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“What do we do if we go over the edge of the ‘fiscal cliff’?”

By Timothy E. Flatley

The numbers are stark and demand action: The 2012 federal budget has total spending at $3.6 trillion and total revenues/taxes at $2.45 trillion (or 68 percent of spending). This creates a shortfall of $1.17 trillion. Scheduled to take place on January 2, 2013, are $1.2 trillion of automatic spending cuts and a series of tax increases on dividends, capital gains and income. Rather than attend to these changes before the election, our government representatives have pushed the deadline to year's end. This leaves very little time for a lame duck congressional session to address the issue.

While we can hope that the governmental dysfunction will subside and a reasonable solution will be reached, we have to plan for the possibility that nothing will be resolved. The following tactics would make sense to implement, once it becomes apparent that we are headed over “the cliff.”

Let us start with earned income. Normally, we advise clients to defer income to future years to reduce the current year's tax burden. Instead we are now advising clients to accelerate income into 2012 to take advantage of the lower tax rates. Sheltering of income also takes on greater importance. Beyond the obvious strategy of maximizing 401(k) deferrals, consider establishing a pension plan, which can allow for much larger contributions.

Continuing the retirement plan theme, the conversion of traditional IRAs into Roth IRAs has become more attractive. You will be required to pay taxes on the converted amount, but assuming no change in the tax status of Roth IRAs, future earnings will be tax free. If your company's plan allows for it, you could also explore taking an in-service distribution from your 401(k) and converting it to a Roth IRA.

With the prospect of rising capital gains tax rates, it may be advisable to sell stocks with unrealized gains, to lock in the lower 2012 rate of 15 percent. Unlike what happens with stocks sold at a loss, you can immediately purchase back a stock sold for a gain. Keep in mind that you may need to set aside funds to cover the tax liability when repurchasing the original position. Municipal bonds would become another more valuable investment tool, assuming you can find issues with a reasonable yield. This may require purchasing lower-quality bonds or waiting for a spike in yields.

Yet another investment vehicle that should be considered is the master limited partnership (MLP). MLPs are typically in the oil/gas space and normally provide distributions in the 4 percent to 6 percent range. Your tax return may become a little more complex, as the distributions are reported on a form K-1 versus a 1099. However, the K-1 allows for the flow-through of losses from the entity, which can reduce the taxes on the yield.

You can also defer the tax liability on gains through the use of a 1031 exchange. The 1031 allows you to exchange “like property” in lieu of selling a property and purchasing another. Gains are deferred and in some situations may be eliminated entirely. You can request our recent *Worth* magazine article on 1031 exchanges or discuss the other investment strategies referenced here by contacting us at 877.430.7382.

TACTICS TO DEAL WITH THE FISCAL CLIFF

1) Accelerate income into 2012
2) Max-out your retirement plan contributions
3) Convert your traditional IRA to a Roth IRA
4) Take capital gains in 2012
5) Look at MLPs for investment
6) Consider 1031 exchanges vs. outright sales

The Delaware Valley region is defined as the following counties: Pennsylvania—Berks, Bucks, Chester, Delaware, Montgomery, Philadelphia; Delaware—New Castle; Maryland—Cecil; and New Jersey—Atlantic, Burlington, Camden, Cape May, Cumberland, Gloucester, Mercer, Ocean, Salem.

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