Can We Avert the "Fiscal Cliff"?

Recently, you may have heard about the "looming fiscal cliff", the "coming fiscal cliff" and so forth. What exactly is it?

Briefly stated, the "fiscal cliff" is a potential $7 trillion dilemma facing Congress this fall – a Congress not known for ready cooperation. If America goes over it, our economy could stumble.[1]

Will Congress act before 2013? Federal Reserve Chairman Ben Bernanke introduced the phrase, referring to an economic downfall he fears will result from a potential 2013 combination of federal budget cuts, the expiration of the Bush-era tax cuts, the end of the payroll tax holiday and extended jobless benefits and other recent stimulus measures. Bernanke told Congress that together, these changes could send the U.S. over a "fiscal cliff" and into another recession.[2]

How bad might the potential downturn be? Maya MacGuineas, president of the bipartisan Committee for a Responsible Federal Budget, thinks the U.S. could see a recession "immediately". Moody's economist Mark Zandi thinks it could shave 3% of off America's inflation-adjusted GDP next year (read: zero growth).[1]

The hope is that Congress will come together and help the economy avoid the cliff. It won't be easy. Remember the big fight over the debt ceiling in Congress? Imagine it expanded to other issues, its magnitude amplified to a new level.

What happens after the election? It will likely be November before Congress really starts to knuckle down and address this dilemma. Legislators have some options:

- They could punt again. The punt wouldn't be as embarrassing as the one chosen by the ill-fated "super committee" that couldn't agree how to reduce the deficit in 2011. It would be more like a handoff: the outgoing Congress could simply extend certain tax cuts or stimulus measures and leave the big and painful decisions for the new Congress. Many journalists and analysts believe that this is exactly what will happen in Washington. Some think a credit downgrade could result.[2,3]
- *They could extend the Bush-era tax cuts again*. If any political change in November is momentous, the stage could be set for another EGTRRA/JGTRRA extension and the planned cuts to defense spending and other key programs might be undone. That would certainly boost the morale of Wall Street and the taxpayer. The consequence? The nation could really pay for it later. Extending the Bush-era cuts would cost the federal government anywhere from $5.35 trillion to over $7 trillion over the next decade, the Congressional Budget Office believes.[1,3]
- *They could do nothing.* Even if the waning days of the 112th Congress aren't as fractious as feared, some analysts think that lawmakers will likely let the Bush-era tax cuts, the 2% payroll tax cut and long-term unemployment benefits sunset, as the need for revenue on Capitol Hill has simply become too great.[2]

What can the Fed do? In Ben Bernanke's assessment: basically nothing. In fact, that is more or less what he told Congress this spring: "If no action were to be taken, the size of the fiscal cliff is such that there's, I think, absolutely no chance that the Federal Reserve ... could or would have any ability whatsoever to offset ... that effect on the economy."[3]

What could happen economically before we get to the edge? A June report from analysts at Bank of America expressed some fears: "As the cliff approaches, we expect first firms and then households to start postponing decisions, weakening the economy in advance of the cliff. When you are approaching a cliff, in a deep fog of uncertainty, you slow down." This spring, Bernanke reminded Congress that "the brinkmanship last summer over the debt limit had very significant adverse effects for financial markets and for our economy" and "knocked down consumer confidence quite noticeably." He urged lawmakers not to "push us to the 12th hour."[2]

Expect a pitched battle on Capitol Hill. Alan Simpson, who for many years served Wyoming in the Senate, recently told CNNMoney that this lame-duck session of Congress could wrap up with seven weeks of "chaos". Yes, just seven weeks; if lawmakers wait to tackle this in earnest after the election, that is all the time they will have to consider what could be some of the most pivotal political decisions they will ever make.[3]

Some political theatre seems to be ahead – a drama with an uncertain ending, with the near-term fate of economy parked at the edge of a cliff.

Citations.

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Financial Considerations for 2013

Should you be afraid of the "Fiscal Cliff"

We are now in plain view of the "fiscal cliff". After the election, Congress may or may not end up keeping income and estate tax rates at their recent levels. Next year may bring some notable financial developments, and it isn't too soon for households to think about them.

You may want to prioritize tax reduction. If the Bush-era tax cuts sunset, everyone will see higher taxes. The federal income tax brackets (10%, 15%, 25%, 28%, 33%, 35%) that we have known for the last nine years would be replaced by five higher ones (15%, 28%, 31%, 36%, 39.6%) come 2013.[1]

High earners may want to watch their incomes. If your earned income for 2013 tops $200,000 - or exceeds $250,000, in the case of a couple – you may face two Medicare surtaxes. While the Medicare payroll tax on earned incomes above these levels is set to rise to 2.35% from the current 1.45%, the second surtax may prove to be the real annoyance: there is scheduled to be a 3.8% charge on net investment income for individuals and couples whose modified adjusted gross incomes surpass these levels.[1,2]

Some fine points about this second surtax must be mentioned. It would actually be levied on the lesser of two amounts – either your net investment income or excess MAGI above the $200,000/$250,000 levels. Most investment income derived from material participation in a business activity would be exempt from the 3.8% surtax, along with tax-exempt interest income, tax-exempt gains realized from selling your home, retirement plan distributions and income that would already be subject to self-employed Social Security tax.[2]

The bottom line is that a bonus, an IRA distribution, or a sizable capital gain may push your earned income above these thresholds – and it will be wise to consider the impact that would have.

You may have less take-home pay next year. Social Security taxes for paycheck employees are slated to return to the 6.2% level in 2013. They've been at 4.2% since the start of 2011. If you earn $75,000 during 2013, you will take home about $1,500 less of it than you would have in 2012. If you earn $50,000, we're talking $1,000 less.[3]

Any 2013 Social Security COLA may be minor. In 2012, the cost of living adjustment to Social Security benefits was 3.6%. Before that, Social Security recipients went three years without a COLA. As inflation is mild, whatever COLA is announced this fall in tandem with Medicare premium changes may not amount to much.[1]

Next year, medical expense deductions may shrink. If you are thinking about delaying a procedure or surgery until 2013, remember that the itemized deduction threshold for unreimbursed medical expenses is set to increase from 7.5% to 10% of adjusted gross income in 2013. Even if that happens, however, the threshold will remain at 7.5% through 2016 for taxpayers age 65 and older.[1]

You may be able to find a better Medicare Advantage plan for 2013. The Affordable Care Act has altered the landscape for these plans (and their prescription drug coverage). Using Medicare's Plan Finder (click on the "Find health & drug plans" link at Medicare.gov), you may discover similar or better coverage at lower premiums. The enrollment period for 2013 coverage runs from October 15 to December 7.[1]

Those without work may find a safety net gone. Extended jobless benefits may disappear for the long-term unemployed at the start of 2013. Will Congress extend them once again? Possibly – but that isn't a given.

The estate & gift tax exemptions may shrink significantly. The (unified) lifetime federal gift and estate tax exemption is currently set at $5.12 million – and it will drop to $1 million in 2013 if Congress stands pat. Federal gift tax and estate tax rates are also slated to max out at 55% in 2013, as opposed to 35% in 2012. Right now, an unused portion of a $5.12 million lifetime exemption is portable to a surviving spouse; in 2013, that portability is supposed to disappear.[4]

Many analysts and economists think that Congress will take things back to 2009 instead of 2001 – that is, a $3.5 million estate tax exemption, a $1 million lifetime gift tax exemption, and a 45% maximum estate and gift tax rate.[4]

Prepare for year-end drama ... and for 2013. The last two months of 2012 will surely bring political theatre to Capitol Hill. As it unfolds, you may want to look ahead to next year and consider the impact that these potential changes could have on your financial life.

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