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Tax Wars
Washington Is Bracing for a Historic Battle Over U.S. Tax Law. Here's What You Should Do Now
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Text
Not since the Great Depression has Congress had so much tax work to do in so little time.

Congress will have to tackle a mountain of tax decisions in the coming weeks. Laura Saunders joins the News Hub to discuss how American taxpayers can effectively plan to deal with the uncertainty surrounding the future of those taxes.
From the income tax to the estate tax, from the alternative minimum tax to levies on capital gains and dividends—plus much more—nearly every area of individual taxes is in limbo. Come January, for example, the top federal rate on dividends could be as low as 15% or, if nothing is done, as high as 40%.
It gets worse: Lawmakers have only four weeks to tackle these massive issues before Columbus Day, when they adjourn until November. During these weeks, each party will be looking for opportunities to make political theater ahead of the coming elections. The drama will likely slow things further, especially in the Senate, where lately it has been tough to muster a filibuster-proof 60 votes for any measure more controversial than a flag raising.
This past week, President Obama gave a barnstorming speech in favor of dropping the 2001 tax cuts for those making more than $250,000, and House Minority Leader John Boehner (R, Ohio) countered with a proposal to extend them for all taxpayers for two years.
Despite the theatrics, says veteran analyst Clint Stretch of Deloitte Tax LLP, "The unprecedented uncertainty on taxes is unlikely to be resolved until December." What's more, he warns, lame-duck sessions are unpredictable as well.
Already the uncertainty has been a costly distraction for many. Laura Wilson, an owner of Asheboro, N.C.-based Pyramid Services, a building and road-maintenance firm with 700 employees, regrets two moves she says were prompted by the current void. This year, she says, she and her co-owner brother, who inherited the firm from their father, plan to distribute its first-ever dividend. "We'd prefer to leave the money in the business," she says, "but considering how much the rate could go up, a distribution made sense."
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Tea partiers rally in Olympia, Wash.: The stage is set for an epic battle over the nation's tax laws, from income and capital gains to estate taxes.

Ms. Wilson says she and her brother also are paying more than $100,000 to buy "key man" insurance that would help pay taxes if either one dies suddenly. (Currently there is no estate tax but heirs may owe significant capital-gains taxes, while next year the estate exemption

is slated to be only $1 million.) If Congress reimposes 2009's much larger $3.5 million exemption, she says, "that would do a lot" to lower her premiums.
Other taxpayers feel overwhelmed just trying to keep up. "A typical question from my clients is whether the expiring Bush tax cuts will affect their 2010 or 2011 returns," says Leonard Williams, an accountant in Sunnyvale, Calif. (The answer: 2011.)
Despite lawmakers' foot-dragging, one fact is sure to galvanize their attention, says Mr. Stretch. It is the certainty that if Congress doesn't act this year, the "Bush tax cuts" will expire and early in 2011 tens of millions of paychecks, at incomes high and low, will shrink as a result of higher withholding.
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1. Pres. Barack Obama 2. Larry Summers, Director, National Economic Council 3. Sen. Harry Reid (D., Nev.), Senate Majority Leader 4. Sen. Mitch McConnell (R., Ken.), Senate Minority Leader 5. Rep. Nancy Pelosi (D., Calif.), Speaker of the House 6. Rep. John Boehner (R., Ohio), House Minority Leader 7. Rep. Steny Hoyer (D., Md.), House Majority Leader 8. Sen. Max Baucus (D., Mont.), Chairman, Senate Finance Committee 9. Sen. Charles Grassley (R., Iowa), ranking minority member, Senate Finance Committee 10. Rep. Sander Levin (D., Mich.), acting chair, House Ways and Means Committee 11. Rep. Dave Camp (R. Mich.), ranking minority member, House Ways and Means Committee 12. Sen. Ron Wyden (R., Ore.), outspoken tax reformer 13. Rep. Paul Ryan (R., Wisc.) tax and budget reformer 14. Sarah Palin, potential 2012 presidential candidate 15. Timothy Geithner, Secretary of the Treasury

That's because the changes of 2001 lowered tax bills for millions of taxpayers with modest incomes as well as for the rich. So the expiration is far more politically volatile than this year's estate tax lapse, which—although stunning—will affect the heirs of perhaps 50,000 people.
Here is a guide to where things stand, along with suggestions for what to do—or not do—in order to cope:
Income-tax rates
• Status: The "Bush tax cuts" of 2001 expire at the end of 2010. The top nominal income-tax rate would revert to 39.6% and the current 33% rate would rise to 36%. Taxes on millions of low- and moderate-income taxpayers will rise as well.
• What's ahead: a fierce battle. President Obama is demanding the 2001 cuts be extended only for those making less than $250,000. But some in his own party, plus many Republicans, want to extend them for all taxpayers, perhaps for two years. Many political analysts don't expect resolution until late this year.

Given that most of the benefit of a tax-cut extension for those making more than $250,000 goes to taxpayers with incomes over $1 million, some are wondering whether lawmakers may wind up imposing a "millionaire's tax," while preserving the cuts for those making less.

• What to do: Watch and wait. Prepare to take bonuses or accelerate income into this year and defer deductions into next year, when they will be more valuable, if it becomes clear that rates will rise. Mr. Stretch from Deloitte Tax points out that whatever happens next year, taxes for upper-income taxpayers are all but certain to be higher by 2012 or 2013, especially with the 3.8% investment income tax that will take effect in 2013, so plan accordingly.

Stealth income taxes

• Status: Two provisions that used to limit benefits for upper-income taxpayers aren't in current law. One is the personal exemption phase-out (PEP), which erodes the $3,700 deduction per family member for singles with income above about $170,000 and joint filers above about $255,000.

The other is the "Pease haircut" (named for the congressman who pushed it), which shrinks the value of itemized deductions for taxpayers with incomes above about $170,000. The Pease haircut often adds about 1% to the tax rate of affected taxpayers, according to Roberton Williams of the nonpartisan Tax Policy Center.

• What's ahead: Both limitations will return unless the Bush tax cuts are extended. Mr. Obama's budget reinstates them, as would expiration of the cuts.

• What to do: These back-door tax increases are hard to counteract, but affected taxpayers should remember that absent extension of the 2001 cuts, their tax rate will be higher than advertised.

Capital gains

• Status: The current top rate on long-term capital gains is 15%, which expires at the end of this year.

• What's ahead: Unless Congress acts, the top nominal rate will revert to 20% in January, which is the rate Mr. Obama's budget has called for. A temporary extension of current law would leave the 15% rate in place. The issue will probably be decided along with income-tax rates.

• What to do: "Don't let the tax tail wag the dog on investments," says Kenneth Kossoff, an attorney with Panitz & Kossoff LLP near Los Angeles. The big exception: He and others are advising clients with transactions involving large capital gains to complete them in 2010 if possible. Remember that if tax rates rise next year, so will the value of long-term capital losses carried forward from the past decade's market slaughters.

Dividends

• Status: The current top rate on qualified dividends (generally, those held longer than 60 days) is 15%. It expires at the end of this year.

• What's ahead: Unless Congress acts, the top nominal rate on these dividends will revert to the top rate on ordinary income of 39.6%.

A temporary extension of current law would leave the 15% top rate in place. Mr. Obama's budget calls for a top tax rate of 20% on dividends, rather than 39.6%. This issue will probably be decided along with income-tax rates.

• What to do: Owners of C-corporations who normally distribute dividends after the new year may want to accelerate them into 2010, and those who don't typically pay a dividend may want to consider it.

Alternative minimum tax

• Status: The "patch" to narrow this tax's reach for the 2010 tax year hasn't been passed yet by Congress. Thus the exemption for married joint filers is currently $45,000, as opposed to nearly $71,000 last year. If the patch doesn't get done, 32 million taxpayers will owe AMT in 2010 versus 5 million last year.

Clint Myers, an investment actuary in Georgetown, S.C., figures it would raise his tax bill 10%—more than the expiration of the 2001 tax cuts would.

• What's ahead: Congressional tax staffers say they think the patch will get done when Congress addresses income-tax issues.

• What to do: People who owe estimated taxes are supposed to be paying at higher "nonpatch" rates until Congress fixes the problem. You can avoid paying at these higher rates or risking penalties by using an IRS "safe harbor," such as paying 110% of last year's taxes.

• Also: if tax rates go up next year, it becomes harder to fall into the AMT. Thus deductions may become more valuable, says Douglas Stives, an accounting professor at Monmouth University in New Jersey.

Charitable donations

• Status: No radical changes are imminent. Congress hasn't, however, reauthorized a provision allowing taxpayers older than 70½ to donate directly from individual retirement accounts to charities for 2010.

• What's ahead: The IRA provision is part of an "extenders" bill that with luck will pass before the new year. But Mr. Obama has proposed limiting the value of donation deductions for upper-bracket taxpayers to 28%.

• What to do: Prof. Stives is advising taxpayers who want to make large contributions in 2011 to consider making them in 2010 instead.

Retirement funding

• Status: This is the first year all taxpayers have been allowed to convert regular IRAs into Roth IRAs, which allow tax-free withdrawals and have other benefits. In addition, there are several proposals before the Senate that would broaden retirement plan options. One would allow employees to convert regular 401(k) assets to Roth 401(k) accounts.

What Would You Owe?

This year's extreme tax confusion has yielded one useful outcome: a bumper crop of free online calculators allowing taxpayers to estimate their federal income tax bills under various scenarios.

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• What's ahead: These proposals are part of a small-business bill that may be passed before Congress adjourns in October.
• What to do: Consider whether to convert IRA assets to a Roth account, which means accelerating income taxes. The good news is that 2010 converters may undo such conversions until Oct. 15, 2011.
Estate taxes
• Status: Because of Senate inaction, the estate tax lapsed as of Jan. 1, 2010, and it returns in 2011 with a $1 million exemption per individual and top rate of 55%. Although there is no estate tax this year, heirs of those dying in 2010 may owe full capital-gains tax on sales of inherited property if the total estate is more than $1.3 million (plus $3 million if the heir is a spouse).
By contrast, 2009 and 2011 laws tax heirs only on gains from the date they inherit an asset. Current law requires extensive recordkeeping and actually raises taxes on many heirs affected by 2010 law.
• What's ahead: Many believe Congress will return the estate tax to its 2009 level—a $3.5 million exemption per individual and a top rate of 45%—with an outside possibility of raising the exemption.
There also is sentiment for giving heirs of those who die in 2010 the choice of using 2009 rules. Congressional staffers have said they expect lawmakers to address estate taxes at the same time as income taxes. Tax returns for those who die in 2010 are due April 15, 2011, or Oct. 15 with a six-month extension.
• What to do: The IRS hasn't yet published a form or guidance for 2010 law. Many advisers are telling heirs of those who die in 2010 to gather records and, if possible, put off irreversible actions until the outcome is clearer. But some executors of estates that benefit under 2010 law have taken the opposite tack and settled them quickly, vowing to sue if Congress makes retroactive changes raising their tax.
Gift and generation-skipping taxes
• Status: This year the top gift-tax rate is 35% and there is no generation-skipping tax. In other years the latter imposes a second layer of tax when donors or trusts make very large transfers to someone two or more generations removed.

• What's ahead: Unless Congress acts, the gift-tax rate will rise to 55% in January. If Congress extends 2009 rules, the rate will be 45% instead. The generation-skipping tax also returns in January. It is unclear how lawmakers will treat these issues when they deal with the estate tax. This late in the year, it would seem unfair to impose these taxes retroactively for 2010, says Carol Harrington, an attorney with McDermott, Will & Emery in Chicago.

But, she adds, "if they are hunting for pennies in the sofa cushions, who knows what will happen?"

• What to do: Many advisers, including Ms. Harrington, are suggesting that wealthy clients plan for taxable gifts in 2010 but not pull the trigger until late December. This minimizes the chance of the donor dying shortly after the gift, which would mean paying unnecessary tax. In addition, the law might be clearer.

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