WHAT IS THE "FISCAL CLIFF"?

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Now that the 2012 election is behind us, attentions are turning more and more to the upcoming "Fiscal Cliff" that, as things stand now, will become a reality as soon as we reach January 1, 2013. It is a popular conclusion that if we indeed do go over the "Cliff," another recession is likely. What is the Fiscal Cliff, and what are the possible alternatives that could prevent us from tumbling over it?

The Cliff

The total effect of going over the Fiscal Cliff in its entirety is estimated to cost the United States economy approximately $600 billion[1]. It has been estimated by the Congressional Budget Office (CBO) and others that going over the Cliff would reduce GDP by 4 to 6 percentage points and increase unemployment by 1 to 2 points. The events that collectively make up the Fiscal Cliff are:

1. The expiration of the Bush tax cuts
2. The implementation of the new taxes included in the Patient Protection & Affordable Care Act of 2010 ("Obamacare")
3. The expiration of the 2% payroll tax cut
4. Normal expiring tax provisions
5. Spending cuts included in the debt ceiling deal of 2011

Bush Tax Cuts

The various tax cuts that were passed during President George W. Bush's term, and extended by President Obama, are all scheduled to expire after December 31, 2012. These include over 30 tax law changes that served to reduce taxes for almost all taxpayers. These cuts include overall tax rate reductions; reduced tax rates on long-term capital gains and qualified dividends; expansion of certain tax credits, including the popular child tax credit; the elimination of the phase-out of personal exemptions and certain itemized deductions; the elimination of some aspects of the "marriage penalty"; and beneficial changes to the estate/gift tax. All of the Bush tax cuts will expire January 1, 2013, if nothing is done by Congress/the President. The CBO estimates the cost of the expiration of the Bush tax cuts to be approximately $221 billion[1].

New Health Care Taxes

When the Patient Protection & Affordable Care Act of 2010 was passed, it included two new Medicare taxes to be imposed on certain high-income individuals to take effect January 1, 2013. These new taxes are:

1. An additional 0.9% tax on wages earned over $250,000 for married taxpayers filing jointly and $200,000 for single taxpayers.

2. An additional 3.8% tax on net investment income for taxpayers with adjusted gross income over $250,000 for married taxpayers filing jointly and $200,000 for single taxpayers.

The CBO estimates the cost of these new taxes to be approximately $18 billion[1].

Expiration of the Payroll Tax Cut

The 2% payroll tax cut that all employees have been benefiting from will expire after December 31, 2012. This tax cut was initially intended to help stimulate the economy but was designed to be temporary. It has been estimated that the average taxpayer benefited to the amount of $1,000 additional take home pay due to this

[1] Economic Effects of Reducing the Fiscal Restraint That is Scheduled to Occur in 2013, Congressional Budget Office, 5/22/12.

cut[2]. The CBO estimates that the expiration of this cut will cost approximately $95 billion[1].

Normal Expiring Tax Cuts – Tax Extenders

Every year there are various tax provisions that are due to expire, commonly known as "tax extenders." Typically, many of these provisions are renewed in some manner. At the end of 2012, these expiring provisions include bonus depreciation, increased Section 179 expense, the AMT "patch," the sales tax deduction, the mortgage insurance premium deduction, the deduction for teacher expenses, and the above-the-line tuition deduction. The cost of the expiration of all tax extenders is estimated to be $65 billion[1].

Sequestration Spending Cuts

As part of the 2011 Budget Control Act, unless equal deficit reductions are passed, automatic spending cuts will be triggered and implemented beginning January 2, 2013. These mandatory spending cuts are to equal $1.2 trillion over 10 years, with $110 billion to occur in the first year (2013). The cuts are required to be achieved 50% through non-defense spending and 50% through defense spending. Spending considered "mandatory," including Social Security, Medicaid, veteran benefits, and, to a certain extent, Medicare, is exempt from the cuts. The 2013 cost of these spending cuts is estimated to be $65 billion[1].

What Will be Done?

What will be done is truly unknown. There has been talk about possible solutions and now that the 2012 election is behind us, this talk will increase. The current Speaker of the House issued a statement the day after the election stressing the importance of stopping the fall over the Fiscal Cliff. Many proposals have been floated, but the results of the election left us basically in the same situation that got us to this point – a Democrat President and a split Congress – and the severe partisanship that has recently been such a large part of the political process doesn't appear to be going away anytime soon. Projecting what will be done before the end of the year is an almost impossible task. Possible actions that could be taken would include the following:

COMPROMISE ON THE BUSH TAX CUTS – Now that the President has been reelected and will be in his final term, there may be an increased desire to reach an agreement before the end of the year so that the effects of the Fiscal Cliff can be greatly reduced. This could include the President and his party joining the Republican-controlled House to extend all, or most, of the Bush tax cuts for all. Currently, the House has indicated its position is to extend the Bush tax cuts for every taxpayer, while the Democrats, in general, have expressed a desire to let tax rates increase for higher income taxpayers. Another possibility is that the reelection of the President is seen by the House as a mandate for his party's positions on the Bush tax cuts and a deal is reached to extend the cuts for all but the highest two tax brackets.

EXTENSION OF THE PAYROLL TAX CUT – It is possible that the popular payroll tax cut will be extended again. While this may appear popular, there are many on both sides of the political isle that agree that this cut was intended to be temporary and should not be extended further. The fact that this tax cut directly reduces the funding for Social Security is a major deciding factor in opposition to any further extension, given the status of Social Security today. Major political players from both parties, as well as from organizations such as the AARP, have publicly stated their preference to allow these cuts to expire.

RENEWAL OF SOME, OR MOST, OF THE TAX EXTENDERS – This is typically what is done with many of the scheduled "normal" expirations and would appear to be likely, given normal circumstances. It will remain to be seen how much emphasis is placed on this area, given the "lame duck" Congress that will be in session prior to the end of the year, but it would not be a shock to see some action taken in this area.

NEW TAX PLAN PASSED – One possibility is that most of the expirations will occur, to be followed by a major new tax bill introduced to offset the effects of going over the Fiscal Cliff. This could include a version of "Obama tax cuts" to replace the expiring Bush tax cuts. It is assumed that this would include some form of tax reduction to eliminate or reduce the effects on lower and middle income taxpayers while allowing for tax increases on higher income taxpayers. This would,

[2] Payroll Tax Cut Unlikely to Survive into Next Year, *New York Times*, 9/30/12.

of course, require cooperation among the different political parties in Washington; so how the parties react to the recent election will be an important factor.

SEQUESTRATION SPENDING CUTS – While it would appear that these mandatory spending cuts are required by law, they could be delayed, or perhaps even eliminated, by passing another law. Many found President Obama's comments at one of the debates indicating that the spending cuts would not occur curious, and commentators wondered if it could indicate that there is a possibility that the sequestration will be avoided. Another possibility of avoiding the required cuts would include an equal deficit reduction package being passed, but it would appear that a law of that scope would be difficult to get passed in a timely manner.

TEMPORARY EXTENSIONS – In recent years, Congress has shown the desire to pass temporary extensions to avoid adverse effects, even if for a short period of time. It is possible that the approach to the Fiscal Cliff will be similar and a temporary solution will be passed, possibly for a short-term period. This "short term" could be as long as a year, or as was suggested by former President Clinton several months ago, as little as three months.

RETROACTIVE EXPIRATIONS – With a lame duck Congress, it is possible that nothing will occur until after year-end. This scenario would involve going over the Fiscal Cliff, and then having the new Congress pass retroactive extensions once it is in session in 2013. This type of retroactive action is not typical and, if it were to occur, would cause not only uncertainty, but confusion involving 2012 tax returns filed prior to any retroactive action.

NOTHING – This, of course, would be the worst possible scenario for the U.S. economy. Even if the normal tax extenders are extended in some form, as has historically been done, the effects of going over the remainder of the Fiscal Cliff will still be significant if nothing else is done.

The only two things known for sure at this time are that we will be hearing much more about the Fiscal Cliff in the coming weeks, and, if nothing is done, the economy will suffer for it. It will remain to be seen how much cooperation exists among the political players in Washington to get something done before we go over the Cliff.

If you have any questions related to the information included here, or wish to discuss further, please contact Charles Marston or Rich Pacella at cmarston@srsnodgrass.com or rpacella@srsnodgrass.com or at (724) 934-0344.

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