



The Fiscal Cliff: Crisis Averted?

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Agenda

- Fiscal Cliff 101
 - What is the Fiscal Cliff?
- American Taxpayer Relief Act of 2012
 - Almost Provisions
 - In-plan Roth Conversions
 - Participant Impacts?
- What's Next for the Markets?
 - Tax, Spending and Debt Ceiling Debates
 - Fiscal Policy
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- Questions and Answers

Fiscal Cliff 101

What is/was the fiscal cliff?

- Term popularized by Fed Chairman Ben Bernanke in February, 2012
- Refers to steep decline in deficit anticipated if George W. Bush-era tax cuts expired on December 31, 2012
 - Estimated to raise taxes by \$494B in 2013
 - Coupled with mandatory spending cuts of \$1.2T set to go into effect on January 3, 2013
- Congressional Budget Office recently opined that the cliff would have led to recession and 9% unemployment in late 2013

American Taxpayer Relief Act of 2012

- ATRA passed on January 1, 2013 in the twilight of the 112th Congress
 - Senate: 89 – 9
 - House of Representatives: 257 – 167
- Signed by President Obama and enacted on January 2, 2013
- ATRA resulted in a less severe decrease in the 2013 deficit relative to 2012 as compared to the sharp decline projected under the fiscal cliff
- Delays sequestration (i.e. automatic spending cuts) for 2 months
- For an easy summary of ATRA's provisions, read our January 2013 Benefits Digest article "[The Fiscal Cliff Act: A Thirteenth Hour Compromise](#)"

Almost Provisions

- ATRA was introduced in its original bill form on July 24, 2012 spawning vigorous debate and numerous revised versions
- With regard to retirement plans, prior versions of ATRA included a modified salary deferral limits structure seeking to significantly reduce deferrals/increase taxable income
- In the final version of ATRA, the 3.8% passive income surtax imposed on certain higher income investors does not apply to retirement plan distributions

In-Plan Roth Conversions

- The ATRA provisions most directly impacting retirement plans relate to in-plan Roth conversions
- A last minute addition to ATRA in an effort to capture additional short-term tax revenue
 - Estimated to produce \$12.1B in revenue over the next 10 years
- 401(k), 403(b) and governmental 457(b) plans may allow participants to defer on a Roth basis
 - After-tax deferrals separately recordkept as Roth source
 - Tax-free earnings at distribution if certain requirements are met
 - Requires plan amendment by employer
 - Available since EGTRRA 2001 and PPA 2006
- In-plan Roth conversions allow for current year taxation on amounts converted to Roth status
 - Prior to ATRA, in-plan Roth conversions required a distributable event precipitating an eligible rollover distribution under IRS Notice 2010-84
 - Converted amounts not subject to 10% distribution penalty
 - ATRA
 - Eliminated the distributable event requirement
 - Stated that conversions are not subject to the 3.8% surtax on investment income of certain higher income earners

In-Plan Roth Conversions

- In-plan Roth conversions are irrevocable
- Participants may use in-plan Roth conversions to avoid the uncertainty of future tax rates
- Participants who expect to be in higher future tax brackets may convert to pay tax at their current/lower tax rate
- Available to surviving spouse beneficiaries and spousal alternate payees, but no other beneficiaries or alternate payees
- Check with retirement plan recordkeeper prior to adoption to ensure capabilities and ensure appropriate employer-level processes
 - Consider potential effects on distribution procedures and required 402(f) notice
 - Communicate effectively to participants to promote utilization
- Awaiting further clarifying guidance from the IRS

Participant Impacts?

Will plan sponsors/participants take advantage of in-plan Roth conversion provisions?

- Pre-ATRA underutilization
 - Is ATRA's liberalization enough to cause a shift?
- Can participants afford the tax bill?
 - IRS suggests increasing withholding to plan for tax liability

Will participants' tax burdens affect how they participate in the retirement plan?

- Some education campaigns encouraged a 2% deferral increase when the payroll tax rate was cut by 2%
 - Will participants decrease deferrals by 2% now?
- Retirement plan distributions are not subject to 3.8% surtax imposed on investment income of certain higher income earners

What's Next for the Markets?

- ATRA provided (temporary) relief related to mandatory spending sequestrations
- The likelihood of a “Grand Bargain” appears low
- Debt Ceiling Debate Part 2
 - House of Representatives passed an extension through May 18, 2013 to provide an opportunity for a broad agreement on spending and tax policy

Tax Debate Structure

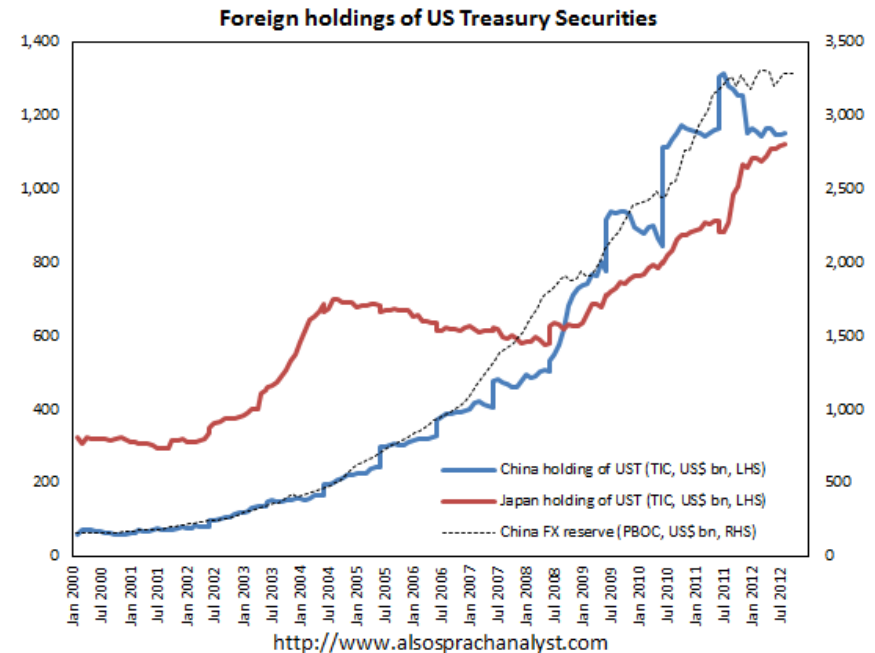
- Debates about taxes and deductions typically revolve around specific taxes and deductions and an assessment of the worthiness and impact of changes
- Urgency of the debt ceiling will make such an assessment unlikely
- More likely changes:
 - Hard cap on the dollar value of deductions
 - Already addressed by the Alternative Minimum Tax
 - Hard cap on the deduction “rate”
 - Discussion of exempting the deductions for municipal and other tax-exempt bonds

Spending Debate Structure

- Best opportunities for agreement lie within Simpson-Bowles
- Sequestration would have impacted defense and discretionary spending
 - Immediate impact on GDP
 - Sequestrations to Defense and Non-Defense Discretionary would have had a \$93 B impact on GDP for 2013, roughly equal to 0.60% of GDP
- Possible alternative – modifications to eligibility and calculation of Mandatory Spending items
 - Chained CPI for Social Security
 - Extend the age for Social Security and Medicare

Fiscal Policy

- Potential for Bernanke to retire at the close of 2013
- Likely replacement Janet Yellen, current Vice Chair of the Federal Reserve
- Monetary policy likely to remain consistent
- Continuation of Quantitative Easing
 - Treasury purchases
 - Mortgage-backed security purchases
- China's rate of growth and purchases of Treasuries have declined
 - Fed's purchase program has only augmented purchases from other sovereign entities



Market Impacts

- Market volatility around critical fiscal policy deadlines
- Low inflation at least through 2013
- Negative real return on the risk-free rate
 - Pressure on the Euro and Yen
- Bank of Japan has announced the intent to stimulate the economy of Japan
- Heavier allocations to equities, real estate, and commodities in pursuit of return
- Modifications in investment strategy for tax sensitive investors

US Stock Market Performance

Russell 3000 Index with Selected Headlines from 2012



Source: Russell Investment Group.

In US Dollars. Index is not available for direct investment. Performance does not reflect the expenses associated with management of an actual portfolio. Past performance is not a guarantee of future results.

Questions & Answers

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