The Fiscal Cliff

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- Without action from Congress, income, capital gains, dividends, and estate and gift taxes are slated to soar as of January 1, 2013.
- Combined with federal spending cuts that are scheduled to begin in 2013, this "fiscal cliff" will have a serious negative impact on economic growth without congressional intervention.

Economic headlines have wreaked havoc with the stock market recently. Whether it has been the ongoing European debt crisis, a deceleration of growth in China, or our own tepid economic and employment growth, these types of headlines led to a decline in the U.S. stock market during the months of April and May. As if this wasn't enough to shake investors' confidence, at the beginning of 2013 we face what has become known as a "fiscal cliff," or a combination of reduced federal spending and increased federal taxes, which are expected to be a meaningful drag on economic activity next year if nothing is done to alleviate their effects.

Federal Tax Rates to Rise

Under the Tax Relief Acts of 2001 and 2003 and subsequent extensions, the lower rates that we have enjoyed over the past decade sunset at the end of this year and revert back to the rates in effect previously. Consequently, only those in the current 15% federal income tax bracket will not experience a rise in income tax rates. Those in the 10% federal income tax bracket will see an increase to 15%, 25% will go to 28%, 28% will go to 31%, 33% will go to 36%, and 35% will rise to 39.6%.

Long-term capital gains tax rates will rise for everyone. For those in the new 15% income tax bracket, the capital gains tax rate will increase from 0% to 10%. For those in higher income tax brackets, the capital gains tax rate will increase from 15% to 20%. With assets held for at least 5 years, the capital gains tax rate will be 8% (instead of 10%) and 18% (instead of 20%), respectively.

Interest income will continue to be taxed at ordinary income tax rates, though at the new higher rates as outlined above. However, tax rates on qualified dividend income will experience a notable increase from 15% for most taxpayers to their new ordinary income tax rate.

Two other tax changes for 2013 involve payroll taxes and taxes related to health care reform. The employee -paid component of Social Security payroll taxes, which had been reduced to 4.2% from 6.2% for 2011 and 2012, will revert back to 6.2% in 2013. In addition, higher earners (those with incomes above $200,000 for individuals and $250,000 for couples filing jointly) will be subject to a new health care reform tax of 3.8% on taxable investment income, such as interest, dividends, capital gains, rents, and royalties; however, retirement plan distributions and municipal bond interest will be excluded. This tax would be eliminated if the U.S. Supreme Court declares the health care reform law unconstitutional in its entirety.

Other noteworthy tax changes will also begin in 2013, including a reduction in the child tax credit, a reduction in the estate and gift tax exemptions, and an increase in estate and gift tax rates. A more extensive discussion of these and other tax changes slated for 2013 are beyond the scope of this article.

Deficit/Economic Impact

In addition to the tax increases scheduled to take effect in 2013, discretionary federal spending is slated to be reduced by $2.1 trillion over the next ten years based on the congressional compromise reached last August, with many of these cuts set to begin in 2013. Based on Congressional Budget Office (CBO) estimates, if the tax increases and spending cuts occur as scheduled, the federal budget deficit will be reduced by several hundred billion dollars or 5.1% of GDP during 2013. However, this will also drive the U.S. into a recession during the first half of 2013, according to projections by the CBO.

Given the draconian economic impact these scheduled tax rate increases and spending cuts would have, Congress is expected to reevaluate them during the post-election lame-duck session this fall or in early 2013.