THE FISCAL CLIFF DEAL

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What It Could Mean For You

After sending the U.S. economy over the fiscal cliff for one day, the Senate and House took action to avert the consequences of $600 billion in spending cuts and tax hikes that were due to strike on January 1, 2013 by passing the **American Taxpayer Relief Act of 2012 (H.R.8)**. This report will discuss the major provisions of the deal and what it means for taxpayers and investors.

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INTRODUCTION

On January 1, 2013, the House of Representatives voted to pass the "American Taxpayer Relief Act of 2012," a bill to avert the fiscal cliff. Having already been passed by the Senate, the bill was quickly signed into law by President Obama, thereby preventing the U.S. economy from being battered by a combination of tax increases and mandatory spending cuts. Although, technically, the economy went over the cliff by one day, all provisions of the bill were backdated to January 1.

The new legislation prevents most of the scheduled tax hikes for the majority of Americans and extends emergency unemployment benefits for one year. However, our concern is that the bill does not address major budget issues like deficit reduction, sequestration, or raising the debt limit. Instead, lawmakers chose to delay automatic cuts to defense and domestic spending for two months, setting the stage for a second debate as the federal government approaches its borrowing limit in February.[1]

While the debt ceiling may again provoke market uncertainty and anxiety about excessive U.S. debt, a positive outcome could give markets a boost. If analysts see a solid multi-year plan for deficit reduction, it could be a very positive event for investors.

TAX CHANGES[2,3,4]

Under the new bill, married couples earning more than $450,000 ($400,000 for single filers) will face an increased tax bill as the current top federal tax rate of 35% goes up to 39.6%. Taxpayers in this upper bracket will also see their qualified dividend and capital gains rates increase from 15% to 20%, an amount far less than the 40% the White House had been seeking.

Some taxpayers under those limits will still be hit by the return to Clinton-era limits on personal exemptions (PEPs) and itemized deductions, which will strike joint filers earning more than $300,000 and single filers earning more than $250,000.

Fortunately, the fiscal cliff deal prevented the expiration of the 2001 and 2003 Bush Tax Cuts for the vast majority of Americans and maintained preferential tax treatment of municipal bond income and qualified dividends. We may see additional tax

H.R.8. At a Glance

Income tax rates: Permanently extends the Bush Tax Cuts for income below $400,000 per individual, or $450,000 per family. Income above that level will be taxed at the highest rate of 39.6%. For earners in the top bracket, capital gains and dividend tax rates will return to 20% from 15%.

Exemptions and deductions: Permanently phases out personal exemptions (PEPs) for single filers with adjusted gross income (AGI) above $250,000 and households with AGI above $300,000.

Alternative Minimum Tax: The AMT is permanently patched with annual inflation adjustments, removing a potential danger for close to 30 million middle class families.

Estate and gift taxes: Permanently extends the lifetime estate and gift tax exemption of $5.12 million (with inflation adjustments), but increases the top tax rate from 35% to 40%. Spousal portability and reunification of the estate and gift tax are also permanently preserved.

Capital gains and dividends: Permanently extends the existing rates (0% and 15%) for long-term capital gains and qualified dividends for individuals with incomes below $400,000 and joint filers with incomes below $450,000. The top rate will increase to 20% for filers with incomes above these thresholds.

Source: USA Today/AP

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reform later in 2013 as lawmakers revisit fiscal issues, but most Americans were able to dodge major income tax increases.

An estimated 77% of Americans will see higher federal taxes in 2013 because a temporary reduction in Social Security payroll taxes expired.

Source: Tax Policy Center

The new 3.8% Medicare tax enacted under the Affordable Healthcare Act was not repealed and has taken effect as scheduled in 2013. The new tax applies to individual filers with modified adjusted gross income (AGI) above $200,000 and joint filers with modified AGI above $250,000. As a result, depending on an investor's modified AGI and taxable income, capital gains and qualified dividends will be taxed at four different rates: 0%, 15%, 18.8%, and 23.8%.

Nearly 25 million Americans will benefit from the extension (for five years) of certain tax credits enacted under the 2009 stimulus bill, including: the American Opportunity Tax Credit, tax credits for college tuition, and enhancements to the child and earned income credits.

Businesses were also beneficiaries of the fiscal cliff deal, which extended for two years several existing tax benefits for businesses, including R&D tax credits, renewable energy tax credits, and a measure allowing bonus depreciation.

The fiscal cliff deal did not address expiring payroll taxes, meaning that now that the payroll tax cut has expired, most Americans will be taking home less each month. On the positive side, this new tax increase will help fund Social Security.

FEDERAL SPENDING

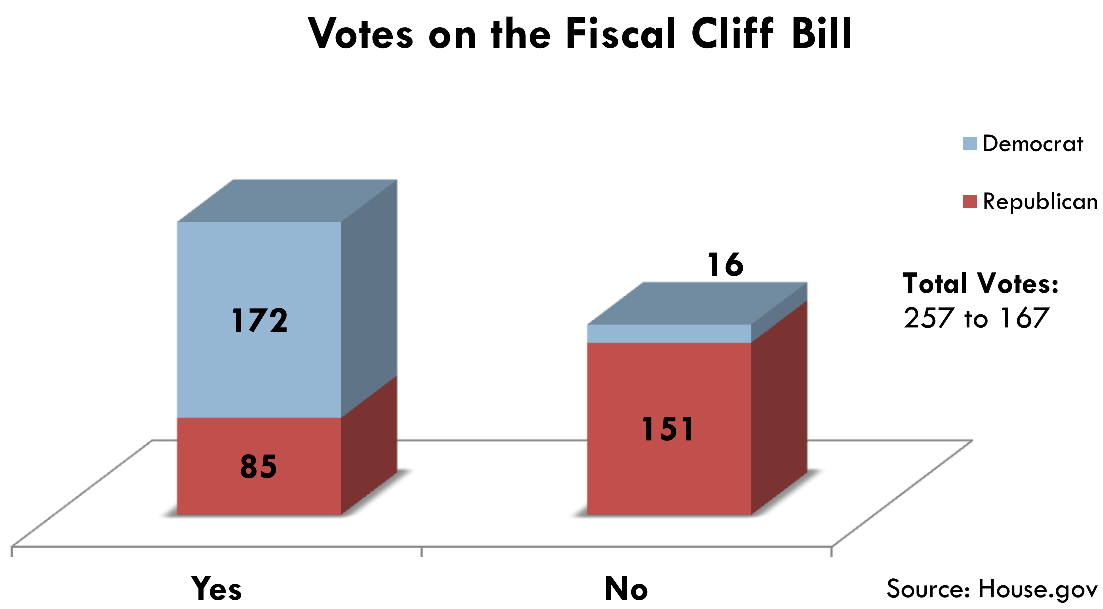
- **Budget sequester:** The bill postpones for two months the start of $1.2 trillion in automatic spending cuts known as sequestration.
- **Unemployment benefits:** Extends emergency unemployment benefits for one year (through December 31, 2013) for the long-term unemployed, assisting approximately 2 million out of work Americans.
- **Medicare pay cut for doctors:** Prevents a scheduled 27% cut in Medicare reimbursements for one year. This 'doc fix' will mean that Medicare service providers will not face serious pay cuts, hopefully maintaining the number of doctors willing to take Medicare patients.

RETIREMENT PLANS

- **Roth conversions:** Allows 401(k), 403(b), and 457 plan participants to make Roth conversions and pay the applicable taxes.

POLITICS

What were the politics of the American Taxpayer Relief Act of 2012? Frankly, neither side can claim victory over the fiscal cliff deal. On the whole, the deal was a compromise between very liberal and very conservative elements (SEE CHART BELOW). Democrats accepted a higher threshold for tax increases; President Obama broke his promise to raise taxes on household incomes over $250,000 and individual income over $200,000. The vote was also a dilemma for Republicans, many of whom had pledged not to raise taxes. However, faced with being blamed for sending the economy over the cliff, had Congress and the White House not reached a deal, the majority of Congressional Republicans held their noses and voted for the deal as it stood. Despite having many misgivings about the lack of significant spending cuts, Republicans took a politically risky step and prioritized getting the bill passed over getting exactly what they wanted. However, they may face a high political price as angry conservatives challenge incumbents in the 2014 primaries. [5]



PROSPECTIVE STRATEGIES

Focus on Tax-Efficient Planning

While some tax rates are increasing for nearly everyone, taxpayers who are under the individual limit of $400,000 or the joint limit of $450,000 won't see their *income* tax rates go up in 2013. However, if you are in the top tax bracket, your income tax rate will increase to 39.6% for the 2013 tax year. When you consider the potential impact of the phase-outs of personal exemptions and itemized deductions, increased payroll taxes, and the new Medicare surtax, the impact could be even greater. [6]

Even taxpayers who are under the $400,000 or $450,000 limits cannot ignore the importance of taxes this year, since the payroll tax will return to its pre-2011 levels (a 2% increase in most cases), and dividend taxes, capital gains, and estate taxes are also increasing. Taxpayers will also be hit by a new 3.8% Medicare surtax on capital gains and qualified dividends that affects individual filers with modified AGI of more than $200,000 and joint filers with modified AGI of $250,000. All these new taxes may impact your bottom line, making a tax-sensitive investment strategy important.[7]

For all taxpayers, these new tax changes increase the importance of tax sensitivity in their financial planning by taking advantage of tax-deferred accounts, managing investment sales, and properly structuring retirement withdrawals.

We always like to emphasize that taxes are just one consideration in an overall financial plan; any changes in investment strategy should be made in view of your long-term financial goals and in consultation with a tax advisor. That being said, here are a few considerations for investors concerned about the impact of taxes on their investments:

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- ☐ **Minimize capital gains and dividend taxes:** Investors should explore options for minimizing taxable gains, such as tax-loss harvesting (selling investments at a loss), or holding taxable investments in tax-deferred retirement accounts like 401(k)s, IRAs, or tax-deferred annuities.

- ☐ **Minimize estate taxes:** If you believe that your estate may be taxed at the federal or state level, you may want to consult with an estate planning specialist to discuss charitable giving, trusts, or ownership options that allow you to transfer assets outside of your estate.

- ☐ **Minimize income taxes:** As your income taxes increase, so does the benefit of maximizing contributions to tax-advantaged accounts such as 401(k)s, IRAs, and HSAs. If your employer offers a nonqualified deferred compensation plan (NQDC) – a popular option for executive compensation - you may want to consider participating as a way to defer part of your compensation (and the taxes on it).[8]

Increase Your Personal Savings

The fiscal cliff deal did not touch entitlement spending on programs like Social Security or Medicare. However, reforms targeting the solvency of those programs are likely to figure in future debates over deficit reduction. So, although your benefits are currently safe, it makes sense to start thinking about your personal savings rate. Work with us to ensure that you are currently saving enough to meet a variety of benefit conditions. You should help try to maximize your tax-deferred savings through a 401(k), IRA, 403(b), HSA or other plan.

Don't Forget Equity Investing

Many Americans fled equity markets in 2012 as slow growth and fiscal cliff woes contributed to market volatility. A November 2012 Fidelity Investments study found that 63% of surveyed investors had lost confidence in markets; of those making strategy changes as a result, over 70% were decreasing their exposure to stocks.[9] However, be sure that you're not moving into too defensive a posture, which may cause you to miss out on possible equity gains in the future. Many investors have taken refuge from volatility in bonds, but today's low interest rates are putting pressure on yields. Be sure that you're not over-invested on low-yield bonds, which could suffer if interest rates spike.

Report concludes on next page.

WHAT NEXT?

While lawmakers were able to avert some of the most immediate consequences of the fiscal cliff, they failed to address the fundamental fiscal reforms needed to ensure the country's long-term economic health. Budget cuts, deficit talks, and changes to the debt ceiling were all left out of the fiscal cliff deal. The nation actually reached its debt ceiling in early January, however the Treasury Department will still be able to pay its bills until sometime in February, when lawmakers will be forced to revisit the issue.[10]

The sequester, the severe cuts to the federal budget scheduled to go into effect on January 1, were also delayed for two months as lawmakers kicked the can down the road for the new 113th Congress to address. These cuts hit all areas of the federal budget, including a $55 million reduction in defense spending, as well as cuts to Medicare, education, FEMA, and many other critical government operations. [11]

Essentially, the spring debate will boil down to two questions: What kind of entitlement and spending cuts will Republicans demand? And will Democrats succeed in getting further revenue (tax) increases on the table? It's clear that Social Security and Medicare, two of the government's largest programs, will be on the table as lawmakers grapple to keep them solvent while trimming the deficit. In exchange, Democrats may seek to increase corporate taxes, as it will be politically difficult to crack open the individual tax code again.[12]

Economists and analysts will be watching closely to see if lawmakers are able to develop credible, long-term fiscal plans to reduce the deficit and tackle our debt issues. As the debate draws closer, we expect to see additional market volatility as politicians stake their positions and pundits debate different plans.

While it's impossible to know the shape of things to come, if Congress is able to put aside partisan differences and make the hard choices that need to be made, markets could respond very positively. However markets react, we are committed to building the strong, flexible financial strategies that can stand the test of time. We hope you've found this report informative; should you have any questions about how the American Taxpayer Relief Act of 2012 affects you or your investments, please contact us.

Sincerely,

V. Michael Greben - Vice President of Investments

If someone you know would like a free copy of this report, please direct them to our website at www.michaelgreben.com or call our office at 888-356-5221 and we will send them one.

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