January 3, 2013

Title: Resolutions & Taxes

Dear Valued Investor:

Instead of champagne toasts and party hats, Washington, DC chimed in the New Year with the same old dance of waiting until the last minute before demonstrating its near inability to work together.

Regardless, the so-called fiscal cliff, a series of economically devastating tax increases and spending cuts that were due to come on line at the start of 2013, was temporarily averted given a last-second deal between the Republican-led House of Representatives and the Democratic-led Senate. The compromise, known as the American Taxpayer Relief Act of 2012, is not the grand solution to address our nation's surging debt issues that many had hoped for. Rather, it is more of a temporary band-aid that resolved the revenue (tax) elements of the fiscal cliff, but delayed addressing the tougher decisions surrounding spending cuts and raising the debt ceiling until February 2013. Specifically, the Act contains the following major provisions:

- Individual income taxes: The Bush tax cuts are permanently extended for individuals with taxable income less than $400,000 ($450,000 for married couples), and the alternative minimum tax patch is made permanent and indexed for inflation.
- Capital gains and dividends: There is no difference on tax rates for capital gains and dividends, although top rates will rise to 20% for individuals with taxable income greater than $400,000 ($450,000 for married couples).
- Personal exemption reductions: Reinstated were limitations on itemized deductions and personal exemptions for taxpayers with taxable incomes greater than $250,000 ($300,000 for married couples).
- Estate tax: The estate tax rate will move up to 40%, but the exemption will remain at $5 million, annually indexed for inflation (which is $5.12 million beginning January 1, 2013).
- Unemployment benefits: Extended unemployment benefits will be funded for another year.

The bottom line is that the federal income tax rate will remain the same for everyone except those individuals with taxable income greater than $400,000 ($450,000 for married couples), which is a change that will affect less than 1% of Americans. However, despite the headline that tax rates remain the same for most, the actual dollar amount of taxes paid will be moving higher for virtually every wage earner due to the elimination of the payroll tax cuts of 2011 and 2012. Payroll taxes help to fund Social Security by taxing 12.4% on wages up to $113,700 (in 2013), which was paid equally by employers and workers at 6.2% each prior to 2011. In 2011 and again in 2012, the President and Congress reduced the share paid by workers from 6.2% to 4.2%, which essentially put extra money via a tax cut in wage earners' wallets. However, starting in 2013, the split will once again revert to 50/50 and result in higher taxes for essentially everyone. To put this in dollar terms, the Tax Policy Center estimates that households making between $100,000 and $200,000 will see an average tax increase of $1,784 in 2013. For higher income earners, the tax burden is much steeper given the combination of higher federal income tax rates, the elimination of payroll tax cuts, the limitation of personal deductions, and the higher tax rate on investment income.

In aggregate, Congressional Budget Office analysis estimates that the tax increases and small spending adjustments outlined in the American Taxpayer Relief Act of 2012 will essentially result in $230 billion less available for spending in 2013. This would result in a drag on the economy in 2013 totaling about 1.5% of gross domestic product (GDP). This growth “anchor” of 1.5% is sizable considering the anemic economic growth in the United States of approximately 2%—but, is considerably less than the 3.5% drag that an unaddressed fiscal cliff would have generated.

All eyes now shift from the cliff to the ceiling. Despite averting the steep cliff, the United States’ limit on how much debt can be issued, known as the debt ceiling—along with the sequestered spending cuts and the funding for the government—all need to be addressed by late February, which means the next fiscal battle is less than two months away. The good news is that there may finally be clarity around future tax policy, which could trigger some consumer and business spending that has been on hold during this time of uncertainty. Additionally, markets do not handle uncertainty well and hopefully having some of these items addressed will allow them to move in an upward direction in the near term. However, there remains much work to be done in the coming months to overcome the contentious policy decisions that Washington delayed addressing, instead of fixing, this past week.

At a time when Americans across this great country are committing to change through the annual rite of New Year’s resolutions, I only hope that our leaders in Washington commit to turn their characteristic procrastination into a quick resolution to the remaining cliff-related hurdles that await us in the coming months.

As always, please contact me with any questions.

Happy New Year,

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More information on the American Taxpayer Relief Act of 2012 can be found at:
http://www.gpo.gov/fdsys/pkg/BILLS-112hr8eas/pdf/BILLS-112hr8eas.pdf