# Taxes and the Election

*What the Election of Barack Obama Means to You*

## Special Edition

This is the first of our quarterly tax newsletters, in which we bring time sensitive information to you as soon as it happens.

The effect of this year's election will be large and perhaps will be felt most acutely by high-income taxpayers.

In the discussion below, we've attempted to summarize the Obama tax plan and its effects. Most of the details are yet to be worked out, but, with a huge majority in Congress, the new President will likely get whatever he desires in new taxes. We've based our commentary on the positions he detailed over the course of the campaign. Stay tuned!

*Kevin Kilcullen and Jim Elliott*

## ***Get Ready for Obamanomics!***

Read my lips…no new taxes! Oops, wrong election! Get ready for substantial increases in taxes on earned income, investment income, capital gains and even a possible increase in social security taxes. How will newly elected President Obama and a Democratic majority in Congress change the tax law for higher income citizens? Let us count the ways:

1. The Bush tax cut on ordinary income will likely be repealed next year for those making over $250,000. President-elect Obama has promised to raise the top tax rate to 39.6% (what it was before the Bush tax cuts were enacted in 2000), without specifying exactly when. It is not a foregone conclusion this will be one of the first priorities of the new Administration, but it seems clear this change will be coming relatively soon.

2. It also appears that the Obama plan could include a 2% increase in Social Security taxes once a $250,000 level is reached. As the Tax Policy Center puts it on their website (http://www.taxpolicycenter.org ):

   "Senator Obama says he would subject high-income taxpayers to additional taxes 'in the range of 2 to 4 percentage points more in total (combined employer and employee)' starting 'a decade or more from now' to help shore up Social Security. Nonetheless, his campaign advisers insist that there is no specific proposal."

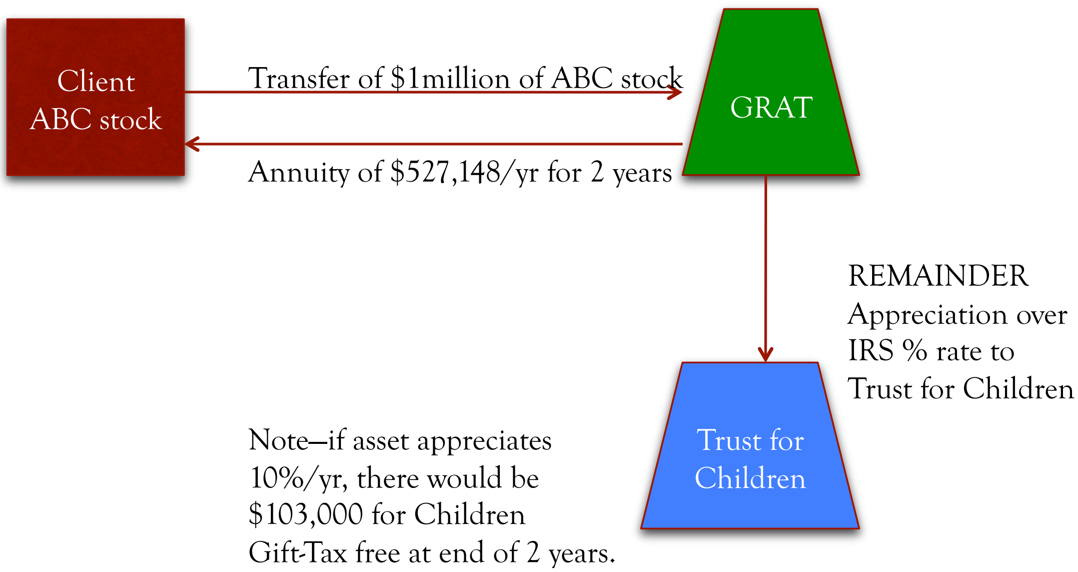
   However, while details are sparse, it is possible that President-elect Obama's Social Security proposal would be implemented sooner, imposing a 2% income tax surcharge on adjusted gross incomes over $250,000, as well as a 2% payroll tax on employers. Such an increase would be an additional tax of 2-4% on every dollar over $250,000. Combined with the increased rate on ordinary income, this means the total tax rate could rise to as high as nearly 42% on wages.

3. The tax rate on both long-term capital gains and qualified dividends will likely be increased from 15% to 20%.
4. President-elect Obama has said in the past that he supports "fiscally responsible" AMT reform, without detailing what that means. Nonetheless, we don't expect the AMT exposure to decrease.
5. Estate Tax Changes: the Obama plan would freeze the current (2009) 45% rate and $3.5 million "unified credit" per person. The Obama campaign also indicated that the $3.5 million might become "portable," meaning it could be combined with the other spouse's credit and alleviate the need for some complex trust structures. It appears that the current version of only allowing a deduction for state estate taxes would also continue.
6. For those of you who manage hedge funds, the new Administration promises to tax income from carried interests at ordinary rates. This is a potential major change, as much of this income is currently classified as capital gains (depending on the facts of the hedge fund).
7. This is probably not the end of it—under the Tax Policy Center's analysis, it is estimated that the budget deficit will grow by $3.6 trillion. (President-elect Obama also plans corporate changes, which we've not explored here, but which could help close that gap.) As mentioned previously, it also is not clear how soon all this will be enacted. If the economy is in a deep recession, the new President may be slower to push for tax increases. Stay tuned.

So what is someone earning over $250,000 in taxable income--or $200,000 if filing single--to do?

- Do a good projection of your 2008 taxes. It may make sense to accelerate income into 2008, or defer deductions into 2009, but not until the timing becomes a little clearer. Additionally, it may not make sense to have the tax tail wag the investment dog, since the differential between capital gains tax rates is not enormous (and since the boost in tax rates may have a blended rate in the first year anyway or may apply to sales or exchanges after the effective date of new legislation). Since it is unlikely any significant AMT relief will occur, there is a need to see where you fit on the AMT spectrum—if you will be in it for 2008, then deferring certain deductions to 2009 would likely be a good idea (for example, making state estimated payments in 2009). As you can see from the above, one big wild card here is payroll taxes. If increased, they could boost the marginal rate on wages to almost 42%, though when is the big question. Another wild card is how your capital losses (and everyone has them after October) can best be used. In general, short-term gains are netted against short-term losses, long-term gains against long-term losses, then if you have losses in one category (say, short-term) and gains in the other, you net the two. The results could be surprising and warrant figuring out before you get too deep into December.

- Estate Tax/Gift Tax Planning—now that we finally will be getting some certainty in the law, it will be time to dust off wills and make sure they fit with whatever new version of the Obama platform is enacted. In the meantime, now is a very opportune time to be doing some specialized gift planning. The IRS-prescribed interest rates in November are exceptionally low (for example, 1.63 percent for loans of 3 years or less), so now may be a good time to do some intra-family lending, selling of assets, or more sophisticated transactions like Grantor Retained Annuity Trusts (GRATs) and sales to trusts. With the recent level of volatility in the market, GRATs and these special sales are even more attractive. Below, we've given an example of the GRAT technique, for which the current IRS interest rate is 3.6% (a very low rate by historical standards).




In this plan, the client places an asset into a special trust (the GRAT). The GRAT then promises to pay the client back an annuity over the life of the trust. This annuity is set up so that, using the IRS rates as determined each month, there will be no residual gift involved. Then, if the asset in the GRAT grows greater than the IRS rate, there will be something left over at the end for children (or for a trust for the children). You will see that, in this example, if a $1 million GRAT can earn 10% per annum while paying out 3.6% (the November 2008 rate), the transfer without gift tax could be almost $103,000. The other benefit of a GRAT is that, if the asset decreases in value, or does not grow at the IRS assumed rate, the client gets all the property back (without a gift tax being paid) and then simply does it again. Using annuity payments to start new GRATs is what is meant by the term "rolling GRATs." In addition, the trust for the children can be set up to be "defective" for income tax purposes, meaning the parent would be liable for the income taxes on the trust, avoiding depleting the trust by income tax payments.

- Of course there are other, timely gift tax planning ideas that should be considered seriously, such as insurance trusts, family limited partnerships, dynasty trusts, residence trusts and charitable trusts, now that it seems so likely that relatively high estate tax levels are here to stay. Some of these will be spotlighted in future newsletters.

WHERE DO WE GO FROM HERE?

In summary, pay attention to your tax issues now, including income and estate/gift taxes. If you anticipate and plan for change, it will be less upsetting (and costly) on arrival. If you have questions about how the new Obama tax plan will affect you, please call any of our tax, trust and estate attorneys at the numbers set forth below:

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