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Analysis: What is the fiscal cliff?

Why is it happening and how will it affect you?

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By Stephen A. Sherman and Sarah J. Sloan
Stoll Keenon Ogden — Special to lanereport.com

Stephen Sherman and Sarah J. Sloan are attorneys for Stoll Keenon Ogden.

"Fiscal cliff" is the term used to describe a combination of fiscal changes scheduled for the end of 2012. At that time, unless Congress acts, tax increases will occur because of the expiration of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010. Additionally, spending reductions will occur under the Budget Control Act of 2011. These changes will cause a large predicted reduction in the budget deficit and, it is argued, a corresponding economic slowdown.

In December 2010, Congress passed the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010. That act extended the "Bush" tax cuts for an additional two years and "patched" exemptions to the Alternative Minimum Tax for tax year 2011. It also authorized a one-year reduction in the Social Security employee payroll tax.

In August 2011, Congress passed the Budget Control Act of 2011. In the absence of bipartisan legislation to decrease the deficit, the act directs automatic across-the-board cuts split between defense and domestic spending, beginning Jan. 2, 2013. At the same time, the Affordable Care Act imposes new taxes on families making more than $250,000 a year ($200,000 for individuals).

If these changes go into effect, total federal revenues are predicted to increase 19.6 percent from 2012 to 2013, and total federal spending would be reduced less than 1 percent. With these changes, it is predicted the 2013 deficit will be reduced by half, with the total federal deficit lowered by $7.1 trillion over the next 10 years. Despite these benefits, these changes are also predicted to cause a double-dip recession in the first half of 2013.

Congress is faced with a difficult decision in order to mitigate the potential damage of the fiscal cliff: (a) do nothing and allow the deficit to be cut by means of a number of tax increases and spending cuts (with a possible recession); (b) stop the tax increases and spending cuts (which would increase the deficit causing a likely debt crisis); or (c) chart the middle ground and carefully craft a solution to resolve budget issues to a limited extent but in a way that would have a more modest impact on growth. No matter the path, almost all Americans will feel the effects of the fiscal cliff.

How will the fiscal cliff affect you?

Of course, most Americans are wondering, “How will the fiscal cliff affect me?”

Falling off the cliff likely will impact the lives of most Americans. For example, for those earning $8,700 or less (single or married filing separately) or $17,400 or less (married filing jointly) in taxable income, the increase of the lowest tax bracket from 10 to 15 percent will certainly be felt. Tax brackets for higher wage earners also are set to rise.

In addition, the “patch” which protected middle-class families from paying alternative minimum tax expired last year.

For the general working public, employees may notice a 2 percent decrease in their paychecks, resulting from the end of last year’s temporary Social Security payroll tax cuts. Paychecks for high-income earners also may be cut an additional 0.9 percent because of the new “Medicare” tax imposed under the Affordable Care Act. Business owners also will not be immune — certain tax breaks for businesses, such as the expiration of bonus depreciation and Section 179 expensing, will end.

The implications of the fiscal cliff may even extend to the home. For example, the lapse of the “Bush” tax cuts would restore the so-called “marriage penalty,” causing married taxpayers to be placed in a higher tax bracket than single taxpayers earning the same amount. Families should also consider reviewing their current estate plans. The current $5 million estate and gift tax exemption and 35 percent estate and gift tax rate will expire Dec. 31, 2012, unless Congress acts, the exemption will fall to $1 million in 2013 and the estate and gift tax rate will increase to 55 percent.

It is possible that Congress may patch up these tax increases and spare some taxpayers from the “fiscal cliff.” However, given the uncertainty of the federal tax laws it is best to assume the worst because, as the saying goes, “it is impossible to be sure of anything but death and taxes.”

Stephen Sherman is an associate in Stoll Keenon Ogden’s Louisville office. He is a member of the State & Federal Tax Practice. Sarah J. Sloan is an associate in Stoll Keenon Ogden’s Lexington office. She is a member of the Business Services Practice with a focus on Mergers & Acquisitions, Health Care and Equine. She is also a member of the Trusts & Estates, State & Federal Tax and Real Estate Practices.