Uncertainty on tax cuts raises issues for investors

Sunday, August 15, 2010
By Len Boselovic, Pittsburgh Post-Gazette

Uncertainty is compounding our economic distress. The scarcity of clarity is readily apparent when it comes to taxes.

Tax cuts, most of them delivered by the Bush White House, are set to expire at the end of the year. Does Congress let all the tax cuts expire; extend all of them; or jury rig a compromise that can't be legislated in 1,000 pages or less?

To be sure, some harbor not a smidgen of uncertainty as to what to do.

Supply siders confidently trot out the familiar argument for maintaining the less onerous tax regimen, assuring us lower taxes will stimulate the economy by encouraging investment and hiring. Nor is there a paucity of certitude among supply side's detractors. A 2008 study by the Center for American Progress documents that investment and economic growth were stronger after 1993 tax increases than they were following tax cuts in 1981 and 2001.

As the ideologues and ruling class in Washington wrestle with this conundrum, taxpayers in the hinterland are seeking a game plan from their financial advisers. The guidance they are receiving lacks detail but does give them a good, albeit unpleasant, idea of the general trend of things to come.

"It's a foregone conclusion, given the level of deficits, that tax rates will go up," says Robert Fragasso, of Fragasso Financial Advisors, Downtown.

Sisterson & Co. tax partner Bill Richardson identified five major issues: taxes on long-term capital gains and dividends; adjustments to tax rates; reinstituting limits on itemized deductions and personal exemptions for higher income taxpayers; and the estate tax.

Unless Congress decides otherwise, the tax rate on long-term capital gains - investments held for longer than one year - will move to 20 percent from the current 15 percent. Given the magnitude of the possible increase, "You're probably going to have a number of people thinking about whether they should sell an investment between now and the end of the year," Mr. Richardson says.

Tax cuts enacted in 2003 lowered rates to 15 percent for most dividends. Unless Congress acts - and if the highest tax bracket reverts back to its pre-tax cut level - high income individuals currently paying 15 cents for every $1 in dividends would pay 39.6 cents on the dollar, Mr. Richardson says.

Potentially higher taxes on dividends next year may be prompting some private or family-owned businesses to consider large dividend payments this year, he says.

Many believe the Obama Administration and the Democrat-controlled Congress won't increase tax rates across the board. Instead, they'll only target families making more than $250,000 annually and individuals making more than $200,000. That would move the top tax rate, currently 35 percent, to 39.6 percent.

Mr. Fragasso has problems with that.

"Philosophically, I think it's wrong to take the most productive members of our society," he says. "We have never taxed our way to prosperity."

Mr. Richardson says doctors and lawyers would not be the only ones affected. So would the owners of manufacturing, distribution and other companies that create jobs, he says. Many business owners in the top tax bracket would be more reluctant to invest in their business or hire additional employees if taxes went up, Mr. Richardson adds.

"When taxes go up, it can affect decision making," he warns.

James Holtzman, of Legend Financial Advisors in McCandless, thinks there's little doubt that at least some taxes will go up. So he recommends that if individuals have any flexibility as to when they will receive a bonus, stock options or other types of compensation, they should ask for it this year rather than wait until 2011.

"We've never had rates this low, so you know they're not going to drop," Mr. Holtzman says.

Congress must also decide what to do about the estate tax. If it does nothing, only $1 million of an individual's estate will be exempt from the tax. Mr. Fragasso expects Congress to set the exemption between $2 million and $3 million, and to not tinker with estate tax rates.

What Congress decided to do about taxes may depend on when it makes the decision: before or after the November elections which are being viewed as a referendum on Mr. Obama's first two years.

Mr. Richardson believes a compromise that extends some tax cuts and modifies rates for some taxpayers and types of income is the most likely outcome.

"I don't think that there's any chance that they're going to let everybody who is paying taxes pay higher taxes," he says. "But so much of this is speculation. You just don't know."

The advisers cautioned that while taxes as a big issue, paying less taxes isn't the ultimate objective.

Business owners should focus on the long-term prosperity of their companies. "Act on this assumption: economics first, taxes second," Mr. Richardson advises.

For individuals, taxes should be a tactical rather than a strategic consideration, Mr. Fragasso says.

While tax treatment may determine what goes into a portfolio, he says, "We'll continue to manage the same way."

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First published on August 15, 2010 at 12:00 am