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Facing the Fiscal Cliff

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It's been described as a fiscal cliff. "Taxmageddon," screamed the headline from the Wa*shington Post*. Economists say it threatens to pull the economy back into recession. On January 1, 2013, the U.S. economy will experience the biggest tax increases in its history, coupled with significant spending cuts … all unless Congress acts to stop it.

It may sound like the worst movie trailer in history, but you'll be sitting in front row seats courtesy of your federal lawmakers.

You may remember the prequel when Congress extended the 2001 and 2003 tax cuts the first time, December 17, 2010, days before they were set to expire. That move bought a two-year respite. In the meantime the problem has gotten worse. As before, we face the expiration of the 2001 and 2003 tax cuts, the alternative minimum tax (AMT) patch, dozens of so-called tax extenders, and several provisions intended to stimulate the economy—such as the payroll tax cut and extended unemployment benefits. The cost of renewing those provisions has grown with inflation. Now add tax increases that were passed to help pay for the Patient Protection and Affordable Care Act of 2010 and the spending cuts included in last summer's agreement to raise the debt ceiling.

If all of these provisions are allowed to end at once—as scheduled under current law—a half-trillion dollars will be sucked out of the economy. The nonpartisan Congressional Budget Office (CBO) projects this would cause the economy to go into a recession, contracting by an annual rate of 1.3 percent in the first half of 2013.[1] This is not to say that these policies should get a free pass from scrutiny. The CBO also notes that continuing current policies will lead to the net U.S. debt growing from an estimated 74 percent of GDP to 90 percent in 2022.[2] The net debt is all U.S. federal debt held by the public. That estimate does not include the debt and unfunded pension liabilities owed by the states, which today amount to another $2 trillion to $4 trillion (15 percent to 25 percent of GDP).[3] Nor does it include the $4.7 trillion (30 percent of GDP) in intragovernmental debt the federal government has borrowed from itself, such as from the Social Security Trust Fund. Strictly speaking, intragovernmental debt is an accounting fiction, unless of course you expect to collect Social Security when you retire. In that respect, it reflects what the federal government has under-collected and over-promised the public in services and benefits to date.

Clearly, a middle ground needs to be reached that allows some provisions to phase out, such as those that were only intended to provide temporary economic stimulus, while paying down the debt in a manner that allows individuals and businesses to adjust to the fiscal reality of lower spending, higher taxes, or some combination thereof.

Will Congress act before yearend? The House and Senate will stage a few votes before the election on extending various policies, but nothing is likely to come of it. Many congressional staff believe Congress will work out a short-term extension after the November election that will buy enough time to tackle fundamental tax reform. At some point though, lawmakers must take a close look at the expiring provisions and make decisions about what gets cut.

Tax Changes to Consider

Here are a few tax issues that might affect you and your clients. Many provisions of the code are indexed for inflation. The figures provided below are in 2012 dollars, either provided by the IRS or the author's own estimations.

Tax Brackets. The 10 percent bracket will disappear and the lowest tax bracket will be 15 percent. Because this rate is applied to the first $17,400 of taxable income for all married taxpayers ($8,700 single), this change alone will result in a tax increase of over $800 for all married taxpayers making more than that amount. Single taxpayers will see a tax increase of over $400. The remaining tax brackets (25 percent, 28 percent, 33 percent, and 35 percent) will revert to the rates in effect in 2000 (28 percent, 31 percent, 36 percent, and 39.6 percent).

Child Tax Credit. This credit will shrink from $1,000 to $500 per child.

Reduced Tax Benefits for Education. The American Opportunity tax credit (formerly Hope Scholarship credit), which now has an annual maximum of $2,500 per student for the first four years of college, will be reduced to approximately $2,000 per student and will only apply to the first two years of college. For married taxpayers, the credit currently phases out over a range of adjusted gross income (AGI) beginning at $160,000 and is completely phased out at an AGI over $180,000. That phaseout range is scheduled to drop to $104,000–$125,000. For singles, the current range of $80,000–$90,000 will drop to approximately $52,000–$63,000.

The annual contribution limit to Coverdell Education Savings Accounts ("ESAs") will drop from $2,000 to $500 per beneficiary. The range of the AGI phaseout will drop from $190,000–$220,000 to approximately $150,000–$160,000 (single: from $95,000–$110,000 to approximately $75,000–$130,000). Distributions will no longer be usable to pay qualified elementary and secondary education expenses, only expenses for undergraduate and graduate studies.

The student loan interest deduction phaseout will drop by about half from $125,000–$155,000 to approximately $65,000–$80,000 (single: from $60,000–$75,000 to $40,000–$60,000).

Phaseout of Itemized Deductions. Married and single taxpayers with AGI greater than about $175,000 will see the return of the phaseout of itemized deductions (Pease), which reduces a taxpayer's itemized deductions, such as mortgage interest, state taxes, and charitable deductions, up to a maximum of 80 percent. This phaseout would begin for individuals making approximately $175,000.

Personal Exemption Phaseout. High-income taxpayers will also be subject to the personal exemption phaseout (PEP), which will begin for married taxpayers making more than about $260,000 ($217,000 single, $174,000 head of household).

Alternative Minimum Tax. The increased exemption amounts for the alternative minimum tax—the AMT patch—already expired. In 2011 the exemption amount was $74,450 for married taxpayers ($48,450 single). Unless Congress acts, the exemption amount will fall to $45,000 ($33,750 single), subjecting approximately 26 million more taxpayers to the AMT. Certain deductions and credits that are available under the regular tax system are disallowed under the AMT. These include miscellaneous deductions, state and local taxes, interest from most qualified municipal bonds, the Hope Scholarship credit, and the dependent care credit.

Estate Tax. The exemption level and tax rates for estates will revert from the current $5.12 million exemption and 35 percent rate to $1 million exemption with a top rate of 55 percent.

Capital Gains and Dividends. These returns take a potential double hit. The 15 percent special rate expires and the rate on capital gains will increase to 20 percent, while dividends become taxed at the individual's marginal rate (15 percent, 28 percent, 31 percent, 36 percent, and 39.6 percent). For taxpayers with AGI greater than $250,000, there is an additional 3.8 percent tax on investment income, which includes income from dividends, capital gain, interest, rent, and passive income.[4] This tax was passed in 2010 as part of the health care reform bill, but does not become effective until January 2013.

Flexible Spending Accounts. The health care reform bill also paired back flexible spending account (FSA) levels commonly provided by employers to $2,500, and increased the threshold for claiming medical deductions from 7.5 percent to 10 percent beginning in 2013.

Tax Extenders. Most of the regularly extended provisions of the code, commonly referred to as tax extenders, already expired at the end of 2011 and are expected to be extended retroactively. Some of these include: deductibility of state and local sales taxes, tax-free rollover or minimum required distributions to charities, parity for employer-provided mass transit benefits, and 15-year straight-line depreciation for leasehold improvements.

Economic Stimulus. Several temporary tax incentives intended to provide economic stimulus expire at the end of the year, including 100 percent bonus depreciation, increased amounts for small business expensing (section 179), and the 2 percent payroll tax holiday that applies to the first $110,000 of wages. Beginning in 2013, there will be an additional 0.9 percent surcharge on wages in excess of $250,000 ($200,000 single).

How does this all add up? The nonpartisan Tax Foundation provides an interactive calculator that can estimate your clients' federal tax burden. A family of four with both parents making $75,000 in wages could expect to see their income taxes increase by about $4,500 and their payroll taxes increase by $3,000. Test out your variables at http://interactive.taxfoundation.org/taxcalc.

Endnotes

1. Congressional Budget Office. 2012. "Economic Effects of Reducing the Fiscal Restraint That Is Scheduled to Occur in 2013" (May). 2.
2. Congressional Budget Office. 2012. *The 2012 Long-Term Budget Outlook* (June). 2–3.
3. Guevara, Andrew. 2011. "Report Reveals Aggregate State Debt Exceeds $4 Trillion." State Budget Solutions (October 24).
4. The tax is applied to the lesser of the taxpayer's net investment income or the taxpayer's modified adjusted gross income in excess of $250,000 ($200,000 single).