Legislative Update: A Pivot in Washington

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Since the beginning of 2009, our government and governments around the world have focused on stimulus legislation in an effort to move their economies out of recession and toward a stable footing. When that process began, I predicted that the time would come - likely in mid-2010 -- when these actions would engender concern about the level of debt countries have taken on. That concern in turn would lead to a major shift in Washington policymaking -- from stimulus to deficit reduction. The recent outcry about the financial stability of Greece, Spain, and other southern European countries suggests that time has arrived.

The depth of this shift was on display before Memorial Day when House Democrats balked at extending unemployment benefits because doing so would add to a deficit already swollen to three times its previous high. They failed to extend benefits even though the unemployment rate at the time was higher than it was when Congress approved these benefits late in 2008 and again in 2009. As one Democratic Congressman noted, "What might have been acceptable a month ago has moved." Another said, "We've hit the wall. We've come to the tipping point where we're not going to [spend money on the economy] anymore."

With many federal spending programs fixed by law, Congress is likely to turn to tax increases in an effort to reduce the deficit. Given the president's campaign promise -- repeated frequently since he's taken office -- not to raise taxes on families earning less than $250,000 a year, it seems clear that the great bulk of these increases will fall on the affluent.

Income Taxes

The president is proposing permitting the Bush tax cuts to expire on schedule at the end of 2010, but only for families with taxable income over $250,000 (individuals with income over $200,000). Under the president's plan, the top tax rate on ordinary income will rise from 35% to 39.6%, the top capital gains tax rate will rise from 15% to 20%, and the top tax rate on dividends will rise from 15% to 20%. (The president also has proposed limiting further the itemized deductions affluent families may claim, but Congress seems poised to reject that proposal.)

Some members of the House Ways & Means Committee (the committee that prepares tax legislation) are expressing concern that, given the size of the deficit, it may not be possible to hold the dividend tax rate to 20%, as the president has proposed. They are considering increasing the dividend tax rate back to 39.6%, taxing dividends in the same manner as ordinary income, as dividends were taxed during the Clinton years before the Bush tax cuts.

The new health care reform law, enacted earlier this year, also imposes new taxes to help finance the new benefits. Congress approved an additional 3.8% tax on taxable investment income earned by families with adjusted gross income above $250,000 ($200,000 in the case of

individual taxpayers). The 3.8% tax does not apply to non-taxable investment income, such as tax-exempt municipal bond interest, or to amounts withdrawn from qualified retirement plans such as IRAs and 401(k)s. The new health care reform taxes are scheduled to take effect at the beginning of 2013.

When the new health reform taxes are combined with the president's proposed tax increase for next year, by 2013 the top tax rate on ordinary income will rise to almost 44% and the top tax rate on capital gains to almost 24% -- an increase in the ordinary income tax rate of almost 25%, and in the capital gains tax rate of almost 60%.

Although the new health care reform taxes are law, the Senate Republicans do have the ability to block the President's program to raise tax rates at the end of 2010. Sixty votes are necessary to move most legislation in the Senate, and, with Senator Brown's election in Massachusetts last January, there are now 41 Republican senators. (The Senate can pass tax legislation with only 51 votes under an arcane process called "reconciliation." However, to do so Congress must first to adopt a federal budget resolution. A budget resolution appears unlikely this year as the Democrats are wary of highlighting the extent of the deficit before the election.)

The Republicans' maneuverability is circumscribed, however, by the fact that the Bush cuts expire by their terms at the end of this year. So, if the Republicans block tax legislation, tax rates on all taxpayers -- not just families with income over $250,000 -- will revert to the former (higher) rates. Because the Republicans presumably will not want to be tarred with raising taxes on middle class families in an election year, they may be forced to accept the president's proposal to limit the increase to affluent families.

Investors should consider steps now to blunt the effects of higher tax rates in 2011. Such steps include selling investment assets in 2010 at current capital gains rates; claiming additional ordinary income in 2010 (perhaps by exercising non-qualified stock options); deferring to 2011 discretionary deductible payments, such as charitable contributions; and giving increased consideration to municipal bond investments, the demand for which may increases as tax rates rise.

Estate tax

Absent a change in law, the estate tax has been repealed temporarily in 2010. But the tax is scheduled to come back with a vengeance in 2011, with an exemption amount of only $1 million and a tax rate of 55%.

Congress has made sporadic efforts to address the estate tax situation this year. A possible compromise seemed possible in May, when a bipartisan group of Senators were poised to accept a deal that would have reinstated the estate tax in 2010 at the 2009 levels (a $3.5 million exemption and 45% tax rate), and then increase the exemption to $5 million and reduce the rate to 35% over the succeeding ten years. This compromise fell through when rank-and-file Democrats objected to legislation in an election year that appears too favorable to wealthy families. That objection suggests that Congress may not agree on action before the November election, and that the 2010 estate tax rules will remain unchanged.

If Congress does not change the 2010 rules, the best-case scenario is that after the election, during a "lame duck" session in November and December, Congress raises the exemption for

2011 from the scheduled $1 million back to $3.5 million (or perhaps something higher). The president is supporting a $3.5 million exemption, as are powerful Democrats, many of whom are from farm states and worry about the break-up of the family farm if the exemption is too low.

To recoup the revenue loss arising from an increase in the exemption, Congress could curtail or eliminate some of the tax-reducing gifting strategies currently available. Legislation has been introduced to require a ten-year minimum term for grantor retained annuity trusts ("GRATs"), a popular strategy for gifting future asset appreciation without incurring gift tax. Other legislation would curtail the use of family limited partnerships and minority discounts.

To take advantage of the one-year hiatus in the estate tax, investors should consider a gifting program this year. By gifting assets, the transferred assets -- and all future appreciation -- are removed from the taxable estate. Individuals may give away up to $1 million during their lifetime without imposition of gift tax. This lifetime exclusion is in addition to the annual exclusion that permits every individual to give away tax-free up to $13,000 per year to an unlimited number of donees. Gifts made in excess of these exclusions are taxed at a lower rate (35%) this year than the rates in effect for past years or scheduled to be in effect for future years. Moreover, gifts made now may escape any curtailment of the rules governing GRATs, minority discounts, and other gifting techniques.

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