



Debating where to turn as Bush tax cuts near expiration

Scott Olson September 18, 2010

The debate over whether to extend tax cuts set to expire at the end of the year is intensifying as the fall midterm elections approach.

House Republicans want to extend the tax cuts they helped former President George W. Bush pass in 2001 and 2003, should Republicans win enough seats to gain the majority.

During a Sept. 1 appearance on CNBC, House GOP Conference Chairman Mike Pence, R-Indiana, said Republicans' first move as a majority would be to extend the cuts.

"Well, we're going to stay focused on Election Day," he said. "But I think before that, we're going to continue to demand that this administration and this Congress make it clear that no American will see a tax increase in January of next year."

Unless something is done by the end of the year, they'll expire.

Supporters argue that an extension is necessary to avoid hijacking any shot at an economic recovery.

Opponents point to a rising deficit and the need to eliminate the extension as a means to start paying down the massive debt.

"The argument for allowing them to expire is that it will allow us to reduce our deficit; that's the rationale for it," said Rachel Smith, an assistant professor of finance at the University of Indianapolis. "The flip

side, and those who are pushing to extend it, think it's a bad time to do that."

Some sort of compromise seems more likely. President Obama has said he wants to renew the tax cuts for 98 percent of households with income below \$250,000 for couples and \$200,000 for individuals.

Obama made his position clear during a Sept. 8 speech in Cleveland. On Sept. 13, House GOP Leader John Boehner said he would support renewing tax cuts for the middle class but not the wealthy if that were his only choice.

As it stands, people pay income taxes on a sliding scale from 10 percent to 35 percent. The old 2000 rates started at 15 percent and escalated to 39.6 percent.

Yet, the higher rates apply only to the wealthiest Americans. Fewer than 1 percent pay the 35-percent rate and fewer than 4 percent pay even 33 percent, according to the IRS.

Most people pay 15 percent to 25 percent. If the tax cuts expire, the rate for many might rise to 28 percent, translating to a tax hike of a few hundred to a few thousand dollars.

Those with children would be hit harder, as the child tax credit would revert from \$1,000 to \$500.

On top of that, the tax on long-term capital gains and dividends is set to rise. The top rate on long-term capital gains—profits on shares or other assets held for more than a year—would rise from 15 percent to 20 percent. On qualified dividends, the rate would rise from a maximum of 15 percent to an investor's marginal income tax rate.

Debate over the tax cuts has been magnified by a sour economy, aided by a colossal housing collapse and massive amounts of spending to fund the wars in Iraq and Afghanistan, said the University of Indianapolis' Smith.

Instead of eliminating the tax cuts, she suggested that federal lawmakers might also want to consider reducing spending.

But "that's definitely not the direction we're headed," Smith said.

A majority of economists agrees the tax cuts should be extended.

Fifty-four percent of those surveyed by the National Association for Business Economics favored extending the current tax rates, while 33 percent favor Obama's plan to renew the higher rates on the wealthy.

More economists—60 percent—said lower tax rates on capital gains and dividends should not be allowed to expire.

Another 22 percent said the lower rate on capital gains and dividends should be preserved for middle-income taxpayers, but not for the wealthy.

The association surveyed 242 member economists. •

Wealth managers weigh in

Indianapolis-area experts offer advice on how to invest amid the debate.

Matt Haab



Haab

Firm: Veros Partners

Funds under management: \$85 million

What Congress will do: At this point, momentum has built for the tax cuts to be extended, so it's now probably close to a 50-50 chance that some action is taken there.

What investors should do: First, take a wait-and-see approach. Most pre-emptive action items can be completed right before year end so there is no need to act before you have more clarity. If they do expire, the biggest impact to investors will be the increase in dividend taxes followed by the increase in the capital gains tax. Investors should take the following actions to protect themselves:
Focus on after-tax returns by positioning portfolios as efficiently as possible between taxable and tax-advantaged accounts. For example, shift ownership of high-dividend stocks into tax-advantaged accounts.

- Consider investing in municipal bonds, as interest from these bonds remains tax-free.
- Consider selling any holdings that have large deferred capital gains before year end.
- Harvest any unrealized tax losses to provide capital losses to carry over to future years. This can be done with little impact to a portfolio by purchasing a similar investment to replace the one sold. Beware of the wash-sale rules before you repurchase the same investment.

Longer term, this also puts a renewed emphasis on maximizing your use of tax-advantaged accounts. Use those accounts to their full potential to save for long-term goals such as retirement and education.

Chris Cooke



Cooke

Firm: Cooke Financial Group of Wells Fargo Advisors

Funds under management: \$1 billion

What Congress will do: Uncertainty is the key word, and one reason investors have been “frozen” of late. Congress may extend the Bush tax cuts for some or all tax brackets, but there is no certainty of this.

What investors should do: Investors with an imminent gain may want to accelerate the gain into 2010 and not take the risk of higher capital gains rates in 2011.

Employees with vested employer stock options may choose to exercise some of their options and realize income now before the looming increase in ordinary income tax rates in 2010. Owners of closely held corporations with excess cash on their balance sheets may want to make additional dividend distributions in 2010, as the increases on dividend tax rates are significant if the Bush tax cuts expire and there is no new action by Congress.

Juli Erhart-Graves



Erhart-Graves

Firm: Worley Erhart-Graves Financial Advisors Inc.

Funds under management: \$145 million

What Congress will do: Congress could allow the Bush tax cuts to expire, but I wouldn't be surprised to see modifications rather than a complete reversion to the pre-2001 tax landscape. Just as with individual households, when our country goes into debt—or should I say deeper debt?—we have to increase income taxes and/or reduce expenses for government services to secure our financial future. Therefore, I expect higher taxes and a reduction in government services over the next decade.

What investors should do: Sometimes we can get so focused on avoiding taxes that we fail to take into account future financial implications of our investment decisions. In any tax environment, investors need a diversified portfolio invested in accounts with different tax consequences (taxable, tax-deductible and Roth IRA).

As tax laws change, investors will need to re-evaluate their portfolios to determine whether current holdings will materially change their tax situation. For some, shifting investments between different types of accounts (for example, housing tax-efficient investments in taxable accounts), or even replacing holdings, may make sense.

Paul Coan

Coan

Firm: Wealth Planning & Management LLC

Funds under management: not disclosed

What Congress will do: Washington has a real problem. Several, actually. Politicians pulled a fast one with tax cuts in 2001 and 2003. At the time, we were told (against all evidence and common sense) that if tax rates were cut there would be a robust economy and millions of jobs would be created. The old trickle-down idea. Washington's own numbers showed any positive effect would be wiped out in 10 years and would become a major problem in terms of budgets. So rather than face the music and the voters with this news, a sunset provision was included in the bill. Fast forward through a decade of war spending and an economic collapse and we are looking around for a lot more money. These tax cuts are the single largest cause of our deficit, dwarfing our wars, the economic stimulus and the bank bailouts put together. If recent history is any indication, Congress will most certainly put politics and re-election aspirations ahead of the country's best interest.

What investors should do: Plan for three outcomes: expiration, extension or modification. If the tax cuts are extended, continue to implement your current financial plan. If you will be hurt should they expire, have an action plan in place, such as taking gains or investing in different types of income-producing vehicles in your taxable accounts. The qualified dividend will also expire. You might consider the possibility of converting your IRA to a Roth IRA. This could allow you to use the lower tax rates and spread the tax due over the next two years.

Joe Clark

Clark

Firm: The Financial Enhancement Group LLC

Funds under management: \$140 million

What Congress will do: The market votes for an extension. Utilities have become a leading sector and the feeling seems to be an extension for now.

What investors should do: Anytime there is a loss of capital to cost of operations—taxes included—there will be a hit to stocks in general. First, to heavy dividend-producing stocks, then to the rest. In our opinion, the yields in bonds are so low that you are better to stay with equities even if the taxes go up, as the dividend with higher tax rates still outperforms the low yields on most fixed investments.