MorganStanley
SmithBarney

Tax Moves To Consider Now

March 2012

Tax attorney Andy Friedman of The Washington Update believes investors and wealthier taxpayers should be ready to make a series of tax moves this year, before the tax law is likely to change

Regardless of what happens in the upcoming election, Washington tax attorney Andy Friedman believes Congress has to address the Bush tax cuts--which are set to expire on Dec. 31, 2012. And it's best, he says, to prepare now for the series of tax moves that would entail. "A lot of [tax] attorneys are going to get overwhelmed as the year goes on," Friedman says. "So at least get the documents in place now to pull the trigger, if necessary, at the end of the year." Friedman was recently interviewed by Jim Tracy, MSSB director of national sales and business development, as part of The Washington Update, a comprehensive educational campaign sponsored by Eaton Vance. The following is an edited version of their conversation.*****

Jim Tracy: Andy, what's your take on the next Presidential election in November?

Andy Friedman: In my mind, this Presidential election is going to turn on how Independent voters vote. Right now this country is divided almost equally among Democrats, Republicans and Independents--about a third each. It's those Independent voters that are going to determine this election.

Tracy: Are there any issues that resonate most with these Independent voters?

Friedman: Mostly economic issues--jobs, businesses, etc. They care about growing the economy. They're less concerned about social issues such as gay marriage, guns or religion. Independents also are uncertain whether to blame the economic difficulties we're facing on the [Obama] Administration or on Congress.

Normally, when you have a recession--or you're working your way out of one--it gets laid at the feet of the Administration. But these are unusual times. A few weeks ago, Independents' approval ratings of President Obama went over 50%. Independents' approval rating of Congress is 9%. That tells me Independents may not blame the Administration.

As we sit here today, the President has a good shot of recapturing the Independent vote. He won it overwhelmingly in 2008.

Tracy: What about Congress? Which party holds the House and Senate after Election Day?

Friedman: The Republicans likely will continue to control the House after the election. They have a sizeable majority there and may lose a few seats, but likely not enough to lose control of the House.

The Senate is more interesting: The Democrats have a six-seat majority in the Senate, and there are 33 seats up for reelection this year. Twenty-three of those seats currently are held by Democrats, many of whom are running from Republican-leaning states. Those Democrats were elected in 2006 as a backlash against George Bush. Now they're running for reelection in Republican states and some may have difficulties. In fact, seven Democrats have announced they will not run for reelection.

That tells me that it will be very close, but the Republicans also could take over the Senate. But--and this is important—even if they get a majority of the Senate, Republicans will not get 60 seats, and you need 60 votes to stop a filibuster. Without 60 seats, any Democrat can stop legislation. So even if the Republicans win the House, the Senate and the Presidency, the Democrats will continue to have a seat at the table. [Republicans would] need Democratic consensus to move large legislation through. It also tells me that we're [probably] not going to see a repeal of health-care reform, because the Democrats in the Senate will block repeal.

As for what is likely to happen legislatively next year, my feeling is that the major decisions are going to be made before the elected officials take office. Congress will have to return to Washington after Election Day for an important lame duck session to address or let expire a number of provisions before the end of the year.

Tracy: Can you be more specific?

Friedman: First, a number of spending cuts are about to begin next year--notably, the $1 trillion in defense cuts that were part of the agreement last August to raise the debt ceiling. Second, Congress has to pass a budget to run the government next year. Third, we may have to raise the debt ceiling again. Finally, the Bush tax cuts are slated to expire at the end of 2012. If that happens, taxes would go up next year on all Americans.

Tracy: What are the odds that, after the election, the Republicans can figure out a way to push through a full extension of the Bush tax cuts?

Friedman: I'd say low. The President is adamant that he will never again extend the Bush tax cuts for affluent Americans. If he maintains that view, Republicans either must capitulate to the President and allow taxes to go up on the affluent, or refuse to pass any legislation at all, permitting taxes to go up for everyone. Either way, [I think] affluent taxpayers in 2013 will be facing higher taxes.

And the expiration of some or all of the Bush cuts is not the end of the story: a new tax under the health care reform law is scheduled to take effect next year. Beginning next year, investment income—such as interest, dividends and capital gains—received by families with total income above $250,000 will be subject to an additional tax of 3.8%. This new 3.8% tax will not apply to non-taxable income, such as tax-exempt municipal bond interest, and it will not apply to money taken out of retirement plans, like IRAs and 401(k)s.

When you add the expiration of the Bush tax cuts to the new 3.8% tax on investment income, you're looking at an extraordinary tax increase on affluent taxpayers next year—the top tax rate on ordinary income going from 35% to almost 44%, the top tax rate on capital gains going from 15% to almost 24% and the top tax rate on dividends going from 15% to almost 44%.

We're also looking at a change in the estate tax. This year, any American can give away $5 million lifetime without any gift or estate tax consequences. If that is not extended, next year the lifetime estate tax exemption drops back to $1 million.

And all of this happens if nothing happens. If Congress passes no legislation at all, what I just described will be our tax system in 2013.

Tracy: What's your outlook for the U.S. economy?

Friedman: At the end of last year, total U.S. debt outstanding equaled 100% of GDP. That is unprecedented since World War II. This large amount of debt outstanding is likely to slow U.S. growth because investment dollars are going to the federal government to buy debt--not into the private sector to help it grow.

That doesn't mean we won't have any growth in the U.S. We will have some growth, but it's going to be muted, say 2.5% a year. That means if you're looking to invest in equities, you want to look worldwide as well as in the U.S.. That is, in other countries, where money is flowing to the private sector, not into the government.

Tracy: Where are the opportunities for fixed-income investors?

Friedman: Investors might consider municipal bonds. As tax rates go up, the value of municipal bonds goes up.

From a tax planning perspective, clients who are thinking of selling a business, or who need to diversify a concentrated stock position or rebalance a portfolio, might consider selling assets this year while we have a 15% capital gains tax rate.

Also, clients should consider Roth IRA conversions. When you convert your traditional IRA to a Roth IRA, you pay taxes now on the value of the IRA. But then everything [you withdraw] from the Roth IRA in the future, including future investment earnings, is income tax free. If you expect to be in the same tax bracket in retirement that you are now, converting can make sense--because tax rates in that bracket are likely to go up.

Tracy: What about individuals who may be thinking in coming years about estate planning?

Friedman: Individuals should take advantage of this extraordinary opportunity to transfer wealth this year. As I mentioned, any American can give away this year up to $5 million in total to kids, grandkids, great-grandkids, etc. And those gifts will grow entirely free of estate tax. We may never see an opportunity like this to transfer wealth again.

Now, transferring this amount of wealth is a little complicated. You're typically not going to leave $5 million outright to grandkids--you’re going to put these assets in trust. So it's important to talk to your [Financial] Advisor about how to structure these asset transfers and how to invest the assets in the trust in a tax-efficient manner.

Moving up on this is important because as it dawns on people that taxes are going to go up, you're going to see a rush to set up trusts and transfer assets. Those things can't be done with a snap of the fingers--they take time. A lot of attorneys are going to get overwhelmed as the year goes on. So at least get the documents in place now to pull the trigger, if necessary, at the end of the year.

Tracy: Is there any chance of more tax favorable legislation in 2013?

Friedman: I think there may be an effort at tax reform next year. With tax reform, you reduce tax rates, get rid of loopholes, simplify the tax code, get rid of the alternative minimum tax, etc. Everybody in both parties wants that, at least in theory.

Corporate tax reform is a part of this. The President recently came out with a proposal for simplifying the corporate tax. We have the highest corporate tax rate in the world, which provides a perverse impetus for companies to move jobs overseas. So corporate tax reform is needed. And once you start dealing with corporate tax reform, you almost have to deal with individual tax reform because so many businesses are arranged as pass-through entities. If there is a light at the end of the tunnel, it would be that next year the parties could agree on some sort of tax reform. Of course, the prospects for agreement on anything in Washington should not be overstated.

***Unless otherwise noted, the source for all information is Andy Friedman as of Feb. 23**

2012-PS-389 03/2012

MorganStanley
SmithBarney