



# From the Desk of Dean Zerbe.



## Reading the Tax Tea Leaves

by Dean Zerbe

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*(Please note additional commentary at the end that was not included in the Forbes article.)*

### **One thing is sure, rates for the wealthy are going up.**

Here's a little irony: It's easier to predict what is going to happen 13 months from now than in the next month.

Democrats are likely to allow parts of the Bush tax cuts—namely, lower rates for those earning more than \$250,000—to expire after Dec. 31, 2010. President Obama ran on this, and there's no reason to think he has changed his mind, especially with the deficit (and Democrats' spending plans) growing and growing.

The bigger questions—from an end-of-2009 planning point of view—are how high rates will go, whether they'll go up before 2011, and what gimmicks might be used to raise effective rates without raising the stated rates. The well-off shouldn't be deferring income until 2011. But whether they should recognize it in 2009 or gamble on stable rates in 2010 isn't clear. My bet is that in 2010, one way or another, wealthier households will see an increase in federal taxes—but not as big an increase as they will see in 2011.

### **Income Tax Rates**

While I expect some of the tax cuts enacted in 2001 and 2003 will stay in place (lower rates for middle-income families; the expanded child credit) the current outlook is that come Jan. 1, 2011, taxpayers will see an increase in the top ordinary income tax rates from 33% and 35% to at least 36% and 39.6%. That's where they were before the Bush rate cuts.

The top rate on capital gains and ordinary dividends will increase from 15% to 20%, but with lower or zero rates remaining in place for middle and low-income taxpayers. Meanwhile, the phase-out of personal deductions and haircut to itemized deductions ("PEPS" and "Pease" in tax-geek talk),

which effectively raise the top marginal rate by another percentage point, will return and hit couples with income above \$250,000 and singles with income above \$200,000.

That's assuming nothing is done on the health care front that affects marginal rates by taking them higher or raising them sooner.

### **Estate Tax**

The widely held view in Washington as of a few days ago was that there would be a one-year extension of the estate tax as it exists in 2009: the first \$3.5 million of an estate is exempt from taxes and the estate tax is imposed at a top 45% rate. But House Democrats had a different idea; Thursday they passed, by a vote of 225 to 200, a bill that would make current exemption and tax rate permanent. (If something isn't passed, the estate tax will disappear in 2010 and then reappear in 2011 to its pre-Bush state, meaning only \$1 million, indexed for inflation, is exempt and the top estate tax rate is a hefty 55%.)

But nothing is ever simple when it comes to the estate tax. In the Senate, there are many Republicans (Jon Kyl of Arizona, in particular) and a few Democrats (Blanche Lincoln of Arkansas, in particular) who will oppose making permanent the \$3.5 million exemption and 45% rate. They are holding out for a permanent exemption of at least \$5 million per person and a rate of no more than 35%.

I predict the politicians will in the end kick the can down the road, all the while blaming each other for not bringing families the sort of certainty they need and deserve. However, if there is a deal struck (unlikely this year, possibly next year—with the odds going up a good deal with today's vote), it will involve a 10-year glide path that will gradually move the law towards the \$5 million exemption/35% rate that is favored by many Senators. An easier prediction is that you will not see Congress move forward

on Obama's proposals to limit family limited partnerships, grantor retained annuity trusts or other tools now widely used to reduce the taxable size of estates.

None of this should be an excuse to delay estate planning, however, since there is no guarantee a stable or permanent estate law will be passed in 2010 either.

### **Taxes and Health Care**

Yes, some health care bill will pass next year. It may be the full-blown package currently being debated in Congress or it may be a more modest package focused on insurance reforms.

Either way, there will be new taxes to pay for it. If it's a big bill, there will be a whole grab bag of increases. The most likely candidates to reach the President's desk are: an increase of the Medicare payroll tax from 1.45% to 1.95% on earnings above \$250,000 for a couple; a 40% tax on "Cadillac" insurance plans; tax penalties on businesses that don't provide "adequate" health insurance (probably the somewhat lighter penalties in the Senate bill as opposed to the thumping penalties in the House bill); small penalties for individuals who don't purchase health insurance; and a tax credit to help middle-income folks pay for health insurance.

There will also be a tax credit for small businesses that provide health insurance. This credit will be a big talking point for politicians who support the insurance expansion, but it will be worthless for the vast majority of small businesses. (The current House version of the small business credit, for example, phases out for businesses with more than 10 employees.)

Also likely to reach the President's desk is the Senate's proposal that the pharmaceutical industry, the medical device industry and the insurance industry pay billions of dollars in taxes per year based on market share. In determining the amount each business will pay, Congress has stated it



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doesn't matter if the company has a large profit margin, a small profit margin, no margin, is bankrupt, is a publicly traded company, is a private company, is a pass-through company (LLC, S Corp., partnership). Companies will pay these billions of dollars in new taxes solely based on gross receipts/market share. This brave new world of tax policy has been subject to almost no analysis, review or hearings. Nevertheless, once Congress latches on to this as a way to raise revenue, it will look to apply the same concept of tax based on market share and sales alone to other industries in the future.

A more unlikely candidate to make it to the President's desk—but a big concern for upper income taxpayers—is the House-proposed individual income tax surcharge of 5.4% for couples with adjusted gross income above \$1 million and singles earning more than \$500,000. The same 5.4% rate would apply to all income, boosting the top capital gains rate dramatically—from 15% now to 25.4%, once the Bush tax cuts expire and the surcharge is imposed.

Fortunately, this surcharge is deeply unpopular in the Senate. Another dark-horse tax hike would limit the value of itemized deductions for the better off. While the top rate they pay would go up to 39.6%, they could only take their deductions against the current top 35% rate. This would be, in effect, yet another sneaky increase in the top marginal rate. The Obama administration continues to float this idea despite the fact that it is not included in either the current Senate bill or the one that passed the House.

## Jobs Bill

The Administration and Congress are desperate to appear to be doing something about the still rising unemployment rate. So a jobs bill will most likely be considered early next year. The usual suspects are coming out, including a \$250 check for seniors and a \$3,000 credit for new hires.

My strong hope is that Congress and the public will give hard consideration to what is easily the most thoughtful tax bill out there to help small and medium business:

S. 1381. sponsored by my former boss, Sen. Charles Grassley of Iowa, the ranking Republican on the Senate Finance Committee. The legislation provides several important tax benefits targeted to small and medium size businesses. One of them would allow small business folks who operate as S corps and partnerships to be able to take full advantage of general business credits. Currently, the individual alternative minimum tax prevents them from doing that.

There is an outside possibility of a temporary payroll tax holiday for business—meaning employers wouldn't have to pay some of the employer share of the Social Security and Medicare payroll tax. My hope is that any Jobs Bill will also make an effort to expand/increase the availability of credit to small and medium size businesses. Despite all the jawing from Treasury, credit remains the top problem for these enterprises.

## Tax Reform

Finally, let me end with an easy prediction. The (recently delayed) report on tax reform and simplification being prepared by the President's Economic Recovery Advisory Board will be mostly ignored by the Obama Administration—just as a similar report prepared for President Bush was ignored by his Administration.

The one exception: Some of the "loophole closers" the report pinpoints will show up in future Obama Administration budgets, as revenue raisers. That's change you can believe in and change you might well have to pay for.

## ADDENDUM

In addition to the above reprint from Forbes, here are some further updates and comments on other tax matters that may be of interest to you:

### Estate Tax

Since the Forbes piece went out just a couple of days ago, things have changed. The House had a narrow vote to make current law permanent. Of more interest is the dog that didn't bark: the House leadership re-

fused to take a vote (because they would lose) on an alternative proposal that would have provided for a \$5 million estate tax exemption and 35% rates. I think the tight vote and the refusal to take a vote on the alternative puts the House in a weak position in negotiations with the Senate, where a majority wants a \$5 million estate tax exemption and 35% rates. The difficulty is getting anything done this year with everything else going on in the Senate.

Two possibilities are being most talked about: early next year there is an agreement that has a glide-path to a \$5 million estate tax exemption and further reduction in the rates (backdated to the beginning of the year); or, there is a two-year extension of current law included in the continuing resolution at the end of the year.

## IC-DISC

One benefit I don't expect to be removed with the expiration of the tax cuts on December 31, 2010 is the IC-DISC benefit for small and mid-size U.S. manufacturers who export goods and certain services. This is a major tax benefit that is providing huge savings to U.S. manufacturers during this tough economic time, and Congress has little interest in eliminating this provision for the foreseeable future.

## Last-In/First-Out Accounting Method (LIFO)

I anticipate Congress repealing LIFO next year. While Congress is beginning to understand that many small and medium businesses will be significantly hurt by LIFO repeal (not just Exxon), I think the most relief provided will be to have a nine-year phase-out for LIFO. If small and mid-size businesses could really beat the war drum, there is a chance the LIFO repeal would be limited to publicly traded companies.

## Carried Interest

As I've long predicted, the treatment of carried interest as ordinary income is being included in the House package of tax extenders this year. I've also long expected the Senate to not agree to this revenue raiser at this time. While I think the chances of the Senate agreeing to this revenue raiser have gone up a bit, the effective date for



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the change in treatment of carried interest could well hinge on whether the extenders package is signed into law this year or next year (see below).

## Extenders

The business extenders (such as the Research and Development Credit) will happen but could possibly be next year if the Senate is overwhelmed with the health discussion as expected. Any extension will be backdated to the beginning of the year.

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