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Legislative Update: Behind–and Beyond–the 2010 Tax Compromise

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The year-end tax compromise Congress recently passed, and the president's motivations for entering into it, provide insights into what may lie ahead when Congress reconvenes in January.

First, the terms of the compromise (H.R. 4853):

- The Bush tax cuts are extended for all income levels through year-end 2012. As a result, the dividend and capital gains tax rates remain at 15% through 2012.
- The AMT is "patched" through 2011, mitigating its consequences for middle-income taxpayers in the same manner as in prior years.
- Long-term unemployment insurance is extended through year-end 2011.
- The employee's share of Social Security tax is reduced by two percentage points in 2011. As a result, working taxpayers will pay Social Security tax in 2011 at a 4.2% rate (rather than the prevailing 6.2% rate). A worker with compensation in excess of the Social Security wage base maximum of $106,000 will save $2,120 in Social Security tax in 2011.
- Businesses may deduct immediately the full cost of capital assets acquired in 2011. This provision is unlimited and applies to all businesses, not just to small businesses.
- Most expired or expiring tax provisions are extended through 2011. Of particular note, investors may move up to $100,000 from an IRA to a charity in each of 2010 and 2011 to satisfy their RMD requirement without incurring tax. To provide investors with additional time to arrange this transfer, the legislation treats transfers from IRAs to charities made during January 2011 as if they were made in 2010. (The popular Build America Bond program was not extended and, thus, expires on December 31, 2010 unless Congress acts in 2011 to reinstate it.)

Perhaps most surprising was that the compromise included estate and gift tax provisions more generous than any past estate tax regime. These new rules remain in effect through year-end 2012:

- A $5 million estate tax exemption and a 35% estate tax rate.
- Reinstatement of stepped-up basis at death.
- The option for individuals dying in 2010 to elect 2010 treatment (no estate tax, no stepped-up basis) or 2011 treatment (estate tax with $5 million exemption, stepped-up basis). Individuals with estates under $5 million will want to elect 2011 treatment. Estate tax returns for individuals dying in 2010 will not be due until mid-September 2011.
- A gift tax exemption of $5 million. This exemption provides a huge tax planning opportunity. A married couple may put up to $10 million in trust for future generations, and this sum can grow through the remainder of their lives. At their deaths, the full trust value will pass to heirs entirely free of both federal gift and estate tax. (To the extent the $5 million gift tax exemption is used, the estate tax exemption is reduced. Thus, for instance, if an investor makes a $2 million gift during life, his estate tax exemption is reduced to $3 million.)
- A $5 million generation-skipping tax exemption.
- All exemptions are inflation adjusted.
- Portability of the exemption between spouses. Thus, for instance, if a husband dies with $3 million in his estate, the wife's exemption rises to $7 million (her $5 million exemption plus his unused $2 million exemption). Note that a spouse must die before 2013 for this rule to be effective.

Why did he do it?

Many observers feel that President Obama gave away too much in agreeing to the compromise, particularly given that the Democrats still controlled Congress during the lame duck session. My understanding is that the president agreed to the compromise for two reasons. First, independent voters, the bulk of whom voted for Obama in 2008, largely abandoned him to vote Republican in 2010. Obama knows he needs to recapture those voters to win re-election in 2012. Independents don't care about whether Democrats or Republicans win debating points–they want to see accomplishments. By entering into the compromise, the president shows independents that he is the one person who can bridge the divide and get things done in a "post-partisan" Washington, thereby setting himself up to regain their votes.

Second, the president believes this deal–particularly the Social Security tax reduction and business investment write-off –will revive the economy and drive down the unemployment rate, which is crucial to his re-election prospects.

What will happen in the 2011 Congress?

The legislation adds about $400 billion in each of the next two years to an already swollen federal budget deficit. It is the pre-Christmas spending spree before the credit card bills come due next year. Preliminary estimates place the 2011 deficit at $1.7 trillion, up from $1.4 trillion last year.

There is some hope Congress will consider taking action in 2011 to address the deficit. Earlier this month, the president's deficit reduction commission prepared a report that garnered the support of a bipartisan majority of the panel. The president will be hard-pressed not to include portions of the report in his 2011 budget proposal, to be issued in February. Republicans, too, have a stake in this effort: they made deficit reduction the cornerstone of their campaign agenda, and will be judged in 2012 on whether they took steps to accomplish that goal. A bipartisan group of Senators already is calling for deficit reduction legislation next year.

Congress has funded the federal government only through the beginning of March. This action sets up a possible deficit reduction debate as Congress considers how much additional funding to provide. Ultimately, any agreement on the deficit is likely to include entitlement reform and tax changes as well as spending reductions.

Other items on the 2011 Congressional agenda are more controversial and, thus, less susceptible to bipartisan action. The president says he will ask Congress to consider immigration reform and climate change legislation, but compromise on those contentious issues will be difficult. Republican efforts to repeal or significantly alter the president's signature programs—health care and financial services reform—almost certainly will fall victim to a presidential veto, if they even get that far. The House Republicans may try to disrupt the progress toward these reforms by failing to increase the budgets of federal agencies charged with implementing them, but these efforts are unlikely to pass the Senate and, in any event, will be unavailing as agencies make do by redeploying funds in their existing budgets.

What does the deal portend for 2012?

The compromise is a paradigm case of "kicking the can down the road." It sets up a reprise of this year's tax debate—but with the presidency up for grabs as well. Congress was unable to address the expiration of the tax cuts before an off-year election; it is hard to see how it will do so when the presidency hangs in the balance. Thus, there is a strong possibility that in 2012 taxes, again, will be set by a lame duck Congress–this time, perhaps, with a lame duck president. Permitting unelected officials to make decisions of this magnitude is a poor way to govern.

Obama has promised disappointed Democrats that he intends to make higher taxes on the affluent a focal point of his re-election campaign, just as he did in 2008. By 2012, he says, the economy will have rebounded and Republican "excuses" that tax rates on the wealthy must remain low to foster economic recovery will no longer apply. But, how will he permit lower rates on the affluent to expire but continue them for the middle class, particularly when a Republican-led Congress is almost certain to reject such "decoupling?" Although, as he points out, he will still be in office when the cuts expire–and, thus, can veto an extension of the upper-income cuts–will he do so if it means permitting taxes on all Americans to rise?

One thing is clear: eventually, taxes must go up. Whether higher taxes occur through further stratification of upper-income tax rates or through tax reform that eliminates many of the deductions we've come to expect, mathematically the budget deficit simply demands greater revenues. We have a two-year reprieve, but we are likely to be paying back our tax refunds with interest.

Andrew H. Friedman is a former senior partner in a Washington, D.C. law firm. He speaks regularly on legislative and regulatory developments and trends affecting investment, insurance and retirement products. He may be reached through his website, TheWashingtonUpdate.com. Neither Eaton Vance, nor Andrew Friedman, nor any law firm with which he may be associated, is providing legal or tax advice as to the matters discussed herein. The discussion herein is general in nature and is provided for informational purposes only. There is no guarantee as to its accuracy or completeness. It is not intended and may not be regarded as legal or tax advice, and financial advisors and other recipients of this information may not rely upon it (including for purposes of avoiding tax penalties imposed by the IRS or state and local tax authorities). Advisors should consult with their firm legal and tax counsel as to matters discussed herein. Clients should consult their own legal and tax counsel before entering into any investment, annuity, estate planning or trust arrangement, and financial advisors should advise their clients to do so. Andrew Friedman is not an employee of Eaton Vance and his commentary is based on independent research.

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