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Big tax changes may be on the way

The fate of the “Bush tax cuts” and strategies to help minimize the bite

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Executive summary

Sweeping tax legislation enacted under George W. Bush is set to expire at the end of 2010. The ramifications for savers and investors are significant, including higher or reinstated taxes across the tax code, affecting millions of Americans. Congress has the remainder of 2010 to agree on legislation that would extend some or all of the Bush-era tax cuts, but nothing is certain, given election-year politics and the highly partisan atmosphere in Washington. Proposals for partial reinstatement are already circulating in the House and Senate, however. This paper reviews how taxes could change across a number of areas if no new legislation is enacted, and highlights several proposals now in Congress. It also discusses two new taxes ushered in with health-care reform, and how investors can help defray tax-related expenses in the future. Key points include:

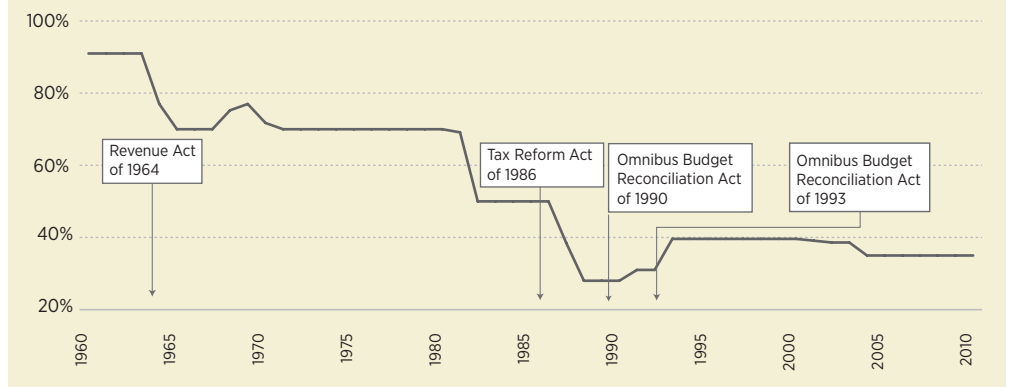
- Income taxes will rise if tax cuts expire
- Estate taxes will return to levels in place almost a decade ago if no legislation occurs
- Dividend and capital gains taxes could rise
- Alternative minimum tax will affect significantly more taxpayers without a fix
- Health-care reform will usher in tax increases
- Investment strategies for tax efficiency

The Bush-era tax cuts were enacted with the passage of the Economic Growth and Tax Relief Reconciliation Act in 2001 and the Jobs and Growth Tax Relief Reconciliation Act of 2003. The acts decreased tax rates across all income levels, reduced capital gains and dividend taxes, and provided for a one-year temporary suspension of the federal estate tax in 2010.

The cuts were enacted under a specific Senate parliamentary rule known as the Byrd rule, named after the late Senator Robert C. Byrd. Under this rule, which at the time required a simple majority vote, the provisions would be enacted for only 10 years. The tax cuts are scheduled to sunset as of December 31, 2010. If allowed to expire, all of the tax rates revert to levels prior to the passage of the laws.

Regardless of what action Congress takes in the coming months to address these expiring provisions, changes in tax laws are likely for 2011, and these changes could result in an overall rising tax environment. By historical standards, today's tax rates are low. In fact, since 1960, federal income tax rates have only been this low, or lower, just 10% of the time [Figure 1].

FIGURE 1: TOP MARGINAL INCOME TAX RATE SINCE 1960



Source: Internal Revenue Service, 2010.

INCOME TAXES

If no new legislation

Without new legislation, marginal income tax rates will rise across the board. The highest income tax bracket would rise to 39.6% from 35%. The current 25% tax bracket would revert back to 28%. The existing 28% tax bracket would rise to 31%. And the 33% tax bracket would increase to 36%. Also, the special 10% tax bracket, created under the Bush tax-cut plan, would return to 15% [Figure 2].

FIGURE 2: INCOME TAX RATES IN 2011

INCOME (Married filing jointly)	CURRENT	IF NO NEW LEGISLATION
\$0-\$17,150	10%	15%
\$17,151-\$58,200	15	15
\$58,201-\$140,600	25	28
\$140,601-\$214,250	28	31
\$214,251-\$382,650	33	36
Over \$382,650	35	39.6

Source: Internal Revenue Service, 2010. Reflects the maximum federal tax rate at each year-end.

Proposals on Capitol Hill

In his FY 2011 budget, President Obama proposed to let the current law expire only for the upper-income tax brackets, and to keep the existing tax schedule in place for individuals earning roughly less than \$200,000 and couples earning approximately less than \$250,000 [Figure 3].

Many Republicans, including Senate Minority Leader Mitch McConnell (R-KY) and Senate Minority Whip Jon Kyl (R-AZ), have advocated for extending the tax cuts in their entirety, across all income levels. Some business groups have expressed concern that allowing the tax cuts to expire would also hurt small businesses and discourage hiring.

In July, Senate Finance Committee Chair Max Baucus (D-MT) kicked off debate on the tax issue with his committee. However, as Congress takes its six-week summer recess, there is speculation that a vote on this issue will not happen until after the mid-term elections, in a lame duck session in the fall. Congress may also vote to merely extend the cuts for another year for all tax brackets until a compromise on a longer-term plan can be reached.

FIGURE 3: THE OBAMA PLAN

INCOME (Married filing jointly)	CURRENT	OBAMA BUDGET PLAN
\$0-\$17,150	10%	15%
\$17,151-\$58,200	15	15
\$58,201-\$140,600	25	28
\$140,601-\$214,250	28	28
\$214,251-\$232,950	33	28
\$232,951-\$382,650	33	36
Over \$382,650	35	39.6

Projected figures for 2011 income tax brackets (married filing jointly) based on estimates from the Tax Policy Center, July 2010.

TAXES ON DIVIDENDS AND CAPITAL GAINS

If no new legislation

The expiration of the Bush-era tax cuts means that taxes on investments would increase. Under current tax provisions, investors pay a 15% tax on qualified dividends and long-term capital gains. If no action is taken to extend current investment tax rates:

- The tax on dividends would more than double to 39.6% (for investors in the highest tax bracket)
- The long-term capital gains tax would increase to 20% from 15%

Proposals on Capitol Hill

President Obama has proposed that the dividend and capital gains taxes both increase to 20% from the current 15% for high-income earners, but remain at 15% for individuals earning less than \$200,000 or couples earning less than \$250,000. Most Republicans propose to extend all of the tax cuts, and the dividend and capital gains taxes would remain at the 15% rate.

THE ESTATE TAX

If no new legislation

This year could mark a once-in-a-lifetime event for the estate tax. For the first time since 1915, the country does not have a federal estate tax because the tax was removed temporarily in 2010 as part of the 2001 tax law. This lapse in the law will allow heirs to escape a federal estate tax payment. One notable example is the estate of George Steinbrenner, owner of the New York Yankees, who died on July 13 at the age of 80, leaving an estate with an estimated value of \$1.15 billion, according to *Forbes*. If Steinbrenner had died in 2009, the first \$3.5 million of the estate would have been exempt from the tax, and the remainder taxed at a maximum rate of 45%. But because he died in 2010, his heirs will avoid paying what could have been a \$500 million bill for federal estate taxes.

Other billionaires whose estates have escaped the estate tax in 2010 include Dan Duncan, an oil billionaire, with an estate worth \$9.8 billion; Mary Janet Morse Cargill, part of the family that owned Cargill, an agricultural services company, with an estate worth \$1.6 billion; and Walter Shorenstein, a real estate magnate with a \$1.1 billion estate.

Without Congressional action, the estate tax will return in 2011 with an exemption for estates of up to \$1 million and with the maximum estate tax rate set at 55% for estates of higher value. If the \$1 million exemption is in place for 2011, the number of taxable estates is expected to increase to 44,000 from 5,500, according to the Urban-Brookings Tax Policy Center [Figure 4].

FIGURE 4: TAX RATES IN 2011 (if Bush-era tax cuts expire)

TYPE OF TAX	2010	2011
Ordinary income	35%	39.6%
Qualified dividends	15	39.6
Long-term capital gains	15	20
Estate taxes	0	55
Gift taxes	35	55
Payroll (individual)	1.45	1.45

Source: Internal Revenue Service, 2010. Reflects the maximum federal tax rate at each year-end.

In addition to the suspension of the estate tax, the “step-up” rules on cost basis for inherited assets that appreciated are no longer in effect as of 2010. Prior to this year, the tax code provided for an unlimited step-up in cost basis on appreciated assets. That is, when heirs inherited appreciated stock, the cost basis of the asset would have been generally based on the value of the asset on the date of death. Without this rule, the inherited security is now valued at the original cost basis of the stock. Depending on the amount of appreciation over the years, it may result in a large capital gain when the asset is eventually sold. Currently, any aggregate gains above \$1.3 million for non-spousal heirs, and \$3 million for property inherited by a spouse, are subject to capital gains tax.

Proposals on Capitol Hill

In July, Senator Bernard Sanders (I-VT) introduced a bill, supported by the Obama Administration and many Democrats, that would restore the estate tax at the 2009 level, exempting up to \$3.5 million from the tax and setting a rate of 45% for estates worth between \$3.5 million and \$10 million. The bill also proposes higher rates for wealthier estates, with a 50% tax for estates worth between \$10 million and \$50 million, and 55% for those worth more than \$50 million. The bill also includes a billionaire’s surtax of 10%. A similar version of this legislation was introduced in the House.

Senators Blanche Lincoln (D-AR) and Jon Kyl (R-AZ) introduced a bipartisan proposal in July that would permanently set the estate tax rate at 35%, with a \$5 million exemption amount phased in over 10 years and indexed for inflation. It would also provide a “stepped-up cost basis” for inherited assets. Heading into 2011, it is clear that investors need to prepare for the return of the estate tax. What is not clear is which estates will be most affected and to what extent as deliberations continue around the exemption amount and tax rate.

ALTERNATIVE MINIMUM TAX

If no new legislation

Introduced in 1969, the alternative minimum tax (AMT) was originally designed by Congress to ensure that wealthy individuals could not avoid income taxes by exploiting weaknesses in the tax code. The AMT is a separate, parallel federal income tax system where certain exemptions, deductions, and credits are not allowed. The AMT rules, however, were not indexed for inflation. As a result, an increasing number of middle-class taxpayers have been subject to the tax.

Over the years, to compensate for rising inflation and income levels, Congress has repeatedly approved a patch to raise the income levels that trigger the AMT. The patches have provided increases in the AMT exemption annually.

If Congress does not act in 2010, the AMT exemption amounts would revert back to levels that were in place in 2000, and an additional 20 million taxpayers would be affected by the tax next year [Figure 5].

FIGURE 5: AMT EXEMPTION AMOUNTS		
	Single filers	Married/filing jointly
2009	\$46,700	\$70,950
2010	33,750	45,000

Proposals on Capitol Hill

For several years, Congress has passed a series of one year "patches" to index the AMT exemption amount for inflation. This year, Congress is considering similar action, but as of this date, no legislative progress has occurred. A proposal to slightly increase the AMT exemption amount for 2010 from 2009 figures is included within President Obama's 2011 budget plan.

HEALTH-CARE REFORM WILL USHER IN TAX INCREASES

Regardless of whether or not Congress acts on the Bush-era tax cuts, there will soon be two new taxes for certain individuals that spring from the Patient Protection and Affordable Care Act and the Health Care and Education Reconciliation Act of 2010. One of the goals of the legislation was to expand health insurance coverage to an additional 32 million Americans currently without insurance. To help pay for that additional coverage, the law increases the Medicare payroll tax for some and creates a new Medicare surtax on investment income.

The increase in the Medicare payroll tax, which will become operative in 2013, will have an effect on higher-income taxpayers. For individuals who earn at least \$200,000 and for couples who earn \$250,000, the individual portion of the payroll tax for Medicare will increase to 2.35% from 1.45%.

The new Medicare surtax on investment income applies to higher-income households as well and goes into effect in 2013. For individuals earning \$200,000 or more and for couples with a combined income of \$250,000 or more, the provision levies a 3.8% tax on net investment income such as interest, dividends, and capital gains. Income from retirement plan distributions, such as pensions, 401(k) plans, Traditional IRAs, and Roth IRAs, is excluded. The tax also excludes interest on municipal bonds.

SIX STRATEGIES TO HELP TAX-LEERY INVESTORS

The combined tax increases related to health-care reform and the expiration of the Bush-era tax cuts would be borne disproportionately by wealthier Americans, particularly given the possible reappearance of estate taxes at a 55% rate [Figure 6].

TYPE OF TAX	2010	2011	2013
Ordinary income	35%	39.6%	43.4%
Qualified dividends	15	39.6	43.4
Long-term capital gains	15	20	23.8
Estate taxes	0	55	55
Gift taxes	35	55	55
Payroll (individual)	1.45	1.45	2.35

Source: Internal Revenue Service, 2010. Reflects the maximum federal tax rate at each year-end.

For investors, there are a number of tax-smart strategies that can be incorporated into a well-designed financial plan. With the help of a financial or tax advisor, investors may find that one or more of the following six strategies help reduce an investment-related tax burden or increase net after-tax income.

1. Municipal bond funds for income

Municipal bond mutual funds can provide regular income that is free from federal, and in some cases, state income taxes, and are particularly advantageous for investors in the highest tax brackets. Unlike municipal bonds, municipal bond funds also provide daily liquidity and the option of a low initial purchase requirement.

2. Mutual funds with tax loss carryforwards for growth

Mutual funds that have experienced losses in the past may provide a tax benefit for investors. Losses may be embedded in the funds for up to seven years, according to carry-forward provisions. As the fund starts to make gains, managers can realize the losses and use them to offset future capital gains, resulting in reduced tax liability for shareholders.

3. Selling appreciated assets before 2011

For investors already contemplating the sale of an appreciated asset, doing so in 2010 may be beneficial tax wise. If an investor sells appreciated assets before the end of 2010, he or she may take advantage of the historically lower capital gains tax of 15%, before it potentially increases. Note that if appreciated assets are given as a gift in 2010 to family members in the 10%–15% tax brackets and subsequently liquidated, no capital gains tax will be assessed.*

* The 0% capital gains rate applies as long as a taxpayer is still within the 10%–15% tax brackets. A significant capital gain distribution could push that taxpayer beyond the 15% tax bracket.

Investing in mutual funds, including municipal bond funds, involve risks and you can lose money. See a fund's prospectus for details.

4. Converting to a Roth IRA before 2011

Investors considering a Roth IRA conversion must act by the end of 2010 to take advantage of the current lower income tax rates in 2010 or opt to spread the tax burden over two years if they choose.[†] Taxpayers with expected higher tax rates may prefer to report income from a Roth IRA conversion on their 2010 tax return, while others may benefit from deferring half of the income until their 2011 tax return and the remaining half on their 2012 tax return. It is important to remember that taxes on the amount converted are generally paid at conversion, but after conversion, any earnings on the investment are allowed to compound tax free and can be distributed in retirement tax free.

Conversions that take place after 2010 can still be beneficial, considering higher taxes are on the way in 2013 as a result of the new health-care reform law.

[†] Income must be reported equally on 2011 and 2012 tax returns.

5. Tax-free charitable rollover

If extended by Congress, investors may take advantage of a tax-free distribution to charity known as a “charitable rollover.” The provision, introduced by the Pension Protection Act of 2006, allows investors who are age 70½ or older to make a tax-free distribution to a qualified charity of up to \$100,000. Avoiding income by directing a charitable contribution tax free from a Traditional IRA is generally more tax-efficient than writing a check to the charity and claiming the deduction on the tax return. One reason is that deductions for charitable contributions may be limited, depending on your income and the size of the contribution. To take advantage of the charitable rollover, the contribution must be a direct gift and not part of a planned giving program. Currently, the charitable rollover includes donations made through December 31, 2009. A proposal to extend the provision for the 2010 tax year was included in the Unemployment Compensation Act of 2010 (H.R. 4213), which passed the House in May. However, the IRA charitable rollover and other tax extenders were removed from the Senate version after attempts to pass the bill failed. The rollover provision and tax extenders may come up for consideration again in the fall.

6. Consider strategies to avoid or minimize the AMT

Managing the relationship between your regular taxable income and the deductions you take on Form 1040 is the key to avoiding or reducing your AMT liability. Working with your tax advisor, there are several strategies you may want to consider such as:

- Avoiding private activity municipal bonds, which are generally subject to the AMT
- Accelerating income in some cases to take advantage of lower, marginal AMT rates
- Delaying certain deductions to future tax years when you may not be subject to the AMT

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Conclusion

There is a great deal of uncertainty about the future of the Bush tax cuts. And future policy changes are likely to complicate the landscape further as government leaders try to spur economic growth, reduce the deficit, and grapple with increased global competitiveness. Indeed, the global economic recovery is evolving at a varied pace around the world, spawning an ever-changing set of implications for tax policy and investments.

In the near term, these impending changes to the tax laws make it more important than ever to stay in touch with your financial advisor and discuss your specific situation. Only he or she can evaluate your current situation, tell you how you may be affected, and help you plan for the future.

Investors are accustomed to hearing about the importance of properly diversifying investments with respect to asset classes and investment styles. Given the prospect of rising taxes, investors must also be concerned about having their assets diversified on the basis of taxability. Tax diversification involves strategically allocating assets across accounts and investment vehicles that are taxed differently — taxable, tax-deferred, and tax-free. With a tax-diversified portfolio, investors may be able to better manage the withdrawal of funds to gain the most tax benefit.

As always, taxes should not be the main driver of any investment decision. But taxes have become an important secondary consideration in planning, and there are a range of strategies, in addition to tax diversification, that may be helpful in protecting your assets for the future.

The views and opinions expressed are those of the authors, are subject to change with market conditions, and are not meant as investment advice.

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