Understanding the Fiscal Cliff

December 2012

The U.S. economy is headed straight toward a Fiscal Cliff. After years of providing economic stimulus through lower taxes, many of these tax breaks are set to expire at the end of the year. Additionally, a number of automatic government spending reductions from the 2011 debt ceiling debate are scheduled to take effect at the same time.

The Fiscal Cliff is the phrase used to describe the upcoming large drop in government stimulus. Through tax increases and spending cuts that are scheduled to go into effect on January 1, 2013, the Fiscal Cliff will take out approximately 3.5% of Gross Domestic Product from the economy. The Tax Policy Center estimates the impact of the Fiscal Cliff to be approximately $625 billion.

With the U.S. economy currently growing under 3% a year, many economists are concerned that the Fiscal Cliff will put the U.S. economy back in recession. In fact, the Congressional Budget Office warned that if the Fiscal Cliff happens as planned, the U.S. economy would be put back into recession and unemployment would rise to 9.1% from its current 7.9% level.

Obviously, the implications of the Fiscal Cliff are extensive, and the economic recovery that Washington has spent so much energy and money on is at stake. As Washington debates the best approach for handling the impact of the Fiscal Cliff, let's look at what is changing and how it may impact you.

What is Changing?

One key component of the Fiscal Cliff is the expiration of the Bush-era tax cuts that were extended during President Obama's first term. The table below shows what the income taxes, capital gains taxes and dividend taxes are for joint filers in 2012 and what they are scheduled to be in 2013.

	Federal Income Tax		Long-Term Capital Gains		Qualified Dividends	
Taxable Income (Married Filing Jointly)	2012	2013	2012	2013	2012	2013
$0 -$17,400	10.0%	15.0%	0.0%	10.0%	0.0%	15.0%
$17,401 - $70,700	15.0%	15.0%	0.0%	10.0%	0.0%	15.0%
$70.,701 - $142,700	25.0%	28.0%	15.0%	20.0%	15.0%	28.0%
$142,701 - $217,450	28.0%	31.0%	15.0%	20.0%	15.0%	31.0%
$217,450 - $388,350	33.0%	36.0%	15.0%	20.0%	15.0%	36.0%
Above $388,351	35.0%	39.6%	15.0%	20.0%	15.0%	39.6%

Source: Internal Revenue Service

Additionally, a number of temporary tax reductions are set to expire at the end of 2012, and new taxes are set to be introduced in 2013. Here is a summary of what additional tax changes are expected:

Provision	2012	2013
Payroll Tax	4.2%	6.2%
Health Care Reform (applied after $200,000 for individuals, $250,000 for joint filers)	0%	0.9% tax on earned income, 3.8% tax on investment income
Marriage Penalty Relief	Expanded bracket and standard deduction	Expires
Child Tax Credit	$1,000	$500 and refund reduced
Estate & Git Tax Individual Parameters	35% top rate; $5 million exemption	55% top rate; $1 million exemption
People Subject to Alternative Minimum Tax (estimated)	4 million individuals	30 million individuals

Source: American Century Investments

How does it impact me?

Everyone's tax situation is different. Depending on how much income you earn and the sources of that income, the amount of taxes you pay will vary. The Tax Policy Center attempted to estimate what the average Fiscal Cliff tax increase would be for the average American. They calculated that the average tax increase would be 5%, or almost $3,500. The adjacent table outlines the impact of the Fiscal Cliff for individuals by income range.

Higher Taxes for All: The fiscal cliff would increase taxes on almost all tax payers. Here is a breakdown of the average tax increase by income level:

Income Level	in $	in %
Up to $20,113	$412	3.7%
$20,114-$39,790	$1,231	4.1%
$39,791-$64,484	$1,984	3.8%
$64,485-$108,266	$3,540	4.2%
$108,267-$143,373	$6,359	5.1%
$143,374-$204,296	$8,271	5.0%
$204,297-$506,210	$12,871	5.2%
$506,211-$2,655,675	$120,537	7.2%
$2,655,676 and above	$633,946	7.9%
All	**$3,446**	**5.0%**

Source: Tax Policy Center

Can't we just extend the current tax policy?

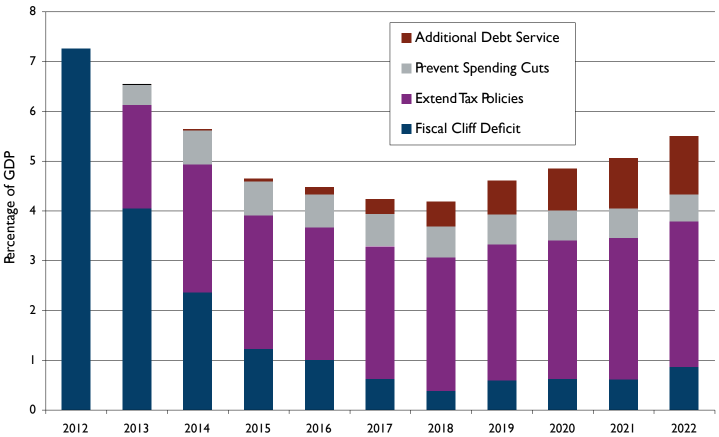
We have enjoyed over a decade of lower tax rates, so why can't they continue at these lower levels? Looking back, the Bush-era tax cuts were designed to help stimulate the U.S. economy during the recession of 2001 and 2002. They were originally designed to expire after 10 years but were extended two more years to avoid increasing taxes on an economy that was recovering from a different recession, the Great Recession.

While the economy is currently growing and not in recession, we are still faced with high unemployment and a lot of global economic uncertainty. The government has to be careful about the magnitude of spending cuts and increased taxes they allow to pass so they don't slow the recovery from the Great Recession. While there doesn't seem to be general consensus on many things in Washington, there is a general belief that the full Fiscal Cliff should be delayed or implemented over time.

In general, low rates are fine if they generate enough revenue to cover the cost of running a government. However, the U.S. currently spends more than it earns by a large margin. The 2012 fiscal year, which ended on September 30, 2012, experienced a deficit of $1.1 trillion. That is the fourth fiscal year in a row where deficit spending was greater than $1 trillion.

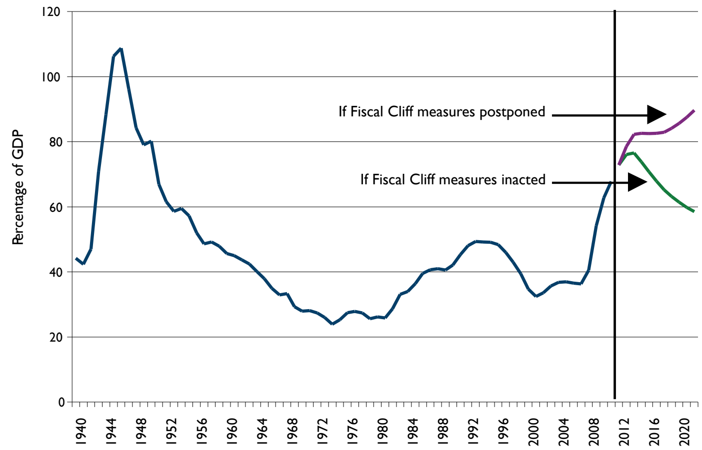
Any amount of deficit spending increases the total amount of debt the government owes. The two charts below highlight the paths of our deficit spending and debt load. The main problem with debt is that you have to pay interest on it and, if rates go higher, the level of interest you pay goes up as well.

Deficits Projected by CBO if Fiscal Cliff Occurs and the Impact of Current Spending and Tax Policy (2012-2022)



Source: Congressional Budget Office

Federal Debt Held by the Public Historically & As Projected by CBO (1940-2022)



Source: Congressional Budget Office

To sum it up, the U.S. has a debt problem, not a debt crisis. However, it is wise to take proactive steps to lower our deficit spending and debt well before it becomes a crisis. The earlier we start, the less painful it should be.

What's on the table?

There are three ways to solve the government's debt and deficit issues: spend less, increase revenues (i.e., tax more) or grow (which is a form of earning more).

In 2010, the Simpson-Bowles Presidential Commission was established to improve the U.S. fiscal situation over the medium and long-term. The commission proposed a balanced approach that combined entitlement reform, spending cuts and tax increases. While the plan did not pass in 2010, their framework and spending analysis continues to be quoted and referenced by tax reformers. The final plan they proposed would target raising $785 billion in new income taxes by eliminating certain tax breaks and would cut spending and entitlements by more than $3 trillion over 10 years. Here are some of the key insights and concerns they exposed in rank order*:

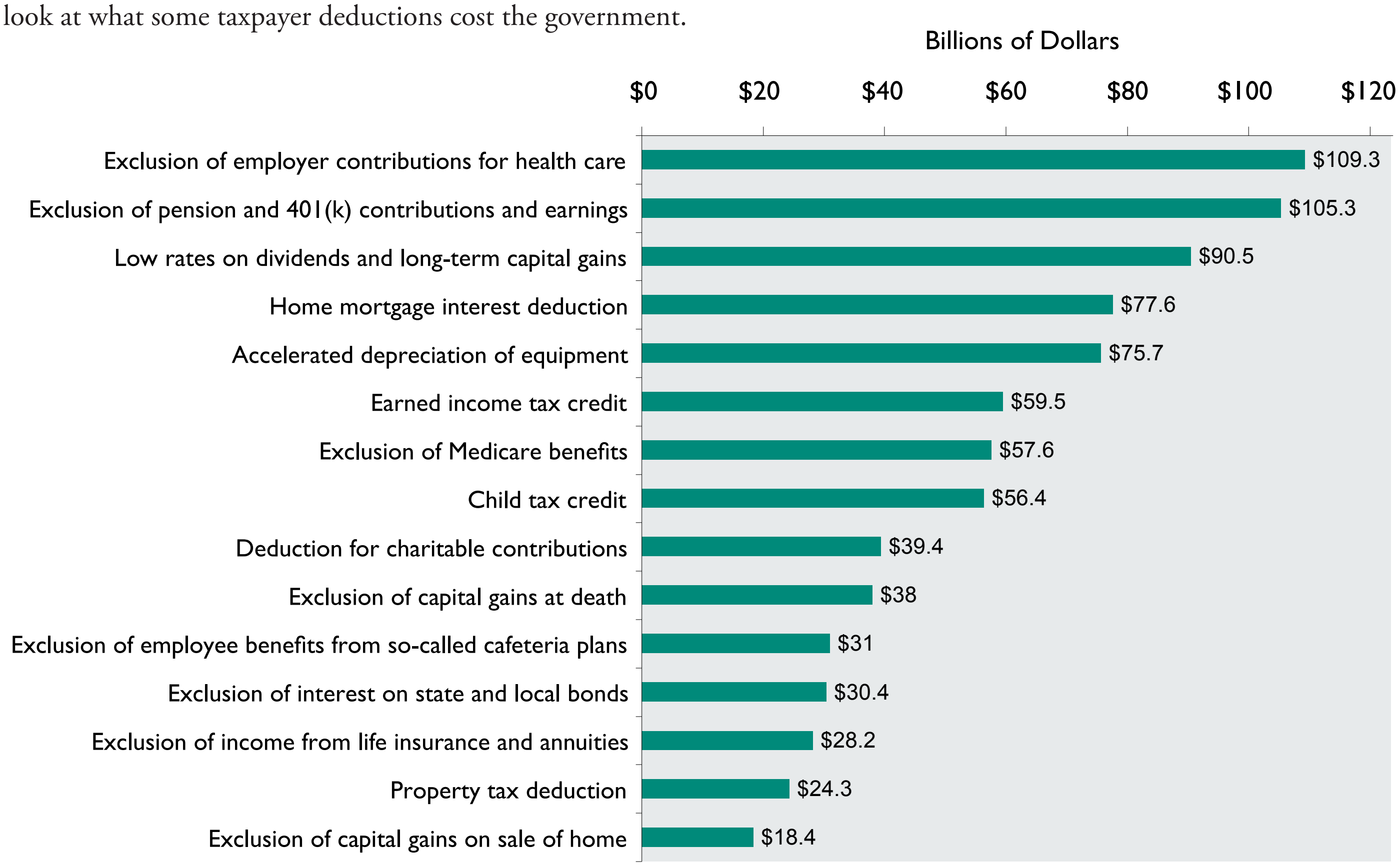
1. **Health Care Spending**: Health care spending in 1981 accounted for 10% of the budget, today it accounts for 25%. By 2020, it is estimated to take up a third of the budget.
2. **Defense Spending**: We currently spend more than the 17 next-largest countries combined on defense related items.
3. **Tax Code**: Simpson-Bowles believes the current code is inefficient, ineffective, and globally anticompetitive. Loopholes should be reduced or closed.
4. **Social Security**: When Franklin Roosevelt created the program, the average life expectancy was 63 and the social security retirement age was 65. Now, the average life expectancy is 78 and you can receive social security as early as 62.
5. **Interest on Debt**: The U.S. already spends $230 billion on interest payments for the debt it has outstanding (enough to fully fund six of the biggest cabinet Departments). Interest costs could rise to $1 trillion by 2020.

*Source: "Over the Cliff: Alan Simpson and Erskine Bowles on the Looming Deficit Crisis," by Michael Skocpol, Advisor Perspectives, November 27, 2012

Tax breaks and loopholes that benefit only certain parts of the population were also mentioned as an area that needs to be reformed. These breaks were addressed by Simpson-Bowles, and were discussed heavily during the recent Presidential campaign. Many of these tax breaks and loopholes exist to incentivize certain behavior like saving money for retirement or buying a home. The challenge is that these tax breaks can add up to significant lost revenue for the government. As you can imagine, changing any tax break or loophole is a very political process.

While we don't know if any of these will be cut or reduced going forward, the following chart has a breakdown of current tax breaks, loopholes and deductions (by size).

Top 15 Tax Exclusions and Loopholes
A look at what some taxpayer deductions cost the government.



Source: Bloomberg Businessweek and Joint Committee on Taxation

As we watch the ongoing debate on how Washington plans to handle the Fiscal Cliff, we look for planning opportunities. Anytime there are tax code changes, there is typically a need to review your financial plan. We encourage you to work with your advisor on how to address the Fiscal Cliff and to determine what actions, if any, may be merited.

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