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'Holiday' on payroll tax is over

Take-home wages will drop; small investor keeps break

By Tim Grant
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Investors dodged a bullet — at least for now — in light of Congress passing an eleventh-hour fix for the fiscal cliff that will hold taxes steady for all but the wealthiest households. But financial advisers say the tax debate should be a wake-up call for people in all brackets.

President Barack Obama and members of Congress reached a deal to raise the federal income tax rate on individuals making more than $400,000 and married couples making more than $450,000 a year from 35 percent to 39.6 percent. The good news for individuals and couples making less than that amount is that their tax rates will not change.

Howard Davis, president of the Davis, Davis & Associates accounting firm, Downtown, welcomed the break in the impasse.

"It does help tremendously going forward to advise clients for the year 2013 and beyond as far as tax planning," he said. "A huge part of the frustration prior to the vote was not knowing where income tax rates would be for 2013 and beyond."

Mr. Davis said it is easier for investors to plan knowing the fiscal cliff deal will make permanent federal estate taxes that exclude the first $5 million in assets for individuals or the first $10 million in assets for married couples. The estate tax rate, however, will rise from 35 percent to 40 percent on assets exceeding the first $5 million or $10 million for individuals or couples, respectively.

For most Americans, the biggest impact from the tense negotiations on Capitol Hill will result from the expiration of a payroll tax "holiday" put in place two years ago.

That will raise the withholding from workers' paychecks (which shows up in the FICA line) by 2 percentage points to 6.2 percent until they reach the wage limit, which this year rises to $113,700. People who hit that limit before the end of the year get to stop paying the tax, which helps pay for Social Security.

While most workers will end up paying more than last year, the payroll tax rate is actually back to where it was in 2009 before Congress and the White House cut the tax to help consumers dealing with the Great Recession.

As the fiscal cliff worries heated up toward the end of 2012, some retail investors pulled money out of stocks and stock mutual funds.

According to EPFR Global, a Boston-based firm that tracks fund flows and asset allocation data for financial institutions around the world, more than $150 billion was removed from stocks, stock mutual funds and stock exchange traded funds in 2012. Meanwhile, about $90 billion flowed into bonds, bond mutual funds and bond exchange traded funds.

Beaver County investment adviser P.J. DiNuzzo said investors — especially stock market investors — could do themselves a favor by not overreacting to fears of trouble on the horizon for the U.S. and global economies.

"I believe 2012 will go down as one of the worst cases in history of retail investors zigging instead of zagging," Mr. DiNuzzo said. "The S&P 500 was up about 16 percent, yet the bonds and fixed-income investments many investors moved into were yielding only 1 or 2 percent.

"But investors who ignored all the doom and gloom were rewarded with stock market returns approximately twice as high as their historical averages. People on Main Street were pulling money out of stocks, but the smart money [investors] — pensions, endowments and hedge funds — were putting money in stocks, going in exactly the opposite direction."

Robert Fragasso, chairman and CEO of Fragasso Financial Advisors, Downtown, recommended converting income-oriented securities to growth stocks. Dividends and interest income are taxed at ordinary income rates while capital gains rates are lower.

The capital gains rate for most incomes will stay at 15 percent. Single filers earning more than $400,000 a year and married couples earning more than $450,000 a year will pay a 20 percent tax rate on capital gains.

No matter what happens, he advises investors to consider options for lowering their tax obligations.

"It doesn't matter whether your tax rate went up in the fiscal cliff aversion deal, the fact is you still have a top tax bracket," said Mr. Fragasso. "It may be the same as before. For the broad middle class, the top tax bracket is often 25 percent, which means you are giving 25 cents of every dollar you earn to the government.

"Why wouldn't you do everything you can to avoid paying more than you need to in taxes? You have all the more reason if you are now at the 39.6 percent tax rate."

One of his top suggestions is to make maximum contributions to 401(k) or similar retirement plans. This money is contributed before taxes.

"So a taxpayer gets, in effect, an interest-free loan from the federal government equal to that bracket to invest for themselves in their retirement plan," he said. "Taxes will be paid later, but the taxes saved will have created much more money meanwhile."

For 99 percent of investors, the effect of the fiscal cliff legislation will be small, but that doesn't mean they are out of the woods.

The second part of the legislation that deals with mandatory spending cuts to balance the federal budget has been pushed off for another two months.

"On a personal finance level, we still do not know how Medicare, Medicaid, Social Security and funding to state programs will impact us in 2013," said Michael D. Kresh, president of M.D. Kresh Financial Services in Islandia, N.Y. "There still is a gigantic budget deficit and different viewpoints on how much cutting should be done.

"When you consider that an estimated 800,000 defense workers would have been laid off based on the spending cuts that were about to take place, that could have affected the economy drastically," he said.

"At this point, we have really only dealt with part of the problem."

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