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INGRAM INSIGHTS Newsletter
November, 2012

On the Precipice: The *Fiscal Cliff*

The phrase "fiscal cliff" has been used to describe the unique combination of financial realities scheduled to take effect in 2013: expiring tax breaks; the imposition of new taxes on high-income individuals; and automatic deficit-reduction spending cuts.

Expiring tax breaks

Lower federal income tax rates, part of the tax landscape for more than ten years, expire at the end of 2012. We'll go from six federal tax brackets (10%, 15%, 25%, 28%, 33%, and 35%) to five (15%, 28%, 31%, 36%, and 39.6%). The maximum rate that applies to long-term capital gains will generally increase from 15% to 20%. And while the current lower long-term capital gain rates now apply to qualifying dividends, starting in 2013, dividends will be taxed as ordinary income. The temporary 2% reduction in the Social Security portion of the Federal Insurance Contributions Act (FICA) payroll tax, in place for the last two years, also expires at the end of 2012, as do temporary breaks relating to the federal estate and gift tax.

Several other significant breaks go away in 2013 as well. Itemized deductions and dependency exemptions will once again be phased out for individuals with high adjusted gross incomes (AGIs); the earned income tax credit, the child tax credit, and the American Opportunity (Hope) tax credit all revert to old, lower limits and less generous rules; and individuals will no longer be able to deduct student loan interest after the first 60 months of repayment. Lower alternative minimum tax (AMT) exemption amounts (the AMT-related provisions actually expired at the end of 2011) mean that there will be a dramatic increase in the number of individuals subject to AMT when they file their 2012 federal income tax returns in 2013.

New taxes

Beginning in 2013, the hospital insurance (HI) portion of the payroll tax--commonly referred to as the Medicare portion--increases by 0.9% for individuals with wages exceeding $200,000 ($250,000 for married couples filing a joint federal income tax return, and $125,000 for married individuals filing separately).

Also beginning in 2013, a new 3.8% Medicare contribution tax is imposed on the unearned income of high-income individuals. This 3.8% contribution tax applies to some or all of the net investment income of individuals with modified adjusted gross income that exceeds $200,000 ($250,000 for married couples filing a joint federal income tax return, and $125,000 for married individuals filing separately).

Mandatory spending cuts

The failure of the deficit reduction supercommittee to reach agreement in November 2011 automatically triggered $1.2 trillion in broad-based spending cuts over a multiyear period beginning in 2013 (the official term for this is "automatic sequestration"). The automatic cuts are to be split evenly between defense spending and non-defense spending. Although Social Security, Medicaid, and Medicare benefits are exempt, and cuts to Medicare provider payments cannot be more than 2%, most discretionary programs including education, transportation, and energy programs will be subject to the automatic cuts.

Understanding the "cliff"

Many fear that the combination of tax increases and spending cuts will have severe negative economic consequences. According to a report issued by the nonpartisan Congressional Budget Office (Economic Effects of Reducing the Fiscal Restraint That Is Scheduled to Occur in 2013, May 2012), taken as a whole, the tax increases and spending reductions will reduce the federal budget deficit by 5.1% of gross domestic product (GDP) between calendar years 2012 and 2013. The Congressional Budget Office projects that under these fiscal conditions, the economy would contract during the first half of 2013 (i.e., we would likely experience a recession).

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