Tax Law

ALERT

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How Will the Obama Presidency Impact Your Taxes?

President-elect Obama will take office on January 20, 2009, with a heavily Democratic populated Congress. As a result, we must expect significant and probably immediate changes to the tax law with at least partial retroactivity to January 1, 2009. It is very difficult to predict what changes will actually be enacted as all tax changes are the result of a highly politicized process and that is not likely to change. Still, it is informative to review the tax changes that President-elect Obama proposed during the campaign.

A significant part of the Obama tax plan is centered around reducing the income taxes paid by most taxpayers, maybe even 95% of all taxpayers. Since the typical reader of this Alert is in the other 5%, for whom taxes are anticipated to increase, that is our focus — the possible impact of an Obama presidency on the income and other taxes of this top 5% group. We will not cover the multitude of credits and other tax subsidies he has proposed for low and middle income taxpayers. There is also a high likelihood of another economic stimulus package, possibly even before President-elect Obama takes office. These provisions are not likely to have a significant impact on high income taxpayers.

Rates on Ordinary Income. President-elect Obama has indicated that he would have a top individual income tax rate of 39.6%. This was the rate in effect before the 2001 Economic Growth and Tax Relief Reconciliation Act ("EGTRRA") and would be the rate again beginning in 2011, absent an extension of the EGTRRA provisions. Many expect that President-elect Obama will accelerate this rate increase in 2009 and some expect it to be effective from January 1, 2009. President-elect Obama also would have the itemized deduction phase-out revert to its previous level of 3% of adjusted gross income in excess of an inflation adjusted base amount. At present, the phase-out is only 1% for 2008 and 2009.

Capital Gains and Dividends. President-elect Obama's proposal for long term capital gains is to increase the current 15% rate to 20%. This would happen anyway in 2011, absent an extension of the 2003 Jobs and Growth Tax Relief Reconciliation Act, which lowered the rate to 15% in 2003. Many expect President-elect Obama to accelerate this change to also be effective in 2009. Historically, a 20% rate on capital gains is extremely low. In the history of the income tax since 1916, there have only been a few years when the rate was this low or lower. In 1916, the top rate on all income was 15%. For the period 1922 – 1933, capital gains were taxed at 12.5%. The effective rate was 20% during 1982 – 1986 and most recently, in 2001 -- 2002. The rate has been 15% since 2003.

Another piece of relatively good news for high income taxpayers is that President-elect Obama's proposal would also tax dividends received from corporations at 20%. While that is also higher than the 15% current rate, it is still a rate that is substantially lower than is imposed on other kinds of ordinary income.

Certainly there are many in Congress who would like to see these rates higher. Time will tell whether President-

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elect Obama is able to hold the line where he has drawn it in light of Congressional pressure and/or budget imperatives. This will be closely watched by high income taxpayers.

Alternative Minimum Tax ("AMT"). The highly unpopular AMT does not appear to be going away. It simply raises too much revenue. Over the last several years, Congress has enacted a series of one year patches to raise the exemption amount (rather than permanently indexing it for inflation) to prevent inflation from subjecting millions of additional middle class families to this tax. The most recent patch, enacted as part of the recent emergency economic stabilization legislation, is estimated to have prevented 20 million families from having to pay AMT. Many high income taxpayers do pay AMT. Sometimes just a combination of state income taxes in a high tax state like California or New York and real property taxes on homes is sufficient to subject a taxpayer to AMT.

President-elect Obama has indicated that he is interested in "fixing" the AMT, but has not provided a detailed proposal. We believe he will support retaining the current exemption level and indexing it for inflation to keep middle income families from having to pay AMT.

We are not aware if he intends to increase the AMT rate. If he does not, then his proposed increase to the ordinary income rate to 39.6% will prevent some families from paying AMT.

Estate, Gift and Generation-Skipping Transfer Taxes. President-elect Obama has advocated a $3.5 million estate tax exemption and a top rate of 45% and we assume that same exemption and tax rate will also apply to generation-skipping transfer taxes. This is the same as the exemption and top rate that will be in effect in 2009 in any event. Under present law, there would be no estate tax in 2010 and then beginning in 2011 the rate would revert to 55% and the exemption would drop to $1 million. It is widely expected that legislation will be enacted during 2009 that repeals the 2010 estate tax holiday.

There have been suggestions that President-elect Obama may agree to make the estate tax exemption "portable" between a married couple so that if the entire exemption is not used at the death of the first spouse, it would carry over and could be used at the death of the second spouse, in addition to that spouse's own $3.5 million exemption. This would certainly be a welcome provision and would simplify many estate plans. His website refers to the exemption as being $7.0 million per couple, which may mean he does support portability.

President-elect Obama's position on the gift tax has not been clearly articulated but hopefully the gift tax exemption will match the $3.5 million estate tax exemption rather than the $1.0 million under current law. For 2009, the annual gift tax exclusion amount, which adjusts for inflation in $1,000 increments, will increase to $13,000 per donee from its present level of $12,000. We are not aware that President-elect Obama has expressed a view on the annual exclusion amount.

Social Security Taxes. President-elect Obama has indicated that he believes social security taxes should be increased for those earning over $250,000 per year. How and when he plans to do this is not as clear. There was initial concern that he would apply the full 12.4% combined employer-employee rate to all earned income above $250,000. This does not appear to be his present intention as his website currently states the following:

> *"As part of a bipartisan plan that would be phased in over many years, they will ask those making over $250,000 to contribute a bit more to Social Security to keep it sound. Obama does not support uncapping the full payroll tax of 12.4 percent rate. Instead, he and Joe Biden are considering plans that would ask those making over $250,000 to pay in the range of 2 to 4 percent more in total (combined employer and employee)."*

We assume he intends to continue to apply the current 2.9% Medicare tax to all earned income as well.

Business Taxes. President-elect Obama's plans for taxes on business are less well defined at this point. We do not believe he presently favors increasing the corporate tax rate above the current level of 35%. He will propose a number of changes to broaden the base to which the rate applies. At various times he has also indicated his support for the following:

- *Research and Experimentation Tax Credit.* Make permanent the 20% Research and Experimentation credit.

- *Production Tax Credit.* Extend for five more years the 1.9 cent per kilowatt hour tax credit for renewable energy facilities.
- *Tax "Carried Interests" in Partnerships as Ordinary Income.* President-elect Obama supports proposals that have been floated to prevent service providers from receiving capital gain income from partnerships in which they acquire interests as a result of performing services for the partnership or its partners. This would apply to relatively few people, but many of them are the readers of this Alert. This represents a significant tax increase for these high income earners.
- *Tax publicly traded partnerships as corporations.* Certain publicly traded partnerships that earn investment types of income are currently permitted to function as partnerships for Federal income tax purposes and thus avoid paying entity level income taxes. President-elect Obama has indicated that he would force these partnerships to pay taxes as corporations. Again, this does not impact a lot of people, but it is very significant for those to whom it is applicable.
- *Oil companies.* President-elect Obama has indicated that he believes oil companies should pay higher taxes but has not offered specifics. There has been speculation that he might seek to end the expensing of exploration and development costs, eliminate the tax credit for tertiary well oil recovery, further restrict the use of foreign tax credits and increase the depreciation lives of assets used by these companies.
- *Codify the "Economic Substance" doctrine.* There has long been a court-made rule that in order for transactions to be respected and taxed in accordance with their form, the transaction must have "economic substance." This rule is often used by the government in court to attack tax shelter types of transactions. There has been a proposal floating around, which President-elect Obama supports, to make this rule one of statutory law. Many feel this is just so it can be scored as a revenue raiser under the PAYGO rules in the budgeting process. In fact, the Chief Counsel of the Internal Revenue Service has stated publicly that codifying the economic substance doctrine is a bad idea.
- *International provisions.* President-elect Obama has indicated a desire to further police the use of foreign tax havens by United States taxpayers. As a Senator he co-sponsored very restrictive legislation in that regard. He also wants to reduce tax benefits for companies that export jobs, probably by ending their ability to defer paying United States income tax on profits they leave abroad.
- *Incentive for creating jobs in the United States.* President-elect Obama is in favor of lowering taxes for companies that expand by creating additional jobs in the United States.

Should you accelerate income or defer deductions in anticipation of higher rates next year?

There are already news stories of sports agents negotiating signing bonuses for their clients to be paid in 2008 rather than 2009 in anticipation of rates going up. While it probably makes sense to receive in December an amount of ordinary income that would otherwise be paid in January or February, we believe people should not get too carried away with the notion of accelerating income. If deferred income would continue to grow at a pre-tax rate over several more years, the benefit of paying the tax later, even if at a somewhat higher rate will likely leave you better off than if you receive the income now and must pay the tax right away. Remember, that once you pay the tax, the tax paid no longer accrues further earnings for your benefit.

The analysis becomes considerably more complicated depending on how you assume you will be taxed in the future. If you can realize ordinary income this year, pay 35% tax, and then invest your after tax retained amount in a way that will yield a single capital gain tax at a 20% rate in five years, you may well be better off doing so as compared to allowing your deferred amount to accumulate pre-tax for five more years and then paying 39.6% (or possibly more) on the full accumulated amount. The result of the analysis is highly sensitive to the assumptions you make about tax rates in the future on various kinds of income, which is something that is very hard to predict. The acceleration of any deferred compensation amounts may be problematic under Internal Revenue Code Section 409A and should be done only after consultation with your tax advisor.

As always, if you find yourself paying AMT, it makes sense to accelerate additional ordinary income until the next dollar would be taxed at the 35% regular rate rather than the 28% AMT rate. You should consult with your tax advisor before making any decisions about accelerating ordinary income.

Many people may be selling securities to trigger long term capital gains in 2008 at 15% rather than wait for 2009 when the rate may be at least 20%. This is a fair consideration, at least as to long term holdings you have decided its time to sell anyway. Of course, if the anticipated sell off depresses prices, the benefit could be eroded or eliminated.

As a result of market events over the past six weeks more thought may be required before harvesting available short-term capital losses this year. It is debatable whether you want to hold off taking such losses when they will offset short-term capital gains which would otherwise be taxed at ordinary income tax rates. However, if you have substantial long-term capital gains for the year (and with long-term capital gains rates at 15% and expected to go to 20%), it may be wise to trigger no more short-term capital losses than you have short-term capital gains for the year, so that the excess short-term capital losses are not inefficiently sheltering preferentially taxed long-term capital gains. Any decisions on what securities to buy, hold, or sell should be made with your investment advisor. If a short-term loss security must be sold to liquidate a position, consideration might be given to selling and repurchasing a short-term gain position. There is no 30-day wash sale for gains and, therefore, such approach could be used to avoid having the short-term loss offset preferentially taxed long-term capital gains while increasing the tax basis to the sold and repurchased gain position.

The analysis for deferring deductions is similar. If you pay a deductible expense in January rather than December, the deduction may be more valuable if the rate is higher, but you will receive the benefit at a later time. If you are paying AMT, it does make sense to defer the payment of additional deductible amounts until next year. Again, you should review your situation with your tax advisor.

Conclusion. Predicting changes to the tax law is difficult, particularly because of the politics involved in the enactment of tax law and the uncertainties presented by the current, on-going financial crisis and global economic slow-down. We believe it is very important to avoid taking extreme actions based on concern about what might happen. As often as not, what actually gets enacted differs significantly from what was expected. As a result, when the action you took ultimately turns out to be beneficial, you are often more lucky than smart. We will continue to keep you apprised of any significant tax legislations and other developments of importance to high income taxpayers.

For more information about any of the techniques and strategies discussed in this newsletter, or any other income or estate tax planning assistance, please feel free to contact any member of our High Net Worth Family Practice Group.

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