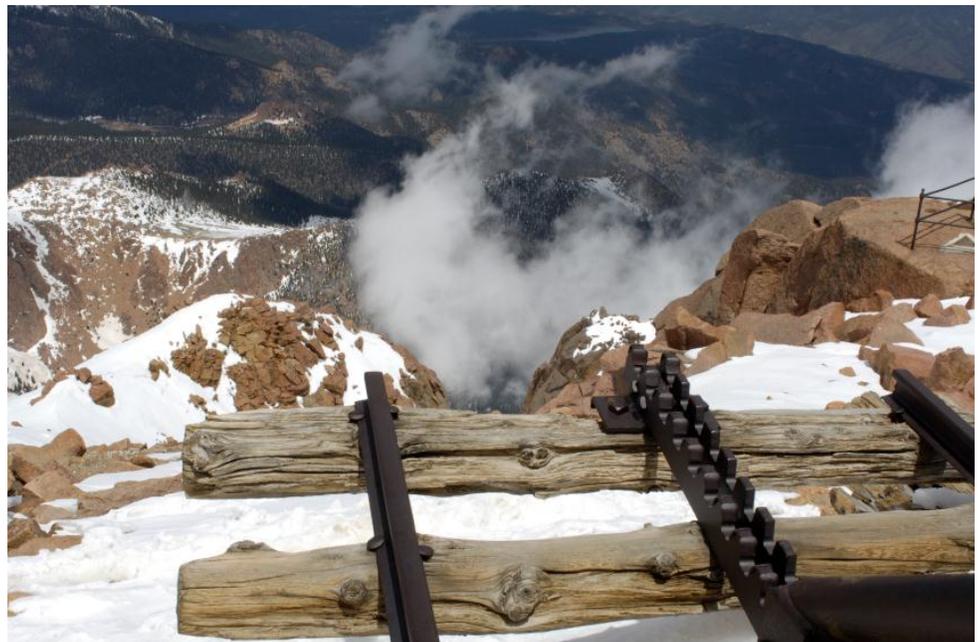




# THE FISCAL CLIFF



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An Impending Tax Storm Ahead

Under current law, the *Economic Growth and Tax Relief Reconciliation Act of 2001*, commonly known as the Bush Tax Cuts, will expire on December 31, 2012, potentially creating serious consequences for American taxpayers and threatening the fragile economic recovery. This report is designed to answer questions surrounding this impending “Fiscal Cliff.”

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# The Fiscal Cliff

## AN IMPENDING TAX STORM AHEAD

### INTRODUCTION

In December 2010, President Obama signed the *Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010*, extending until 2012 the provisions of the *Economic Growth and Tax Relief Reconciliation Act of 2001*, commonly known as the Bush Tax Cuts. Under the current provisions, all tax cuts are scheduled to expire on December 31, 2012, potentially creating serious consequences for American taxpayers and threatening the fragile economic recovery.

If nothing is done to extend or modify the tax cuts by year's end, millions of Americans will see their tax burdens rise significantly; workers will lose out on a payroll tax holiday, doctors treating Medicare patients will take a 27% pay cut, middle class taxpayers will face an alternative minimum tax meant for the rich, and automatic federal spending cuts will kick in, eliminating unemployment benefits and social programs for the out of work.<sup>1</sup> Already, business spending is down and executives say that uncertainty over the outcome of the fiscal cliff debate is causing them to hold back on large capital expenditures.<sup>2</sup>

Currently, with the 2012 elections over, Democrats and Republicans are actively debating the issue however, solutions will be politically painful, and it is uncertain that a compromise will be achieved before the New Year.

### Will the Fiscal Cliff Derail the Economic Recovery?

The expiration of the Bush Tax Cuts could affect more than just tax burdens. According to the Congressional Budget Office, the fiscal cliff could push the U.S. economy into recession beginning in the first-quarter of 2013. The effect of removing billions of dollars from consumers' pockets could shave as much as four percentage points from first-quarter GDP growth.<sup>3</sup>

Additionally, the programmed expiration of emergency unemployment benefits and federal spending cuts triggered by the federal debt ceiling could further harm the recovery by cutting social programs. While it is critical that lawmakers rein in federal spending, most analysts agree this needs to be done gradually in order to avoid threatening economic growth.

### THE FISCAL CLIFF DEBATE: POTENTIAL ACTIONS THAT COULD BE TAKEN

*Note:* Since the fiscal cliff debate represents breaking news, the situation is continuously evolving. The information contained below was correct at the time of writing.

With the 2012 presidential and congressional elections behind us, lawmakers are settling down to the work of hammering out a compromise to avoid sending the economy over the cliff. While President Obama won a second term with a solid mandate for the future, Congress is split, with Republicans retaining a majority in the House and Democrats controlling the Senate. A split Congress means that all sides may believe that they have voter support, making a compromise difficult to achieve. Deep divisions between both parties remain and lawmakers are still hewing to the party line.

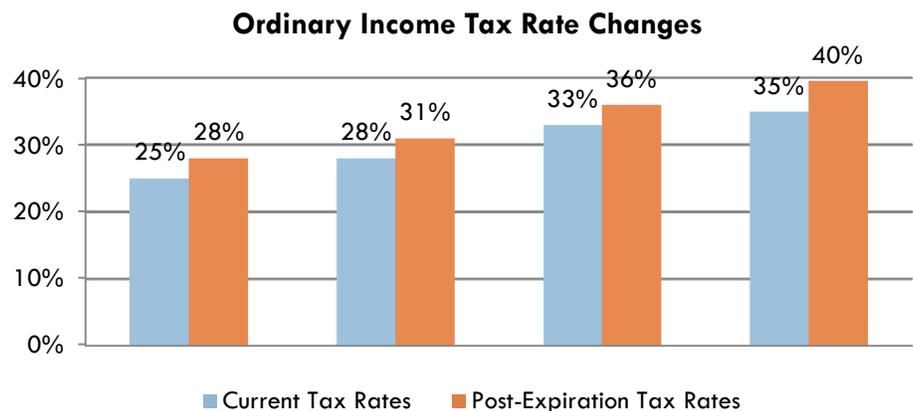
Both parties actually have a lot of common ground in the fiscal cliff debate. Neither side favors a sequester – federal spending cuts, an un-patched AMT, or Medicare cuts for doctors. Both sides want to address American’s debt by raising revenue and reducing expenditures. The major point on which the parties disagree is a familiar one: taxes. Democrats have called for increasing taxes on upper-income earners, a move which Republicans have opposed. However, newly chastened Republican lawmakers appear to be willing to allow higher tax revenues in the form of eliminated deductions for high-income earners, but no tax increases. Democrats appear to be willing to consider a compromise that would limit or eliminate deductions as well as set the top income tax rate above the current 35% level, but below 39.6%.<sup>4</sup>

It is possible that no compromise will be reached by December 31<sup>st</sup>. If the Republicans do not give ground on the income tax issue, Democrats have indicated that they are willing to allow the Bush Tax Cuts to expire in order to gain bargaining power in the New Year. A more positive (but less likely) scenario would bring Republicans to the negotiating table for a bi-partisan deal. Such a deal could extend certain tax cuts and repeal the automatic federal spending cuts while reducing long-term deficits by raising revenue and overhauling certain entitlement programs like Medicare and Medicaid whose rising costs are unsustainable.<sup>5</sup> This would set the stage for meaningful tax and budget reform over the next few years and reassure deficit-watchers that the U.S. is managing its debt.

## OVERVIEW OF MAJOR TAX PROVISIONS DUE TO EXPIRE

The Bush Tax Cuts were fairly extensive and covered a wide range of tax provisions. In general, here are the changes that are scheduled to occur in January:

- Marriage penalty elimination breaks will expire:
  - The standard deduction for married couples will be lower – no longer double the single filer deduction.
  - The ceiling of the 15% tax bracket will be lower – also no longer double that of single filers.
- The tax rate on qualified dividends earned by middle and upper-income earners will balloon from 15% to the taxpayer’s ordinary income tax rate; as high as 39.6% for the highest tax bracket.
- The 10% tax bracket for lower-income earners will revert to a 15% tax bracket.
- The child tax credit will drop from \$1,000 to \$500.
- The Earned Income Credit will be eliminated for lower-income taxpayers.
- The tax rate on long-term capital gains earned by middle and upper-income taxpayers will rise from 15% to 20%.
- Ordinary income tax rates will jump. [See chart.](#)
- The AMT will revert to the higher 2001 levels, which have not been adjusted for inflation, meaning that many middle-class earners will fall into AMT territory.



- The Personal Exemption Phase-Out (PEP) and Pease itemized deduction phase-out will be restored, removing the value of some exemptions and deductions (like charitable contributions) from high-income earners.
- The Lifetime Estate Tax Exemption will drop back to the 2001 level of \$1 million (from the current \$5.12M for 2012); any amount over the exemption will be taxed at 55%.
- The Lifetime Gift Tax Exemption and Lifetime Generation Skipping Tax (GST) will revert from a \$5.12M to a \$1 million exclusion.

#### **How Will the Tax Cut Expiration Affect Businesses?**

In the wake of the financial crisis, President Obama and Congress enacted a stimulus bill designed to spur economic activity. From 2008-2010, businesses were allowed to write off 50% of the cost of capital expenditures in the first year (lowering their tax bill) and depreciate the remaining 50% using normal schedules. In 2010, the tax breaks were extended to allow capital investment made before the end of 2011 to be entirely written off in the first year; currently, 50% of the cost of capital invested in 2012 can be written off in the first year. All these tax breaks are scheduled to expire on January 1, 2013, potentially significantly increasing the tax bill of many businesses. For more information about business tax issues, please contact us.

## PROSPECTIVE STRATEGIES FOR 2012

Regardless of what lawmakers do to address expiring tax cut provisions, it is important to think ahead and plan for a less favorable tax situation. There is still time left in 2012 to take a few steps to mitigate your potential tax burden next year. That being said, taxation issues are not the only factor that needs to be addressed during the investment planning process – which is why we always strive to take a holistic view of your specific situation and recommend a personalized strategy.

### **Lower income taxes by repositioning investment assets**

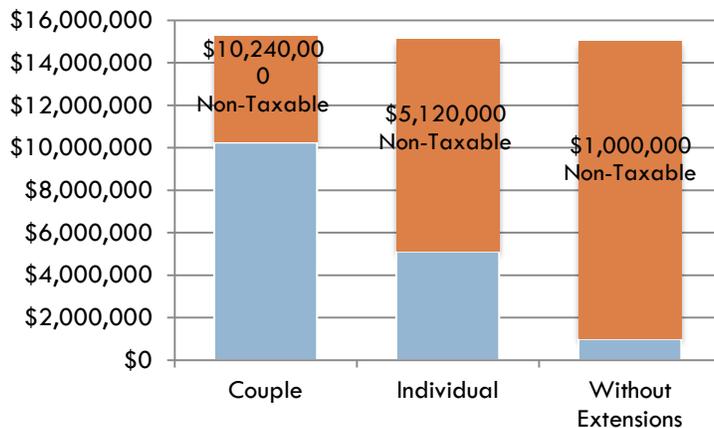
A relatively straightforward way to lower your income tax (since capital gains and dividends would be taxed at your ordinary income tax rate) is to shift assets between taxable and tax-deferred accounts. By moving dividend-paying stocks into a qualified retirement account (such as an IRA or 401(k)/403(b)) and replacing taxable investments with tax-favored investments, you can retain the same portfolio while limiting your tax burden. For example, if you currently hold a stock paying a 3.5% dividend in your taxable account and a municipal bond paying 3%, the after-tax yield is about the same. However, next year a taxpayer in the top income tax bracket would see the after-tax yield of the stock drop to 1.98% (since the dividend will be taxed at 39.6%) versus the 3% tax-free muni bond yield.

### **Lower income taxes by realizing capital gains**

Since the capital gains rate may increase next year, a simple solution is to realize capital gains at the current, lower 15% rate. This can be done by selling select securities, realizing the gain this year, and thus paying capital gains tax at the lower rate. Of course, this strategy is somewhat of a gamble, because if the cuts get extended and the investment appreciates, you could miss out on some growth. Again, we stress the need for personalized planning accompanied by the guidance of an expert.

## Reduce estate taxes by using the \$5.12M exclusion

High net worth investors still have the ability to reduce the potential burden of future estate taxes by making gifts during 2012. The first \$5.12M of assets transferred (per donor) during 2012 is not subject to taxation, with any overage taxed at 35%. Next year, the exemption will drop to \$1M and overages will be taxed at a maximum of 55%. Taxpayers should also remember that they can transfer up to an additional \$13,000 annually per donor/per non-spouse recipient under the Annual Gift Exclusion. For example, a couple could gift a total of \$26,000 annually to each of their children (\$13,000 per parent) without adding to the lifetime exclusion amount.



## Reduce estate taxes with a credit bypass

The current \$5.12M estate tax exclusion can be effectively doubled to \$10.24M by using a family trust and a marital trust, a scenario known as an “A-B Trust.” In this arrangement, \$5.12M would be placed in a family or bypass trust (the B trust), and the rest distributed to the spouse or marital trust (the A trust) in order to exploit the maximum marital deduction. Using this example, under next year’s \$1M cap and a 55% tax rate, a couple would save \$550,000 in estate taxes by using two credit bypass trusts.

## CONCLUSION AND STEPS TO TAKE

The impending fiscal cliff of 2013 could have a significant impact on individuals, businesses, and the U.S. economy. While we hope that lawmakers will get to the negotiating table and resolve this serious issue, we believe it is imperative for investors to develop a course of action that will minimize their tax burden. If the tax cuts expire, individuals have a very narrow window of opportunity in which to take advantage of the current \$5.12M estate tax exclusion, the GST exemptions, and other favorable tax provisions.

If you haven’t begun to make plans for a larger tax bill in 2013, it’s time to start now. By starting the process early, you can take advantage of this year’s more favorable tax climate and make strategic financial decisions before the end of 2012.

We firmly believe that successful tax planning requires combining the skills of *financial, legal, and tax experts* who can look at your whole financial picture and help you develop a strategy that’s right for your long-term financial needs. If you have any questions about how the expiration of the Bush Tax Cuts could affect your financial wellbeing, or what we can do to assist you, please let us know. It is a pleasure to serve you.

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## Footnotes, disclosures and sources:

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<sup>1</sup> All tax data referenced in this document is from IRS.gov and taxfoundation.org

<sup>2</sup> <http://dealbook.nytimes.com/2012/11/05/the-election-wont-solve-all-puzzles/>

<sup>3</sup> <http://www.cbo.gov/publication/43262>

<sup>4</sup> <http://taxvox.taxpolicycenter.org/2012/11/15/can-congress-raise-taxes-on-the-rich-without-raising-their-rates-maybe/>

<sup>5</sup> <http://www.cnn.com/2012/11/16/politics/fiscal-cliff/>