



FISCAL OUTLOOK: ARE WE ANY CLOSER TO A GRAND BARGAIN?

Fiscal Cliff Calendar	
Date	Event
December 3-6, 2012	Lame duck House third session
December 11-14, 2012	Lame duck House fourth session
January 1, 2013	Fiscal cliff
January 8, 2012	New Congress is sworn in
January 20, 2013	Obama is sworn in
Mid-late January 2013	Debt limit likely reached

Source: BofA Merrill Lynch Global Research

After a close campaign, President Obama has been re-elected, the Democrats retain control of the Senate, and the Republicans maintain control of the House. The question now is if and when the President, the Senate, and the House will compromise to solve the pending fiscal cliff. Following the election results, markets sold off sharply with the S&P 500 losing 5.3% in the following week. Investors were initially concerned that officials would continue to fail to come to any workable compromise. Now, as officials speak of negotiations,






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investors watch with baited breath to see if our leaders can resolve the fiscal cliff in lame duck sessions by the end of the year. Markets are showing some recovery, with the S&P 500 now down only 2.1% since the election.

THE RESULTS ARE IN, BUT NOT MUCH HAS CHANGED

The return of the same political leadership we have seen over the past two years leaves the U.S. with a deeply divided government that will likely make compromise in deficit discussions difficult.

	2012 Election outcome	Previous Election outcome	Net change	Commentary
White House 	Obama <ul style="list-style-type: none"> Popular vote: 50% - 48% Electoral College: 332 - 206 votes 	Obama <ul style="list-style-type: none"> Popular vote: 53% - 46% Electoral College: 365 - 173 votes 	<ul style="list-style-type: none"> Popular vote margin: -5% Electoral College: -33 votes 	<ul style="list-style-type: none"> Obama swept all battleground states to win decisively within the Electoral College, but he is still the only incumbent to win reelection by smaller popular vote margin Will be focused on legacy building: deficit reform, climate change and immigration Key first test: How he handles fiscal cliff negotiations – hammer or olive branch?
House of Representatives 	Republican Majority <ul style="list-style-type: none"> 238 - 197* seats 	Republican Majority <ul style="list-style-type: none"> 243 - 192 seats 	<ul style="list-style-type: none"> Loss of 5 seats 	<ul style="list-style-type: none"> Republicans maintain control, Tea Party candidates mostly successful Fewer moderates on both sides (e.g. Blue Dog Democrats nearly non-existent) <u>More</u> partisan overall Watch language from Congressional leadership for clues on future willingness to compromise
Senate 	Democratic Majority <ul style="list-style-type: none"> 55 - 45** seats 	Democratic Majority <ul style="list-style-type: none"> 53 - 47 seats 	<ul style="list-style-type: none"> Gain of 2 seats 	<ul style="list-style-type: none"> A surprising victory for Democrats who unexpectedly picked up seats in IN and MA, and held vulnerable seats in VA, MO, WI, ND & MT Given close races in 2012 and with expected close races in 2014, Senate may be <u>less</u> partisan with some Democrats and Republicans more inclined to compromise

* Projected

** Includes two Independents who are presumed to caucus with Democrats

Source: PIMCO

THE FISCAL CLIFF

The fiscal cliff refers to the agreement lawmakers have to reach by the end of 2012 with regard to tax and spending policies to avoid plunging the nation back into recession. Table 1 displays the upcoming fiscal cliff policy changes along with two options which could minimize the drag on GDP growth. It is comforting to note that there is more agreement than disagreement between parties on the actions needed to avoid the fiscal cliff.

At this time, the majority of investment professionals see three possible outcomes. Market Street believes the best-case scenario is that government officials will decide on a short-term agreement that will avoid the fiscal cliff and lay out the framework for a “grand bargain.” The base-case scenario is that officials are unable to make enough progress with the limited time available to them, and are only able to accomplish a short-term agreement which avoids the full fiscal cliff. This outcome would result in continued policy and economic uncertainty for individuals and businesses. The worst-case scenario is that officials refuse to budge on the key items being disputed, temporarily plunging us over the fiscal cliff and into a recession.

Table 1 - Fiscal cliff options, in billions and percentage of GDP

Increased Revenue from:	Legislated	Option #1	Option #2
Expiring payroll tax holiday	115	115	115
Expiring personal tax provisions	27		
Expiring business tax provisions	75		
New healthcare taxes	24	24	24
Alternative Minimum Tax	40		
Expiring Bush tax cuts for Upper Income earners	83	83	
Expiring Bush tax cuts for remaining earners	171		
Total increase in revenues	535	222	139
Reduced Expenditures from:			
Lower Medicare physician reimbursement	14		
Ending extension of unemployment benefits	33	33	33
BCA* spending reductions (Sequester)	85		
Total expenditure reductions	132	33	33
Total fiscal adjustment	667	255	172
Total fiscal adjustment (%GDP)	4.3%	1.6%	1.1%

*BCA is the Budget Control Act of 2011

Source: Tax policy Center, CBO, J.P. Asset Management

MARKET OUTLOOK

This persistent policy uncertainty directly affects business growth as businesses have put off spending and hiring as they await a clear outcome of policy changes. Also, there are concerns over whether the deal made will be enough to avoid another rating downgrade of U.S. debt. On a more positive note, it is generally expected that the re-election of president Obama will mean continued accommodative monetary policy given his support of Federal Reserve chairman Ben Bernanke. Current policy should continue to aid the recovery of the housing market, a key driver of U.S. economic growth. As speculation remains over what a “grand bargain” may look like, leading economic firms see the following items as almost certain to take effect:

- The 2% Payroll tax cuts are likely to expire. However, JP Morgan believes this will have a less than expected impact on economic growth as individuals opt to decrease savings rather than cut spending.
- A 3.8% Medicare surcharge on investment income (capital gains & dividends) for higher tax rate payers will not likely be repealed. The additional 0.9% tax on employment income above \$250,000 (joint filers) is likely to go into effect.
- Neither party is expressing any interest in continuing with extended unemployment benefits; the current extension of up to 99 weeks of benefits is due to fall to the normal 26 weeks on January 2nd, 2013.

The bottom line is that although cutting spending and/or raising taxes could potentially slow GDP growth in the U.S., the deficit is growing at an unsustainable rate and must be addressed. According to Vanguard’s chief economist Joe Davis at a recent financial advisor conference, there are five options to fix the deficit problem; default, growth, belt tightening, inflation, or financial repression. Of these, Davis stated that financial repression is what the U.S. has been doing, inflation is too dangerous at this stage in our recovery, and default is not an option. This leaves growth and belt tightening which will require a bi-partisan compromise in order to be successful.

As mentioned in our second quarter Investment Review, Market Street feels it is unlikely that the government will fail to take any action and allow the combined spending cuts and tax increases to come to terms. Given the enormous cost of non-action to the economy, we can only hope that politicians will come to a last-minute agreement. While this will not alleviate the effects of uncertainty over the short term, it will likely result in a fiscal drag well below the worst case scenario of 4.3% and allow the U.S. to continue on a path of slow but steady economic growth.

TAX TALK

Our September Tax Talk described the opportunities presented in 2012 for both income and wealth transfer tax savings. During 2011 and 2012, Market Street has done significant tax planning to ensure that our clients maximize tax savings according to their respective circumstances. As the remaining window of opportunity closes, we are looking to Congress for direction in the coming year and beyond.

The fiscal cliff looms and another year of tax uncertainty could be on the horizon. With the re-election of President Obama, all eyes are now watching for the compromise that current lawmakers have been unable to reach during the last four years. Many expect the looming fiscal cliff to spur another extension of expiring legislation since there is no time to implement a comprehensive solution before year end. The one thing that seems certain, however, is that given revenue and budget concerns, taxes will eventually rise.



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WHAT WE KNOW

There are a few legislative changes that will become effective in 2013. The Health Care Reform legislation will most likely NOT be repealed on January 1, 2013. Good, bad or indifferent on the greater issue, the enactment means new Medicare taxes will begin on January 1, 2013. Wage earners can expect to pay an additional tax of 0.9% tax on earnings over \$200,000 for singles in 2013 (\$250,000 for married filing jointly) and individuals should plan to spend an additional 3.8% for tax on unearned income in excess of \$200,000 for singles (\$250,000 for married filing jointly) to fund the program.

*Health Care Reform
will NOT be repealed,
so new Medicare taxes
take effect in 2013.*

*2013 Annual exclusion
amount is increased to
\$14,000*

For gifting and estate planning in 2013, the annual exclusion amount is increased to \$14,000 (\$28,000 for married couples who gift-split.) If done annually, this gifting strategy can be a powerful wealth transfer tool.

INCOME TAX OUTLOOK

Three possible scenarios addressing the income tax uncertainty have been discussed by commentators.

Scenario #1: If Congress cannot reach a compromise, income taxes will revert to pre-Bush-era tax cuts. The maximum ordinary income tax rate will be 39.6%, qualified dividends will be taxed at ordinary rates (maximum 39.6%) instead of 15%, capital gains rates go up to 20%, itemized deductions will be subject to limitation and AMT will not be inflation-adjusted thereby affecting many more taxpayers. Those changes, coupled with the new Medicare taxes, will potentially create a significant tax increase for most taxpayers. This scenario is unlikely due to the negative impact to the economy.

Scenario #2: Congress could enact another “kick the can down the road” fix, extending the Bush-era tax cuts for a short time. This extension would allow time to write comprehensive tax reform and would save taxpayers from a radical upward shift in taxes all at once.

Scenario #3: The third scenario would be enactment of the taxes proposed by President Obama. His proposal is to extend the Bush-era tax cuts for all but the wealthiest taxpayers.

Each of the scenarios has possibilities; each addresses part of the problems coming with the end of the year. Which one will ultimately be selected is, at this point, anyone’s guess.

ESTATE PLANNING

The estate planning environment is very similar to the income tax arena – no certainty except there is probably a less favorable environment in the near future. President Obama has made a proposal that would increase the tax rate to 45% and bring the estate and Generation Skipping Transfer exemptions down to \$3.5M rather than allowing the rate to go back to 55% with exemptions of \$1M, but so far there is no agreement. There is also discussion of having the gift tax exemption revert to \$1M. If the rates do revert, an additional negative to consider is the elimination of the portability of a spouse's unused exemption. This could mark the end of a period permitting some of the best wealth transfer options US taxpayers have ever seen.

CONCLUSION

Expect the debate to continue as 2012 winds down. Up to this point, Congressional observers are as split as Congress itself with predictions covering all of the above scenarios as well as mutations of each. The willingness of Congress to come to a compromise on the issues as each side tries to stick to their underlying values remains the most significant barrier to a timely agreement. Market Street will continue to monitor legislation and will communicate the details of the decision on taxes when they happen.