BROWN ADVISORY

The Taxman Cometh

For taxable investors, the last five years have been as good as it gets. The 15% tax on long-term capital gains is the lowest since World War II, and dividends have received preferential tax treatment (also 15%) for the first time ever. We do not, however, expect these low rates to continue much longer.

Bush Tax Cuts and Sunsets - Current Legislation

	Rate Through 2010	*Rate After 2010*
Dividends	15%	Up to 39.6%
Long-term Capital Gains	15%	20%
Individual Income Tax Rates	10%	
	15%	15%
	25%	28%
	28%	31%
	33%	36%
	35%	39.6%
Estate Taxes	Top rate falls from current rate of 45% to 0% in 2010	55%
Gift Taxes	Top rate falls from current rate of 45% to 35% in 2010	55%

Our nation has a history of sporadic tax cuts, followed by slow but steady tax increases and ever-increasing government spending. Whatever the cause, the U.S. deficit is growing in absolute dollar terms, and the long-term budget outlook is troubled. To further complicate the mix, we face a highly unusual legislative conundrum related to the Tax Code: President Bush's tax cuts of 2001 and 2003, which amount to almost $200 billion per year in tax relief, are set to expire in 2010, followed by a reinstatement of the much higher rates that existed in 2000. Absent future legislation, long-term gains will be taxed at 20% and dividends will be taxed at the top rate of 39.6% beginning on January 1, 2011. Congress probably will enact tax legislation next year, but such legislation is unlikely to contain a wholesale extension of the Bush tax cuts. In the years since the tax cuts, the Republican Party – traditionally the champion of low taxes – has seen its political fortunes decline.

This strange tax scenario is a financial concern to be sure, but if you're a politician, the choices are career-threatening. Politicians go to great lengths to avoid association with tax increases, but the cruel reality of the numbers will not go away. The Alternative Minimum Tax (AMT) is affecting millions of additional taxpayers each year, but repealing this hidden tax would reduce Treasury revenues by almost $1 trillion over the next 10 years. Failing to extend the Bush tax cuts permanently will impose a tax increase on millions of taxpayers, yet extending these lower rates leaves little room to protect those becoming ensnarled by the AMT. Our next President – regardless of party affiliation – and the newly-elected Congress will face an ugly fiscal plight. To state the obvious, the fall elections will have a lot to do with where taxes are headed, and the outcome is, of course, unknown. Nevertheless, here are some thoughts on what changes might be in store and when they could become effective.

INCOME TAX CHANGES

Long-Term Capital Gains

From 1978 until 2003 the tax on long-term capital gains generally alternated between 20% and 28%. Our best guess is that the tax rate on gains will return to the 20-28% range by 2010. Although the 15% rate has been popular, it seems unlikely to survive given the deficit and spending picture, as well as a strong probability of continued Democratic control of Congress.

We believe that no change to the tax on long-term gains will occur before the next President is inaugurated in January 2009. A new President and Congress probably could not enact such a change before May 2009. It would be unusual (but not unprecedented) for such a tax increase to be made retroactive to the beginning of 2009. A mid-year effective date, however, seems much more likely, and an effective date of January 1, 2010 seems quite plausible.

Dividends

We approach with more trepidation the challenge of predicting the future tax rate on dividends. Until 2003, dividends always had been taxed as ordinary income, and that rule is slated to return in 2010.

The arguments with respect to timing of the long-term capital gains tax increases also apply to the anticipated change in the tax on dividends, with one caveat. A retroactive tax increase seems a little more likely for dividends than for long-term gains. A retroactive change to the capital gains tax rate seems unfair because it deprives an investor of the ability to make an informed investment decision on an after-tax basis at the time of the sale. The receipt of dividends, however, is an involuntary act, and it might be argued that a retroactive tax increase on dividends would not deprive investors of the opportunity to make an informed decision.

Estate and Gift Taxes

Full repeal of the estate tax – the cherished dream of an intense and decade-long lobbying effort – is almost certainly dead. However, in its place is likely to be a very significant reduction in estate taxes. The exemption is likely to be higher, and the tax rates lower. We believe a compromise will be achieved in Congress that will settle on an exemption in the $4-5 million range (per individual) with a top rate as low as 35% (versus the current rate of 45%).

Gift tax rates are likely to follow the same rate schedule, but it is impossible to predict whether the lifetime gift tax exclusion will be re-coupled with the estate tax exclusion (as it was prior to 2001) or remain at a lower level ($1 million today).

The timing of these changes is critical, of course. No one knows when Congress may agree on a compromise – the political stars must align properly – but it is increasingly clear that regardless of when the legislative debate is settled, the changes will not be effective until January 1, 2010. Meanwhile, there seems to be no inclination to upset the schedule adopted in 2001. So we are stuck with existing law until that date – a $2 million estate tax exemption, growing to $3.5 million in 2009; a $1 million gift tax exemption; and a maximum 45% tax rate on both estates and gifts – even though we think it is safe to assume a new set of rules will be in place for 2010. With widely differing policies emerging from the campaign trail and the exact make-up of the legislature unknown, there is a fair amount of political uncertainty regarding the details of the next estate tax regime, except that a full repeal probably is not plausible.

MARKET IMPACT OF TAX INCREASES

The prospect of an increase in the long-term capital gains tax will certainly induce taxable investors to sell some appreciated assets before the advent of the higher tax. Will this have a significant adverse impact on the market? While the approach of a tax increase could create some downward pressure on certain stocks or even on the market, we expect that such pressure would be both temporary and minor relative to the traditional drivers of the market.

Although every sale has at least some theoretical impact on the market, tax-sensitive investors make up a relatively small percentage of the trading volume on the equity markets. Institutional investors (pension funds, mutual funds, insurance companies, foundations and institutional trustees) hold almost 70% of the outstanding shares of the 1,000 largest U.S. corporations.[1] With the exception of mutual funds and institutional trustees, these investors would be indifferent to a change in the 15% tax rate. As for the other 30% of the market, hedge funds, which are notoriously tax-insensitive, make up the lion's share, at least by volume.[2] Individuals who have invested in mutual funds surely care about the 15% rate, but most mutual funds managers seem to pay little attention to taxes. Morningstar, the mutual fund research firm, reports the median annual turnover (percentage of investments that are sold in a given year) for U.S. stock funds is 70%.[3] By comparison, tax-sensitive investors will generally have an average turnover of about 30%. Even if selling by taxable investors is sufficient to drive down particular stocks, we would expect other investors to eventually step in to snap up bargains.

Consider Sales of Concentrated Positions

Investors with large, low-cost stock positions are among those with the most to lose if the tax rate on long-term gains is raised. Since we expect this increase, are we advising our clients to sell now? It depends. Incurring a tax sooner to take advantage of a lower rate generally makes sense if the tax would have been incurred in the near future anyway. Given sufficient time to defer the tax, however, the benefits of deferring the tax can exceed the benefit of the lower tax rate. There are a number of unknowable variables in this calculation, including the rate of return, the magnitude of the tax increase and the length of deferral. Thus, this decision involves as much art as science. In general, where a diversification program already exists for a concentrated position, we are accelerating that program somewhat in 2008, and where a program is not yet in place, we are discussing the possibility with our clients.

Perhaps viewed as a thin silver lining, one positive side of an increased tax rate (aside from hopefully improving the fiscal balance of government revenues and spending) is the increased value of a charitable deduction. Since current income tax laws allow those who itemize their deductions to reduce their taxable income by the value of their charitable contributions (within limits), offsetting income that would be taxed at a higher rate would make some sense. While we are not advocating that a regular charitable giving plan be altered, it is worth considering the impact of deferring a large one-time contribution.

We welcome the opportunity to work closely with you and your other advisors to offer insights on investments and tax planning that will result in the most successful outcome for you.

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[1] The Conference Board, Press Release dated January 22, 2007
[2] "Public Interest Demands Hedge Fund Rules," Randall Dodd, *Policy Innovation*, January 12, 2007
[3] Morningstar.com, 2008

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