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Taxes and the New President: What to do now?

In past years, conventional tax planning has revolved around deferring income and accelerating deductions. However, tax planning for 2008/2009 presents two great uncertainties: the election of a new president and the faltering economy. With these things in mind, we are reprinting a recent article published by the New York State Society of CPA's. It discusses some of the possible changes to our tax system and the impact that it may have upon your year-end tax planning.

We recommend that after you read this article, please consult your SKP contact person to discuss how best to adjust your personal planning to these new developments.

Taxes and the New President

By Melissa Hoffmann Lajara, NYSSCPA E-ZINE
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NEW YORK -- With a nation still reeling from relentless stock market dives, a staggering economy and widespread home foreclosures, some believe raising funds through taxation is necessary.

With the selection of Illinois Senator Barack Obama, that responsibility is expected to rest on the shoulders of the wealthy -- via either legislation or the expiration in 2010 of a host of tax breaks installed by President George W. Bush.

The definition of "wealthy," for Obama's purposes, is an individual making more than $250,000 per year -- and most of those individuals have CPAs managing their money.

"It will be very difficult for CPAs because CPAs will find themselves with substantially more work to be done in terms of planning and in terms of complications," said Alan Dlugash, a past chair of the Taxation of Individuals Committee and a speaker at this year's Post-Election Tax Planning Conference on Dec. 8 at the FAE Conference Center in New York City.

But there are ways a CPA can prepare and even some ways to benefit, said Sidney Kess, a nationally known tax expert and educator also presenting at the conference..

"The CPA has to try to anticipate the changes, and may want to take certain steps because of that," Kess said. "Stock has declined, so it may be a good time to make gifts. Make loans to family members. Take advantage of the current economic situation."

A CPA needs to take the recession into account, as well as the possibility of tax increases in the near future, Kess said.

Planning “is more important now than ever before. It may be that capital gains will never be as low as they are right now,” he said. “There are challenges and opportunities for the CPA and his client as a result of economic and legislative uncertainty.”

Both candidates made a lot of promises during their campaigns. Among other things, Obama offered a $4,000 tuition credit, a universal 10 percent refundable credit to offset mortgage interest payments for lower-income families and a 50 percent health tax credit on employee premiums paid by employers -- which, according to Obama’s Web site, would bring down national health care costs by $2,500 per family each year.

But, Kess noted, the president “can only recommend” such dramatic alterations to the current system. The actual changes would have to come from Congress. Although the Democrats gained a number of seats in the election, there is still no guarantee that Obama’s proposals will see the light of day.

“He’s got a split Democratic part, different members with different agendas, and then you’ve got the Republicans,” Kess said. “There’s a long way to go before things are changed.”

Kess should know. A CPA member of the Society for the past 50 years, he has witnessed and worked through several presidential transitions. However, he said pointing to the current economic crisis, “we’ve never had anything like what we’re going through right now.”

A bevy of CPAs in different areas of taxation, are all mulling the same question: What do we do now?

Proposed Changes

Tax Rates

The most recent major change in tax rates was the reduction of the capital gains rate by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA).

Subsequent legislation passed during the Bush administration lowered the rates across the board, but is scheduled to sunset in 2010. The two highest current capital gains rates are 33 and 35 percent.

By design, the tax code rewards certain behaviors, such as procreation and home ownership, with credits. Obama has said he supports repealing a portion of the tax cuts for families making more than $250,000, and all tax rates would remain the same, except the higher pre-EGTRRA rates of 36 and 39.6 percent for the two top tiers of taxpayers. They would be reinstated.

“As far as relief for individuals, a lot of the relief that passed from 2000 to 2003, and is set to expire in 2010, in will be extended but only for taxpayers with less than 250,000 in income,” Kess said. “As I see it, the tax relief would include a higher child tax credit, marriage penalty relief, the 10 percent tax rate.”

Obama backed himself into a corner with the tax rates, said William Henry Jones, immediate past chair of the Taxation of Individuals Committee.

“He has to give a cut to everyone making under $250,000,” he said. “He only said it 500 times during the campaign. He doesn’t have to do it right away, but sometime in the next three years, he has to, and he will.”

Dlugash, who will primarily discuss year-end tax planning at the conference, said he sees a possible resurrection of Congressman Charles B. Rangel's proposed tax law of 2007, "which included enormous tax increases in capital gains as well as ordinary income, as well as the reinstitution of adjustments that had already been phased out."

Jones said he believes Obama will only raise the capital gains rate for those making more than the benchmark $250,000.

"Because of the state of the economy right now, it's not clear when [Obama's] solid direction toward higher taxes will go into effect. The state of the economy may delay the onset," said Dlugash.

However, "for planning purposes, one must assume taxes will be higher on all fronts," Dlugash said. "In terms of tax planning, what that means is that the timing of transactions has to take into effect the fact that tax rates will go up. Such things as the timing of the sale of long-term assets, … timing of receiving bonuses, structuring transactions in which there's the ability to characterize between capital gain and ordinary income, all of these types of transactions need to consider proposed law changes."

Mortgage Interest Deduction

It has been a long-standing tenet of the code to have mortgage interest allowed as an itemized deduction on Schedule A to Form 1040. When Congress toyed with the idea of eliminating it several years ago, the public and all of its sectors nearly erupted, and the deduction remained intact. Obama's campaign promises included a universal 10 percent deduction of mortgage interest.

The Alternative Minimum Tax (AMT)

Created four decades ago to prevent a small number of very wealthy individuals from avoiding taxation, the AMT -- not indexed for inflation -- has become a net that has the potential to trap millions of middle-class taxpayers. Each year, Congress passes patches to prevent the AMT from affecting middle-class taxpayers. Obama has said he would index and extend the 2007 AMT patch, according to the Tax Policy Center.

"The Alternative Minimum Tax needs to be viewed in light of whether there are going to be specific changes," Dlugash said, "or whether it's just likely the impact will be minimized because tax rates are going up."

The Estate Tax

The estate tax in the U.S. is imposed on the transfer of the "taxable estate" of an individual. Rates and the amounts subject to tax have varied over the years and decades due to tinkering. Currently, both are at a recent low and subject to expire in 2010 after which they revert to the older, higher amounts. Obama has said he would eliminate the estate tax for 99.7 percent of estates. For the remaining 0.03 percent, which is estates of over $7 million, he would retain the current 45 percent rate.

"At a minimum, we're going to get some estate tax exemption," Kess said. "A top estate tax rate of 45 percent, exemption amounts portable between spouses and valuation based on the date of death value, rather than on a carry-over basis, from what president-elect Obama indicated prior to the election," Kess said.

Corporate Taxes

Obama has said he would repeal tax breaks and "loopholes that reward corporations that retain their earnings overseas" and would use the savings to lower the corporate tax rate for companies that expand or begin operations in the U.S. He has indicated he would require carried interest be taxed as ordinary income, and would make the research and development tax credit permanent. He also said he would eliminate all capital gains taxes on investments in small and start-up firms.

Other Proposals

Prior to the election, Obama said he would institute a $4,000 tuition tax credit and a job tax credit of up to $1,000 for lower-income Americans. He said he would also eliminate all income taxes for seniors making less than $50,000 per year, expand the earned income tax credit and increase tax benefits for child care. In addition, he would offer up to $7,000 in consumer tax credits for the purchase of environmentally friendly vehicles.

"There's one thing he has to be careful of," Jones said. "Just because he's got the House, Senate and executive office, doesn't mean he's going to be able to do whatever he wants. If he goes too far in one direction, he could lose the House in the next election. That's what happened with Clinton."

Dlugash said he thinks that any simplification through Obama's tax policy is unlikely, and that additional complexity must be thwarted.

"We have absolutely no excuse if we don't come down extremely hard on proposed changes to the tax law that add substantially to the complexity of the law," he said. "It's that silence in the past that has allowed the dysfunctional state of the tax laws to exist."

States are expected to see some tax law changes as well, which Mark A. Plostock, a current and past member of several Nassau Chapter taxation committees, will review at the conference. Plostock will also address other methods that the tax departments may employ to increase revenue.

"You'll see more and more audits being performed," he said. Taxpayers who haven't paid taxes in many years may see some sort of amnesty, where interest and penalties may be abated. "They'll be collecting a lot of old taxes, then have that person on the tax rolls," Plostock said.

Plostock said he believes the changes in the makeup of Congress and the new presidential administration will benefit New Yorkers and potentially others in the tri-state area.

"It will help the states to get federal aid, being that they have the majority in Congress," he said. "There might be a bigger chance of seeing some AMT relief because we have such high state taxes. But between the financial crunch and all the rhetoric that went on in the campaigns, it's [hard] to know what's going to shake out."