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CLIENT NEWSLETTER

FALL 2012

January 1, 2013: The Fiscal Cliff

You've probably heard or read about it. But what is it?

Back in 2001, the first of the so-called "Bush-Era Tax Cuts" included a provision that *all of the changes* in that 2001 tax law would automatically expire on December 31, 2010. Other legislation during the Bush Administration created additional changes. Some of those laws exempted a few of the tax cuts from the 12/31/10 expiration date, making them permanent. (At the end of this Newsletter is a definition of "Bush-Era Tax Cuts".)

In 2010, with the December 31st deadline approaching, Congress and President Obama extended the 2010 expiration date to December 31, 2012 which now looms before us. In 2011, as a result of the "Budget Crisis", Congress enacted the Budget Control Act of 2011 which stated that if an agreement could not be reached on extending some or all of the Bush-Era Tax Cuts beyond 12/31/12, then all, that is 100%, of Federal government expenditures would be cut across the board. This cut would include the Military, all government programs, everything. Only Social Security was exempted from this cut.

Given the fact that Democrats and Republicans cannot seem to agree on anything (even repairing the dome of the Capitol Building), there is now a good chance that we will be hit with a triple-whammy on January 1, 2013:

1. Almost all of the Bush-Era Tax Cuts will expire. With few exceptions, all federal income tax laws will revert to what they were on December 31, 2000. This means that *everyone's taxes will go up*. For some, the increase will be very large. At the end of this Newsletter is an abbreviated list of the expiring tax cuts.

2. The mandatory spending cuts in all government programs will go into effect.

3. The 2% reduction in Social Security taxes on employees enacted under the "Middle Class Tax Relief and Job Creation Act of 2012" will also expire at the end of 2012.

This is a deadly combination for the economy. Very scary stuff. Raising taxes and cutting government spending both have the same effect: They remove money from the economy. It's a stimulus in reverse. Failure to extend the tax cuts will remove about $3 billion from the economy over the next 10 years; mandatory budget cuts will remove about $109 billion *per year* (Source: Congressional Budget Office estimates). Most economists, both liberal and conservative, agree that a drop in the Gross Domestic Product (GDP) of several percentage points is inevitable in 2013 if this happens.

A drop in GDP means a new, and probably more severe, recession.

Political pundits are saying that neither party is thoughtless enough to allow this to happen, regardless of the outcome of the election. Some are saying that after Election Day, the lame-duck Congress will come back and fix the situation; others say it won't happen until early 2013, with the changes retroactive to January 1, 2013. Certain Senators from both parties are currently trying to work out a solution; the House is not involved.

There is only one *major* point of disagreement between Democrats and Republicans: Republicans want *all* the Bush-Era Tax Cuts extended; Democrats want all of them extended, *except* for people with taxable income (that is, after all deductions) exceeding $250,000 per year (married filing jointly) or $200,000 per year (single). The rates for these levels would rise from 33% to 36% or 36% to 39.6%. There's lots of room for compromise here, most obviously raising the $250,000 and $200,000 amounts, and/or adjusting the rates. Both parties agree that rates for individuals with taxable incomes below these amounts should not change.

What can you do? Regardless of your personal political beliefs, this looming disaster cannot be allowed to happen. Write to your representative in Congress, write to your Senators, write to the President. Urge them to come to an agreement before the end of the year; the sooner the better.

Our next Newsletter will focus on the Affordable Health Care Act and/or Tax Law changes (if there are any). News Flashes and Newsletters are posted on our website www.famtax.com.

Please feel free to call or write if you have any questions.

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Dan and Eric

"Bush-Era Tax Cuts":

The "Bush-era" tax cuts is the collective term for the tax measures enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA). In addition to the individual, capital gains, dividends and estate tax rates that remain the focus of the attention, EGTRRA made over 30 other major changes to the Tax Code, which are now about to expire. The 2010 Tax Relief Act extended all these measures through 2012. EGTRRA also made many changes to retirement and pension rules in the Tax Code. These changes were made permanent by the Pension Protection Act of 2006 (PPA).

Selected Impacts of Failure to Extend Bush-Era Tax Cuts:

Individual income tax rates are currently 10, 15, 25, 28, 33, and 35 percent. These will become 15, 28, 31, 36, and 39.6 percent. The 10% bracket will be eliminated, thereby taxing lower income people an additional 5%. The upper 4 brackets will all increase by 3 to 4.6%.

Various credits, including the Earned Income Credit, Child Credit, and others, will be reduced or eliminated.

The **estate tax exemption**, currently $5.2 million (indexed for inflation), will drop to $1 million (not indexed for inflation), thereby causing many middle class families to be forced to do expensive and extensive estate planning to minimize taxes. Bear in mind that the value of your home and the proceeds of your life insurance both count towards the exemption limit. The top **estate tax rate** will rise from 35% to 55%. There will be similar effects on Gift Taxes.

Capital Gains are currently taxed at 0% for those in the 10% and 15% tax brackets, and 15% for those in higher tax brackets. These rates will become 10% and 20%, respectively.

Dividends from "qualified" corporations are currently taxed in the same way as capital gains. In 2013, dividends will be taxed as ordinary income, the same way interest is taxed.

Various **Education** deductions and credits will be reduced or eliminated.

Cancellation of Mortgage Debt on your personal residence, either by forgiveness or in a "short sale" will once again be taxed as income. Example: If you short-sell your home for $100,000, but your mortgage is $150,000, the $50,000 debt that you never have to pay will be taxed as income.

Many **business tax** breaks will be reduced or eliminated.

Other items being eliminated: 100 percent bonus depreciation, enhanced Section 179 expensing, Deduction for State & Local Sales Tax, Teachers' classroom expense deduction, deduction for PMI mortgage insurance premiums, various energy tax incentives.