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Strategic Insights

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Election 2012: Déjà Vu All Over Again

Mapping perils, possibilities and planning options post-election

The election is over. Now what? The general elections are behind us, billions of dollars have been spent by all parties, and the outcome is that all the pieces on the chessboard remain roughly the same. President Barack Obama retains the White House, Republicans hold the House, and Democrats continue to control the Senate. Despite several new faces and a minor shift in the "majority" composition in the House and Senate, not much has changed.

We continue to speed toward year end and the expiration of the Bush tax cuts, the commencement of the new healthcare surtaxes, and the beginning of automatic spending cuts. The cumulative impact of these year-end events—described aptly as the "fiscal cliff"—would be a devastating shock to the economy. We continue to believe that we are more likely to be standing at the edge of the cliff before any resolution is reached. That's the bad news. The good news is that we expect a Congressional fix before we fall off the precipice. We also believe, based on the current makeup of our legislators and President, that the contours of a compromise are likely to be skewed toward Democratic terms.

More specifically, when it comes to estate planning, it may be wise to consider gifts before year end to avoid the possible loss of the current exemption. For income tax planning, President Obama's victory puts significant momentum behind tax increases for 2013. With the higher probability of tax increases, taxpayers may want to consider accelerating the recognition of long-term capital gains and exercising stock options before year end. Looking longer term, the outlook for comprehensive income tax reform, both corporate and individual, remains murky. However, there are rays of hope if tax reform becomes a central element of a grand bargain.

CLEAR AS MUD

The more things change, the more they remain the same, is perhaps the best way to describe the election results. President Obama retains the presidency, and the House and Senate remain in control of the Republicans and Democrats, respectively. What really changed? In a word, nothing! In some cases, it could be described as the worst-case outcome in terms of addressing the fiscal cliff and future tax policy, in our view. The President could sustain a veto, the House could control tax (among other) legislation, and either party could filibuster (non-reconciliation) bills in the Senate. Essentially, Democrats and Republicans will each have "veto power" over any proposed legislation, with neither being able to advance its own agenda. However, things may not stay the same. Perhaps the current or the incoming Congress and the President will review the past two years, come to an understanding about the country's dissatisfaction with gridlock, and decide that compromise may be the better approach.

POST-ELECTION POLITICS AND THE LAME-DUCK SESSION

The election is now behind us, but those re-elected and those recently defeated will be returning to Congress in mid-November in the waning days of the 112th Congress, a so-called lame-duck session. There are seven weeks remaining until year end, but only 16 days that the House is in session before its scheduled year-end recess. The House and Senate reconvene in early January 2013 as the 113th Congress. The bottom line is that there is much to be done and little time to do it.

PATCHING THE ALTERNATIVE MINIMUM TAX (AMT) AND EXTENDING THE "EXTENDERS"

The most likely scenario is that the AMT will be patched and many of the bipartisan tax extenders will be extended during the lame-duck session. If they are not addressed at that time, it is likely they will be addressed in the very beginning of the new Congress and that the fix will be retroactive to 2012. We believe that Congress understands the administrative headaches about retroactive fixes; thus, it is more likely that they will be addressed before year end.

OTHER TAX ISSUES AND SPENDING CUTS

With respect to other tax issues, such as the expiration of the Bush tax cuts, and the commencement of automatic spending cuts, there are two likely scenarios.

First, the most likely scenario is that during the lame-duck session the President and Congress agree to agree in the future—a "kick the can down the road" approach. Under this scenario, it is possible that President Obama and Congress will extend all the tax cuts and suspend spending cuts into 2013 when more time can be devoted to an appropriate solution. Hitting the "pause button" allows Congress to tackle the issues while forging a compromise. It is anticipated that the "pause" will be no more than one year. In fact, several Democratic senators have already called for a six-month extension of spending and tax cuts to give tax-writing committees time to develop a $4 trillion debt-reduction plan with a ratio of approximately $2 in spending cuts for $1 of additional revenue. There are hints that the President may be in favor of this tactic, to some extent. During the Presidential debate, President Obama indicated, without any detail, that the automatic spending cuts (sequestration) would not occur. Perhaps sending somewhat of a mixed message, the President continues to vow that he will veto an extension of the Bush tax cuts for upper-income earners. This threat may be ameliorated with a temporary extension of current tax rules coupled with a goal of developing a tax plan targeted to raise revenue equal to, for instance, 19% of gross domestic product (GDP); otherwise automatic tax increases for "upper-income" taxpayers kick in: a carrot-and-stick approach. A post-lame-duck compromise would, however, likely be skewed closer to the Democrats' terms—resulting in tax increases for upper-income taxpayers:

- Qualified dividends would likely move in lock-step with long-term capital gains rates (perhaps at a rate of 20% for certain taxpayers).
- Marginal tax rates could also rise for upper-income taxpayers, but "upper-income" could be redefined to include only those making more than $1 million.
- The estate and gift tax exemption has a greater chance of looking like the 2009 rules (45% tax rate, with a $3.5 million estate and a $1 million gift exemption).

Second, and less likely, would be an outcome where Republicans hold fast to their anti-tax pledge and we go over the fiscal cliff, but maybe only until enough pain is felt by both parties, too much blame is given to one party, or the government suffers a promised downgrade in its debt rating by Moody's. If we were to plunge over the cliff, tax rates would increase for all taxpayers, not only upper-income taxpayers, and automatic spending cuts would commence. The President then would likely propose a tax cut for those making less than $250,000 and put Republicans in the unusual position of potentially opposing that cut.

ANALYZING THE BUSH TAX CUTS

Assuming that Congress wants to resolve the issues during the lame-duck session or soon thereafter, we anticipate that Republicans will continue to push for a full extension of the Bush tax cuts, while Democrats will continue to push for extension of tax cuts only for those making less than $250,000, protecting approximately 98% of households from a tax increase.

In analyzing the Democratic approach, the projected revenue of taxing the so-called upper-income taxpayers would be roughly $860 billion over a 10-year window. While it sounds like a large number, based on the President's 2013 budget, this tax increase represents a very small portion of the total budget over that same time period. If the goal is to fully rein in the deficit, placing the burden solely on upper-income taxpayers is clearly insufficient to solve the problem, in our view. It may be a start, but either more tax increases are needed or spending cuts must be part of the solution.

While there is still some disagreement as to the appropriate rate of tax for qualified dividends, there is a general consensus in both houses of Congress that the dividend rate should move in lock-step with long-term capital gains rates, likely 20%. There appears to be bipartisan support for extending the so-called estate tax portability provisions, otherwise set to expire at year end, which allows a surviving spouse to use the unused estate tax exemption of a predeceased spouse.

DON'T FORGET ABOUT THE FISCAL CLIFF

Numerous tax changes are on investors' minds, but many other issues must be addressed to avoid the full effects of the fiscal cliff. This will likely be preceded by reaching the limit on the national debt ceiling again before year end, but, according to the Treasury, measures will be taken to push the day of reckoning into early 2013.

Even if the "pause button" is hit and spending cuts and tax increases are put on a temporary hold, the President and Congress must still address these issues in a more permanent manner. One of the benefits of avoiding the fiscal cliff—by delaying tax increases and deferring spending cuts—may have near-term advantages for the economy but would present its own profound longer-term complications: it would lead us over a bridge to nowhere. Near-term real GDP is expected to grow by 1.7%, and unemployment is projected to drop to 7% by 2014. But longer term, real output and income would be lower than they would be by simply falling off the cliff. And this would lead to persistent large deficits and escalating federal debt. Additional symptoms of the fiscal hangover would be a reduction in national savings and investment, slower growth, and an "unsustainable" level of federal debt, according to the Congressional Budget Office (CBO). A downgrade in the government's credit rating would likely follow and possibly also an increase in interest rates.

To avoid these longer-term problems, a grand bargain must be reached. For instance, an approach advocated by groups like the Organisation for Economic Co-operation and Development (OECD) should be undertaken, which suggests that the federal budget deficit should be reduced "at a gradual pace so as to put the federal debt-GDP ratio on a downward path and restore fiscal sustainability."

WHAT MIGHT A COMPROMISE LOOK LIKE?

Assuming doing something is better than gridlock, what would a compromise or grand plan look like? First and foremost, most economists and advisors agree that the compromise should be designed to avoid a near-term shock to the economy while putting our government on a longer-term fiscal diet. This grand plan should balance the need for additional revenue (through tax increases or tax reform) and reduced spending (entitlement reform or slowdown of scheduled spending increases) while avoiding large negative hits to the economy.

One possible compromise solution would be the Simpson-Bowles plan. Perhaps President Obama will come to embrace the architecture of that previously "failed" plan (which actually garnered a majority vote in favor, but not the supermajority vote necessary for a Congressional vote). One version of the Simpson-Bowles plan proposed to reduce the tax rates (and the number of tax brackets too) and broaden the tax base by eliminating or significantly reducing tax deductions. It eliminated the AMT tax and the preferential rates for dividends and capital gains, and it subjected newly issued municipal bonds to income tax. As a result, overall tax revenue was projected to increase to about 21% of GDP (higher than Senator Ryan's budget plan and even higher than historical averages). Since that level of revenue is still not sufficient to reduce the deficit, it paired tax increases with significant spending cuts and entitlement reform, such as increasing the normal retirement age for Social Security benefits to age 69 by 2075. Regardless of this specific call for tax reform, most policymakers believe that any tax reform should be done in conjunction with entitlement reform. This way, it would be viewed by the public as a path toward progress and would hopefully garner bipartisan political support.

YEAR-END PLANNING IN AN UNCERTAIN TAX ENVIRONMENT

So what should taxpayers do in this period of continued uncertainty in the waning days of 2012?

- Estate Tax Planning: Given the election results and the President's desire to lower the estate and gift tax exemptions for 2013, there could be a considerable opportunity cost for failing to use the current gift tax exemption before year end. Two elements help quantify the opportunity cost if a gift is not made and the laws revert to the 2001 rules. First, the failure to act and a reversion to the $1 million exemption may subject a taxpayer to estate tax on as much as $4,120,000 in additional assets. At a rate of 55%, the "cost" is $2,266,000 of additional federal estate tax at death ($4,120,000 x 55%), plus any state death taxes. Second, any growth or income earned on the $4,120,000 will also be subject to estate tax, also at an estate tax rate of 55% (an exemption of $3.5 million and a tax rate of 45% would decrease the opportunity cost). To avoid losing the benefit of the current exemption, taxpayers should consider gifts, whether in trust or outright, before year end in a sensible and flexible manner.

- Income Tax Planning: Unlike estate planning, income tax planning remains more complicated. With estate planning, transfers are usually intrafamily, there is no immediate payment of taxes, and significant flexibility can be retained. Income tax planning, on the other hand, usually requires a tax recognition event (and the payment of income taxes) and irrevocable decisions with limited or no flexibility. For these reasons, taxpayers should evaluate income tax decisions based on an increase of 3.8% (investment surtax, which *will* happen in 2013) and perhaps on a jump in tax rates (which *may* happen in 2013). Taxpayers should prepare, plan and project the consequences of a tax rate increase, but they may want to wait for possible forthcoming legislation. Taxpayers should also:
  - **Consider exercising stock options** that are scheduled to expire near-term before year end so that compensation income is accelerated into 2012, before the new 0.9% wage surtax kicks in and before reversion to the 39.6% tax rate. Stock options with longer-term expiration dates should generally be held to capture the leverage inherent in most options.
  - **Consider accelerating long-term capital gains** from the sale of stock or other assets in 2012 to capture the current 15% gains rate and to avoid the new 3.8% investment surtax commencing in 2013. However, investors should understand the "breakeven" returns needed to make one indifferent to selling in 2013 or at a later date. If returns are anticipated to exceed that "breakeven" rate, investors would benefit from selling later; if not, sales should be accelerated into 2012.
  - **Consider converting Traditional IRAs to Roth IRAs** before year end to capture the lower ordinary income tax rates. One of the many benefits of a 2012 Roth conversion is that it can be reversed as late as October 15, 2013.
  - **Consider reviewing your investments in tax-free municipal bonds.** In the near term, tax-exempt bonds will remain free of federal income tax, regardless of tax rates, and free of the new 3.8% investment surtax. Because of this, they will remain relatively more attractive when compared with taxable alternatives. Longer term, newly issued tax-exempt bonds could be subject to partial income taxation.

- **Consider what to do about charitable gifts.** Charitable giving is a bit more complicated as we approach year end. On the one hand, higher tax rates in 2013 would make a charitable deduction more valuable next year. On the other hand, 2013 revives rules that could cause taxpayers to lose a portion of their itemized deductions, including charitable gifts. When weighing these considerations, it may simply be better to take a current deduction and the upfront tax benefits under a set of known tax rules. It is noted that charitable gifts would not reduce the 3.8% investment surtax, since the surtax is on "net investment income" without reduction for charitable gifts.

- Investing in a Post-Election Environment: We believe a post-election fix to reduce the "fiscal cliff" to a "fiscal bump" is likely and would be bullish given all the fiscal disaster fears that have restrained businesses from hiring and investing and discouraged risk taking in general. In the meantime, our strategy remains generally the same, anchored by improving macro fundamentals.

  - We continue to emphasize a "get paid to wait" portfolio strategy that emphasizes the production of cash flows across all asset classes rather than solely yield or price return. We believe investors are going to need real fundamental catalysts such as economic growth, job growth, and rising profits, as well as ultra-high liquidity by the global central banks, in order to leave "Fear Island" and move into more productive assets. This process is already under way, in our view, as slowing global momentum is starting to reverse and will accelerate once the "fiscal equation" becomes more transparent and recent global monetary stimulus feeds into the system.

  - We would not expect a material effect on the market in 2013 if taxes were to rise at the dividend or capital gains level (including the 3.8% investment surtax) given where the crowd is already located and the positive-carry environment the Federal Reserve is creating. In the end, we believe there is good value in the market, attractive opportunities in specific segments of the fixed income market, attractive yields in hard assets, and growth pockets in housing, technology, and energy industries. This should be enough to keep concerns over the fiscal cliff to small pullbacks of 5% to 6% (and not the high-teen percentage pullbacks of the previous summer periods).

  - Given our expectations of the fiscal drag, we expect profits to grow approximately 5% for 2013 to around $108 on the S&P 500. In this background, the market should be able to withstand the psychological pullbacks and reach the 1600 level next year, which would represent a price-to-earnings multiple of around 14.5X (still a 12% discount to the long-run multiple).

  - All things considered, we expect an upward drift next year in the broader market but our industry and sector strategy could change, depending on how Congress shapes the 2013 fiscal picture.

LOOKING TO THE NEW YEAR AND POSSIBLE TAX REFORM

Unlike the expiration of the Bush tax cuts and patching the AMT exemption, there is no year-end (or any other) deadline for tax reform—it is only an aspirational goal. President Obama and others have consistently criticized the tax code as inefficient, laden with loopholes, and catering to special interests. There is some truth to that. We continue to believe that under President Obama's second term, we are far more likely to see corporate tax reform rather than a fundamental tax reform that includes individual income taxes.

The President has devoted more energy to corporate tax reform than personal income tax reform. In his fiscal year 2013 budget, the President called on Congress to “immediately begin work on corporate tax reform that will close loopholes, lower the overall rate, and not add a dime to the deficit.” This was followed by his framework for business tax reform jointly issued by the Department of the Treasury. The report generally calls for the reduction of corporate tax rates to 28% and a broadening of the tax base, with several additional revenue proposals, including the taxation of large pass-through businesses and taxing carried-interest income as compensation income.

In terms of individual income tax reform, the President’s plan primarily focuses on revenue-positive reform (but revenue-negative against current law baselines) by raising tax rates on those making $250,000 or more (for married couples). Mixed in would be limitations on tax deductions for upper-income taxpayers and partial taxation on municipal bond income and healthcare exclusions. In addition, the President supports the so-called Buffett rule, which would require those making more than $1 million to pay a minimum tax rate of 30%. All of these proposals add up to simply tax increases rather than fundamental tax reform. For this reason, we believe such a plan would never pass the Republican-controlled House.

Tax reform should be comprehensive because of the interaction between corporate and individual rates. For instance, a change in depreciation rules as part of corporate tax reform would have significant implications for individuals conducting businesses as partnerships, S-corporations, or single- or multi-member LLCs because those entities simply pass their net income through to the individual only to be taxed at personal tax rates.

CONCLUDING REMARKS

We continue to come closer and closer to the edge of the fiscal cliff; we continue to have no clarity as to the direction that the President and Congress will be able to take; and we continue to have as much uncertainty about taxes as we have had for the prior two years. However, we are hopeful that Congress and the President will move forward in a spirit of cooperation and compromise. If they do, we believe that the end result would tend to favor the Democratic choices over those of the Republicans, which means that at some point in coming years, we will see higher income tax rates. In light of these anticipated changes, now may be a good time to revisit your investment strategies and tax planning strategies before the year ends.

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IN SUMMARY

The year-end expiration of the Bush tax cuts and the commencement of healthcare surtaxes and automatic spending cuts all pose a threat to an economy still struggling to find its footing. Unfortunately, legislative efforts to deal with this looming fiscal cliff are unlikely until after year end. Still, we do expect a congressional fix before we fall off the precipice, possibly by year end—but it will likely come in the form of simply hitting the “pause” button and letting the next Congress address these weighty issues. Regardless of the result, however, near-term tax planning is likely to be plagued by higher-than-usual uncertainty. It would be wise to consider gifts before year end to avoid the possible loss of the current exemption. For income tax planning, taxpayers should consider the implications of a tax-rate increase but may want to wait for hints of a compromise from a lame-duck session before accelerating capital gains into this year or exercising stock options before year end.

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