Financial Planning Newsletter

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Fiscal Cliff

Hello!

With the upcoming Presidential election next month, much of the focus in the media has been towards this. Yet another topic that should be given equal consideration is the "fiscal cliff", which is scheduled to go into effect at the end of this year and early into 2013. There are two parts to the fiscal cliff: the expiration of the Bush tax cuts and the planned spending cuts. I thought it would be helpful to provide you with additional details on these.

Overview

The concept of the fiscal cliff stems from the various fiscal policy compromises between the Democrats and Republicans over the past few years. Shortly after the 2010 mid-term elections, President Obama made a deal with Republicans to extend the Bush tax cuts for another two years and to also reduce the Social Security payroll tax in order to stimulate our economy. Both of these reductions are set to be in effect until the end of this year.

In terms of the budget spending cuts set to start next year, this resulted from a deal passed by both the House and Senate in August 2011 in order to avoid the threat of the U.S. not being able to honors its financial obligations. As part of this deal, a bipartisan, special committee was formed to determine where another $1.2 trillion in savings could be generated over a ten year period. Also, in the event that a mutual agreement could not be made, the savings would then come as a result of automatic cuts to governmental programs starting next year. Since the special committee failed to reach an agreement, we are now facing this reality.

Expiration of Bush Tax Cuts

Assuming no Congressional action, the Bush tax cuts will expire at the end of this year. Here are some items that will be affected:

- **Federal Income Tax Rates –** these will increase across the board. The lowest tax rate will go up from 10% to 15%, while the highest tax rate will increase from 35% to 39.6%.
- **Long-Term Capital Gains –** currently, the tax rate is 15% (0% for those in the 10% and 15% tax brackets). In 2013, the rate is scheduled to increase to 20% (10% for those in the 15% tax bracket). For those higher income households, there will an additional 3.8 percent tax as a result of the Affordable Care Act.
- **Qualified Dividends –** at this time, these are taxed at a flat 15% (0% for those in the 10% and 15% tax brackets) while ordinary dividends are taxed as ordinary income tax rates.

  Starting in 2013, there will be no distinction between the two and as a result, all dividends will be taxed as ordinary income tax rates.
- **Alternative Minimum Tax (AMT) Rates –** these return back to year 2000 figures.
- **Estate Tax Exemption and Tax Rates –** for this year, the exemption is $5.12 million per individual. In 2013, this is set to revert back to pre-2010 rates, which was $1 million per person. The highest estate tax rate will jump from 35% to 55%.
- **Child Tax Credit –** this amount is scheduled to reduce from $1,000 to $500 next year.

- **Earned Income Tax Credit –** before 2009, this credit was only applicable for up to two dependents. Since 2009, this credit had been temporarily given to those with three or more dependents and it is scheduled to revert back to two dependents next year.

Budget Spending Cuts

There are three main types of private foundations:

- **Budget Control Act of 2011 –** the automatic spending cuts enacted from this Act will go into effect in January 2013, affecting both defense and non-defense spending. This will result in $120 billion in reductions next year and $1.2 trillion over the next ten years.
- **Federal Unemployment Benefits –** instead of the extended period these benefits are currently being paid, they will only be paid for up to 26 weeks through each state's unemployment benefits programs.
- **Reduced Payments to Medicare –** the rates at which Medicare pays physicians will be reduced by almost 30 percent starting in 2013.

Other Planned Changes

- **Payroll Tax Increase –** since last year, employees have had lower Social Security taxes withheld from their paycheck, from a rate of 6.2% to 4.2%. This reduction is scheduled to end at the end of this year causing most Americans' net paychecks to be smaller due to the higher tax being withheld.
- **Healthcare Taxes** – these new taxes are due to the passage of the Affordable Care Act, also known as Obama Care. They will be used to cover the costs of expanding health insurance coverage to everyone and will affect households with incomes of greater than $200,000 for single filers and $250,000 for joint filers.

How This Affects U.S. Households

In looking at these tax increases and spending cuts, most households will be affected no matter what income level they are in. Those with lower incomes will no longer have the higher child tax credit or the earned income credit on more than two dependents. For the middle income households, they will be affected by the higher income tax rates, greater probability of being subjected to AMT, as well as the higher percentage withheld for Social Security tax. High income households will also be affected by the higher income tax rates as well as rises in the tax rates for long-term capital gains and qualified dividends.

Action by Congress

It is highly unlikely that Congressional members will address the fiscal cliff issue until after next month's elections. At that point, there will likely be a compromise made between the House and Senate before the end of the year to avoid the fiscal cliff. From then, a mutual agreement would be made by early next year with revised terms.

Conclusion

According to a recent study by the Tax Policy Center, households in the U.S. will incur an average tax increase of $3,446 next year if no changes are made to current law. This will likely lead to lower consumer spending, higher unemployment rates, a distressed stock market, and as a result, lead the U.S. heading into another recession.

Even though these tax increases and reductions in spending would help to bring down the U.S. deficit, it would likely have a significant adverse effect on the nation's recovery. There needs to be a long-term, well-thought out plan regarding entitlement and tax reform in order to address our national deficit, not short-term fixes. The parties need to put their philosophical differences aside and work together to address the fiscal cliff.