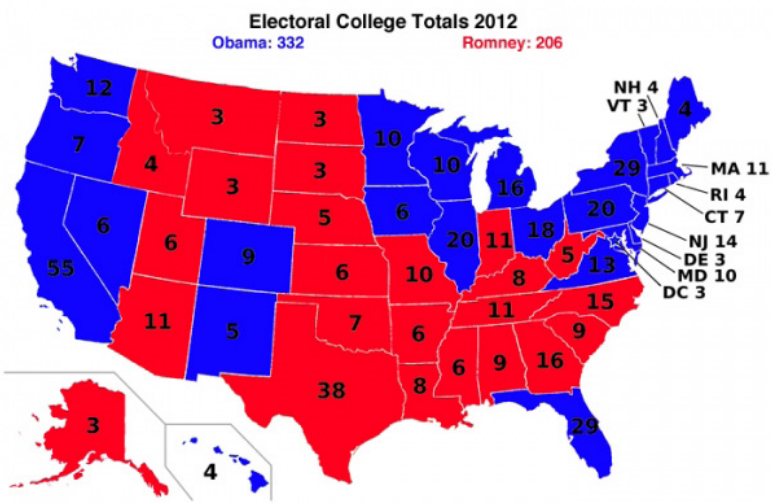
PRAETORIAN GUARD

SPECIAL ELECTION ISSUE: FISCAL CLIFF November 2012

Thoughts on the Election's Impacts

As we eluded to in our most recent newsletter, the time to decide was upon us. It came. We voted and ultimately did NOT decide (with a degree of clarity) the future path we want our elected officials to take. The implications are discussed in this biennial edition of Praetorian Perspectives.



THE CHOICE AND THE DECISION

At its heart, this election was about a choice of how to solve the fiscal challenges facing America—those are both short-term (annual deficits) and long-term (structural unfunded liabilities in entitlement programs). There are many related issues: unemployment and taxes are high on the list, but at the core is a choice.

As a nation, we decided to maintain divided government and give our elected officials one (final?) chance to put the country first and solve the problems. The only option remaining for the Executive and Legislative branches is to compromise—time has run out for any of the normal Washington shenanigans.

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PEERING INTO THE CRYSTAL BALL

There are two events within the next four months that will put this issue in a position where it has to be dealt with: first, the "fiscal cliff" of January 1, 2013 when current tax rates rise and a host of budget cuts (the sequester) kick in; second, the debt ceiling will be reached by mid-February 2013.

This is actually a good thing. We believe that we are at a once in a political generation moment where neither party can dictate its will to the other. The timing of those two events make it impossible to "kick the can down the road" to the next election. We already did that in 2011.

President Obama and Speaker Boehner are going to spend more time together in the next few months than the past several years—not by choice but by necessity. Both leaders must recognize that their objectives are three-fold:

1. Improve conditions for the private sector that will allow the economy to begin to accelerate from its meager growth of the last three years. This means temporary measures won't work; targeted measures won't work—businesses large and small require knowing the tax rules and rates for the long-term in order to plan based upon a multi-year horizon.
2. Increase the tax revenue (which is not the same thing as increasing the tax rates) received by the Federal Government with minimal adverse impact on accomplishing item #1 above.
3. Decrease spending at the Federal level (in a verifiable manner) which is accepted by the debt markets and the credit rating agencies. Without action we'll see our deficit financing costs rise, if not skyrocket, in the next few years.

What this looks like already exists—it's going to be an updated Simpson-Bowles Commission version 2.0. Those interested in the details can find the full report on the Praetorian Guard website (www.praetorianguard.biz/news-resources.html). We recognize this plan was rejected in 2010. However, it now stands as virtually the only existing comprehensive plan with the possibility of enactment within the time constraints of the fiscal cliff and the debt ceiling being reached.

THE PROBLEM AND THE BENEFIT OF EXTERNAL DISCIPLINE

Our elected leaders need to recognize and address the obvious fact (to most outside the Washington Beltway) that we have both a spending and revenue problem. We must acknowledge that Washington's "default" is to work on the revenue issue today and use accounting tricks for the spending issues of tomorrow (which never seem to materialize in practice). We believe this pattern will no longer work because bond markets will not accept gimmicks given the nation's debt now exceeds the value of the US economy. The market made clear in August 2011 (with the first ever downgrade of US debt) that the rules were in the process of changing.

Identifying the issues is not difficult:

Short-term: We spend too much at the Federal level and have insufficient revenues to meet current demands. Each dollar borrowed today only exacerbates the long-term problem (see below).

Long-term: Our social programs' unfunded liabilities, primarily Medicare at $38.6 trillion and Social Security at $8.6 trillion (according to the 2012 Trustee's Reports) will BREAK the Federal Government within the next 30 years.

SPECIFICS WE EXPECT TO SEE BY APRIL 2013

Tax Reform:

This is the most important aspect of any deal because it allows both the President and the Republicans to claim victory and "save face" simultaneously. Under this broad heading, Congress must eliminate most of the $1.1 trillion in tax expenditures embedded in the tax code. Tax expenditures are those exemptions, deductions and credits in the tax code which reduce the Government's revenue intake and thus increase the deficit (just as if Congress had appropriated and borrowed the money for the same purpose).

The benefit: over a period of years eliminating (best option) or capping (acceptable option) these expenditures will increase tax revenue and reduce economic distortions. The greater revenue allows for reductions in marginal tax rates for all income brackets.

The cost: No one's ox can be spared—ALL must be gored. Congress and the President must be deaf to the screams—the Republic will NOT end if we adjust the deductibility of mortgage interest or eliminate some of the 44 federal job training programs.

Second, we expect marginal rate reduction. This is the breaking point for the Republicans. If they can claim "victory" here with a reduction and perhaps consolidation from the current 5 brackets to 3-4 brackets, virtually all else is possible.

Third, and most significant to getting business support, is a change to the corporate tax code by adopting a territorial tax system. Currently, US business profits are taxed where earned and then if repatriated to the USA, an additional tax equal to the difference between the US rate and the foreign rate where earned is assessed. Thus, if the foreign rate is lower (as it is for a significant number of our competitors), the foreign profits never return to the USA. The economic literature on this is virtually all focused on a "tax holiday's impact" and not a permanent tax change. The objective again is to increase conditions for growth AND increase government revenue. This action does if enacted on a permanent basis.

The key point here is that an opportunity like this last happened in 1986— we may not see the necessary political conditions to make this happen again for a long time.

Federal Spending: The benefit of divided government is that there will be no large new spending programs and we'll have to slow the growth (called a cut by the mathematically challenged) of existing programs. The focus of all will be on tax reform.

Social Security Reform: In 2011, the US paid out over $738 billion in benefits (20% of Federal expenditures). At the same time, the "Trust Fund" is projected to be exhausted by 2037—we face at least a 22% across the board cut for every year thereafter. This is unacceptable, but it is the current "plan" (if one can call it that).

We expect to see modifications for at least two parts of Social Security, with phase-in starting in 2014 and being fully implemented by 2025.

1. The amount of wages subject to FICA will increase at a faster rate than the 4.3% average annual increase since 1984. The current limit for 2013 will be $113,700 and we predict a cap on earnings subject to Social Security Tax will remain but that it will rise at a faster rate.
2. The Full Retirement Age, currently age 67 for those born after 1959, will increase to account for greater life expectancy and years in retirement. This is virtually identical to the 1983 reforms and is aligning the demographic reality with the fiscal situation. This will have a very long implementation time and those under age 45 should expect that their Social Security full retirement age (and likely the early retirement option) will be affected.

IMPACTS ON FINANCIAL PLANNING, MARKETS AND THE ECONOMY

Marginal Income Tax Rates: Uncertain as of this writing is if rates are rising for the top two brackets or if other tax expenditures are reduced/eliminated. We expect that the top two brackets will increase to their Clinton era levels but that there may be some carve out for business entities that file as individuals (S Corporations, LLCs, etc).

Estate Tax: It will be a part of the tax reform, will NOT be eliminated and will see relatively large exemption equivalents (we predict $3.5 million per person with continued portability). Until legislation is enacted, our recommendation is to hold off on any updates to the estate plan currently in place. This will have no discernible impact on markets.

Dividends and Capital Gains Tax Rate: This will be a more heated battle than the estate tax but expect to see an increase in the tax rate associated on these two forms of income but retaining a lower rate than ordinary income. Our prediction is a 20-25% rate compared to the current 15% level. By the time this is enacted, perhaps by the time you are reading this, its impact will already be priced into the market.

Gift Tax Exclusion Amount and Tax Rate: Currently at $5.12M per person (doubled for a married couple) with a 35% tax rate above that. This dollar amount will almost certainly be reduced after the first of the year while the tax rate increases. Clients in the position to make gifts larger than the annual exclusion amount should consider completing those gifts by 12/31/2012 to take advantage of the current exclusion amount.

Unemployment: It will remain at current levels (7.9%) through Q1 2013 as long as firms see progress on the tax and spending reform. If the nation takes the plunge off the fiscal cliff, this will return to 9% or higher by the end of 2013. While a lagging indicator, this is one of two bellwether statistics (the other being the 10-year treasury note interest rate) which reflects if businesses believe progress is being made.

Inflation: Continue to expect this to be manageable, defined as in the 1% to 2.25% range. The economic situation in Europe and the short-term excess capacity in the United States will keep inflation muted for the next 12-24 months.

Closing Thought

You cannot escape the responsibility of tomorrow by evading it today.

—Abraham Lincoln