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December 19, 2012

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Clear Harbor Flash — The Fiscal Cliff: Hang In There

The combination of tax hikes and spending cuts known as the "fiscal cliff," which will take effect if Congress does not act before New Year's Day, has already begun to impact our economy. Hiring and capital expenditures have slowed while businesses wait for clarity on tax rates and potential macro impacts in 2013 and beyond. Delayed decisions on jobs and wages have placed households and consumers in limbo, helping explain a recent ebb in consumer sentiment. Hundreds of companies have paid early or special dividends this year to avoid the expected increase in taxes in 2013.

Having given considerable attention to potential impacts from the fiscal cliff, we at Clear Harbor are cautioning our clients to take a longer view of the potential policy impacts on their portfolios. No proposal currently on the table in Washington includes adjustments to the taxation of dividends and capital gains sufficient, in themselves, to warrant improvising dramatic adjustments to portfolio allocations. However, it is worth outlining the current state of negotiations between the White House and House Republicans, lessons from past major tax reform efforts, and the basic steps in the process to look for in the coming weeks, months and years.

Current Status: Improving Signals from Key Players

No outcome is yet clear, and political posturing—with attendant volatility in financial markets—remains foreseeable, quite possibly past January 1. However, the shape of concessions on both sides suggests that neither party wishes to risk responsibility for a complete impasse much beyond the technical deadline at year-end.

A few weeks ago, Rep. Cathy McMorris Rodgers (R-WA) won an important leadership post in the Republican House Caucus, signaling a more compromise-oriented approach from the House Republicans. Last week, Speaker Boehner made the important concession to accept the reality of higher income rates. On the Democratic side, President Obama has twice reduced his demand for new tax revenue, to $1.2 trillion from his original $1.6 trillion.

In short: leaders on both sides are trying to work together to avoid the worst scenarios, and all viable proposals exist within familiar frameworks for taxes and spending. No one at this stage is attempting the kind of "grand bargain" that would carry truly unpredictable implications for most investment decisions. (While we would celebrate a comprehensive solution to our long-term challenges, the lack of structural reform proposals does limit the scope of changes likely in the near term.)

History Predicts a Long Fiscal Debate Ahead

Some commentators see these events are bullish for short-term deal-making. However, beyond any near-term compromise to avert the cliff, our longer-term fiscal imbalances will still loom. History suggests that issues of such technical and political complexity will take a long time to completely resolve.
Let's start with tax reform. Ever since the Federal Income Tax Act of 1913 reestablished the income tax that had been phased out following the Civil War, we have had only three significant revisions to the tax

code, coming in 1939, 1954 and 1986. The ’54 and ’86 revisions were comprehensive reforms of tax codes that were far simpler than they are today, yet still took considerable time to develop. The ’54 reform began with deliberations in Congress and the Treasury Department in early 1953, leading to a plan that Eisenhower took to Congress in his 1954 State of the Union Address. The Internal Revenue Act of 1954 finally became law that summer (including its now infamous 91% top bracket). In 1986, President Reagan had 65% job approval and strong bipartisan support for tax reform, yet it still took him seventeen months to enact the new law.

This time, the challenge of broader tax reform is complicated by the imminent expiration of Bush tax cuts, the return of payroll taxes to pre-stimulus levels, the initiation of new taxes to fund programs under the Affordable Care Act (“Obamacare”), and the sequester and spending cuts from 2011 Budget Control Act. Nor do any of these issues reflect the greatest financial challenge our country faces: entitlement spending as the Baby Boomers retire.

Accordingly, any “2013” fiscal legislation will more likely not take effect until 2014. Indeed, we believe that a true reshaping of fiscal policy will require at least several distinct phases of negotiation. These may include:

1. **Down Payment (next two weeks):** The unusual scope of policy changes slated for the end of the year require, at a minimum, near-term solutions to avoid extraordinary risks to the economy, further ratings downgrades, financial market panic, and accompanying political fallout. We expect some agreement will be reached in near term, but with many provisions of a short-term nature.
2. **Debt Ceiling (next 0-3 months):** Also pressing is the need for some agreement to increase the nation’s debt ceiling. This may come as part of initial agreement over next couple of weeks, but the duration of the extension—one year or two—represents leverage to many Republicans, and may yet prove sticky.
3. **Next Fiscal Cliff (next 6-12 months):** Any short-term extensions agreed to avert immediate risks on January 1st will likely expire at some point in 2013, possibly creating a repeat of the current standoff if a broader agreement is still not finalized.
4. **Tax Reform and/or Entitlement Reform (next 1-2 years):** The longer-term fiscal policy changes will likely take years to finalize, as we saw in previous tax reforms. Medicare and Social Security are particularly sensitive matters, and ones where Democratic leaders perceive a mandate to fight any cuts in benefits.
5. **Implementation (next 0-30 years):** Due to the concern of having much of the policy changes resulting in too many short-term impacts, look for many of reforms to take shape over long-term. Even the Simpson-Bowles plan had some policies not phasing out until the year 2038.

Whatever immediate action is agreed to, federal policymakers will remain in the headlines for years. This why we are not looking to “trade” the fiscal cliff and, instead, look at investing over the longer term.

Changes in Long-Term Capital Gains Taxes: A Reality Check

Specifically, Clear Harbor’s analysis uncovers no compelling reason to liquidate favored holdings solely to realize taxable long-term capital gains under present 15% federal rates. This reasoning holds for the likeliest range of outcomes for new rates, including a simple reversion to 20% (even when adding the 3.8% planned to fund the ACA)—particularly if those shares appear likely to be held, and to appreciate even modestly, in the coming years.

However, clients who anticipate a cash requirement during 2013 may benefit from considering at least a partial sale this month, under known rules. Such a conversation is one we encourage as part of any prudent year-end portfolio review. It is this close attention to the specific objectives, including tax considerations, of each client that distinguishes our professionals. I urge you to reach out to us directly with questions or concerns at any time.

Indeed, more than anything else, the fiscal cliff is a reminder that successful portfolio strategies result from applying all known factors to the specific needs of an individual investor. While we remain alert to the risk-adjusted implications of changing tax rates, know that Clear Harbor maintains a steady eye on the company fundamentals, industry trends, and macroeconomic realities that are more central to wealth creation than any public policy has ever been.

We wish you the very best for the holidays, and look forward to our next conversation.