fiscal cliff– is there anything I can do?

with kirk swartzbaugh

In today's world many of us live paycheck to paycheck. Regardless of our income, the majority of the world is just breaking even at different levels. The more we earn, the more we spend on mortgages, education, necessities, and "niceties"….and TAXES! The "fiscal cliff" economists are talking about refers to the spending cuts and tax increases scheduled to take effect in 2013 if Congress does not take action to remove or modify the current plan. In this article, we will only focus on the tax aspects.

If Congress does nothing, the following will occur:

- The top tax rate on Ordinary Income will rise from 35% to almost 44% (almost a 25% increase)
- The top tax rate on Capital Gains will rise from 15% to almost 24% (almost a 60% increase)
- The top Dividend Tax Rate increases from 15% to almost 44% (almost a 300% increase)
- The Estate Tax Exemption drops from $5,000,000 to $1,000,000 and Rate rises from 35% to 55%

For many of you, this is not good news! That being said, there are things you can do personally and corporately to take advantage of the more favorable tax atmosphere during the remainder of 2012 or minimize the impact on your finances in 2013.

- To reduce the effect of the increase in the Tax Rate, individuals could contribute as much as they can, to Qualified Plans (i.e. 401(k)s, Individual Retirement Accounts (IRAs), Health Savings Accounts (HSAs), etc.) to lower your taxable income. Lowering your taxable income will lower your tax liability. Corporations could consider Non-Qualified Deferred Compensation (NQDC) Plans for their highly compensated individuals so the executives/key-employees can defer more than their Qualified Plans allow due to IRS limitations on 401(k), IRA and HSA contributions. The beauty of NQDC plans to employers is that after a few years of executives deferring their own monies, the executive is less likely to leave the company due to the tax consequences. Since NQDC accounts can't be rolled over, they are paid out as additional ordinary income when they leave the company.

- To capitalize on the Capital Gains rate before the change, individuals could consider selling concentrated holdings such as single stocks and/or personally owned businesses in 2012. This may help prevent "having all of your eggs in one basket." Although diversification does not ensure a profit or protect against loss in a declining market, there will not likely be a better time tax-wise to sell some of the single stock holdings and diversify. And if you are on the fence about selling your business, you will likely net take home a lot more money in 2012 than you will in 2013.

- The increase to the Dividend Tax Rate may cause people to re-think the currently popular investment philosophy of chasing dividend-paying stocks. Many people feel chasing trends to be pointless, especially when the stock price on a dividend-paying stock typically fluctuates in sync with the dividend payment (i.e. it is simply returning your money earlier, rather than adding value). Plus, it is taxable, and in 2013, that tax rate may increase significantly.

- Last but definitely not least, is the once-in-a-lifetime $5,000,000 Estate Tax Exemption. This means a husband and wife can pass a combined $10,000,000 to their heirs without incurring any Estate Taxes (assuming no claw back or retroactive change in the future). The consensus among the experts on this subject is that few think it will remain at such a high level, so we believe this is a heck of an opportunity.

In summary, even though the "fiscal cliff" is pretty alarming, there are a few things you can do to take advantage of / prepare for it in advance.

For more information, please contact your trusted advisor at Swartzbaugh-Farber – 'Client Centered – Client Advocates™'.