Finding TAX RELIEF May Require a Microscope

By Troy Anderson

While President Obama touts the Taxpayer Relief Act of 2012 as a "victory for middle-class families" that will boost the economy and shrink the deficit, Stewart A. Feldman says this claim is nothing more than a deceptive mirage.

"That is nothing more than a façade," says Feldman, a founding partner of Houston-based The Feldman Law Firm, a tax and corporate law firm for closely held businesses. "It's a marketing ploy on behalf of both parties to diffuse the criticism."

In a recent client memorandum, Feldman noted that the so-called Taxpayer Relief Act does extend certain tax cuts—temporarily averting the "fiscal cliff"—but it also dramatically increases taxes on high-income taxpayers and will impact all Texans.

"Stealth taxes abound in the 'Relief' Act," wrote Feldman, also the chief executive officer of the Houston-based Capstone Associated Services, a provider of turnkey captive insurance services for middle-market businesses and their principal owners. "For planning purposes, high-income business owners living in Texas can now expect an effective personal income tax rate of approximately 45 percent.

"Depending on the city/state in which you live, we now live in a 45 percent to 55 percent tax world. Said another way, you begin working for yourself around July 1 of each year."

When President Obama announced the agreement in early January, a White House statement described the act as a "bipartisan solution that keeps income taxes low for the middle class and grows the economy."

In the statement, the Obama administration asserted that the plan "means millionaires and billionaires will pay their fair share to reduce the deficit through a combination of permanent tax rate increases and reduced tax benefits." The statement also noted that the president "kept his promise of asking the wealthiest two percent of Americans to pay more while protecting 98 percent of families and 97 percent of small businesses from any income tax increase"—raising $620 billion in revenues over the next decade.

Is This Really A Solution?

But economists, bankers, tax experts, and business owners told *NBIZ Magazine* that they tend to agree with Feldman: "This isn't just a tax increase that hits the rich."

"This act is certainly damaging," says Curtis Dubay, a senior tax policy analyst at The Heritage Foundation in Washington, D.C. "There is no doubt about that, and it will certainly lower investments, which will in turn reduce jobs and wages for middle-income and low-income Americans."

The last-minute passage of the Taxpayer Relief Act in early January helped avert the impact of $600 billion in spending cuts and tax hikes scheduled to take effect this year—the so-called "fiscal cliff"—that some economists thought could push the U.S. economy back into recession.

The Taxpayer Relief Act will avoid most of the scheduled tax hikes for a large majority of taxpayers, but it does not address the larger budget issues such as deficit reduction, raising the debt limit, or tax reform. As a result, the stage is now set for another fiscal showdown as the U.S. approaches its statutory borrowing limit in late February.

"The president really seems to cling to the view that the tax increases on people making more than $200,000 or $250,000 can really be a full solution, or close to a full solution, of the deficit problem— and, of course, in the end the tax increases don't even apply to that broad of a group," says Alex D. Viard, a resident scholar at the American Enterprise Institute in Washington, D.C.

"Even if he did get taxes increased on everybody making above $200,000, a whole range of people—political commentators and economists—have all stated, and there is just no dispute about this, that there is certainly no possibility that taxing this group can come anywhere close to being a full solution to the long-run fiscal imbalance we face. The imbalance is just too big."

The Taxpayer Relief Act

The Taxpayer Relief Act restores the 39.6 percent tax rate for high-income households, as in the 1990s. The top rate returns to 39.6 percent for singles with incomes above $400,000 and married couples with incomes above $450,000, according to the White House.

As part of the measure, individuals with incomes exceeding $250,000 or married couples making more than $300,000 will see a phase-out of personal exemptions and certain itemized deductions—equating to as much as five percent in income taxes, Feldman wrote.

FICA and Medicare taxes can add up to an additional 16.2 percent on the first $113,700 in wages, Feldman noted. As part of Obamacare, there is an additional 0.9 percent Medicare tax on individuals with wages in excess of $200,000 and married couples with income above $250,000, as well as a 3.8 percent Medicare tax on net investment income that will apply to dividends and capital gains and other types of investment income, Feldman wrote.

The act raises the tax rate on the wealthiest estates—upwards of $5 million per person—from 35 percent to 40 percent, according to the White House statement.

And the legislation increases the nominal top long-term capital gains and qualified dividend tax rates from 15 percent to 20 percent on individuals earning in excess of $400,000 and married couples making more than $450,000—which, when combined with the additional 3.8 percent and long-term capital gains, equals 23.8 percent, Feldman wrote.

"When you put this all together, it's ugly," Feldman says. "So to suggest this wasn't a drastic tax increase is Pollyannaish."

The increased tax on dividends, which would have increased to 43.4 percent for high-income earners under the scheduled tax hikes, triggered a "special-dividend bonanza" late last year, with hundreds of companies issuing "special" dividends. These "special" dividends are payments companies made to shareholders outside the regular payment cycle.

"There was certainly an expectation that dividend taxes were going to go up with the 'fiscal cliff,'" says Sydney Finkelstein, the Steven Roth Professor of Management at the Tuck School of Business at Dartmouth College in Hanover, New Hampshire and the author of the book *Why Smart Executives Fail: And What You Can Learn from Their Mistakes*.

"It turns out they only went up from 15 percent to 20 percent, which is not gigantic, but another way to look at it is that there is a one-third increase in the tax rate. In anticipation, a lot of companies were thinking about their investors and ended up declaring these special dividends—some of them quite sizable—that would enable people to get cash out of the company and pay a lower tax rate."

After the stock market crash during the Great Recession, many investors turned to dividend stocks for a more stable source of income.

Negative Impact

Joseph A. Decker, Jr., the director of the Fort Bend County Small Business Development Center in Missouri City, Texas, says the tax increase on dividends will have a negative impact on the growth of new companies and business investment.

"When you have to pull money out of the market and out of companies and corporations, it limits their activities in terms of investing in other areas—expansion and things like that," Decker says. "I think it represents a negative condition in terms of the individuals who have the ability to take those funds that would normally either be left in the company to grow in a specific area or invest and pull them out so they will not be taxed by the federal government. I think it will have a negative effect in terms of growth of new companies and start-ups."

Higher dividend taxation, according to the AEI, impedes investment that fuels long-run growth, depresses stock prices, and weakens incentives for good corporate governance. Raising dividend taxes hampers investments, eroding the capital stock and slowing long-run economic growth. A smaller capital stock makes workers less productive, holding down their wages, according to the AEI.

"It increases the tax burden on investments, it increases the penalty on stocks relative to borrowing, [and] it encourages firms not to pay dividends and to distribute cash in other ways to investors or to divert funds to internal projects," Viard says.

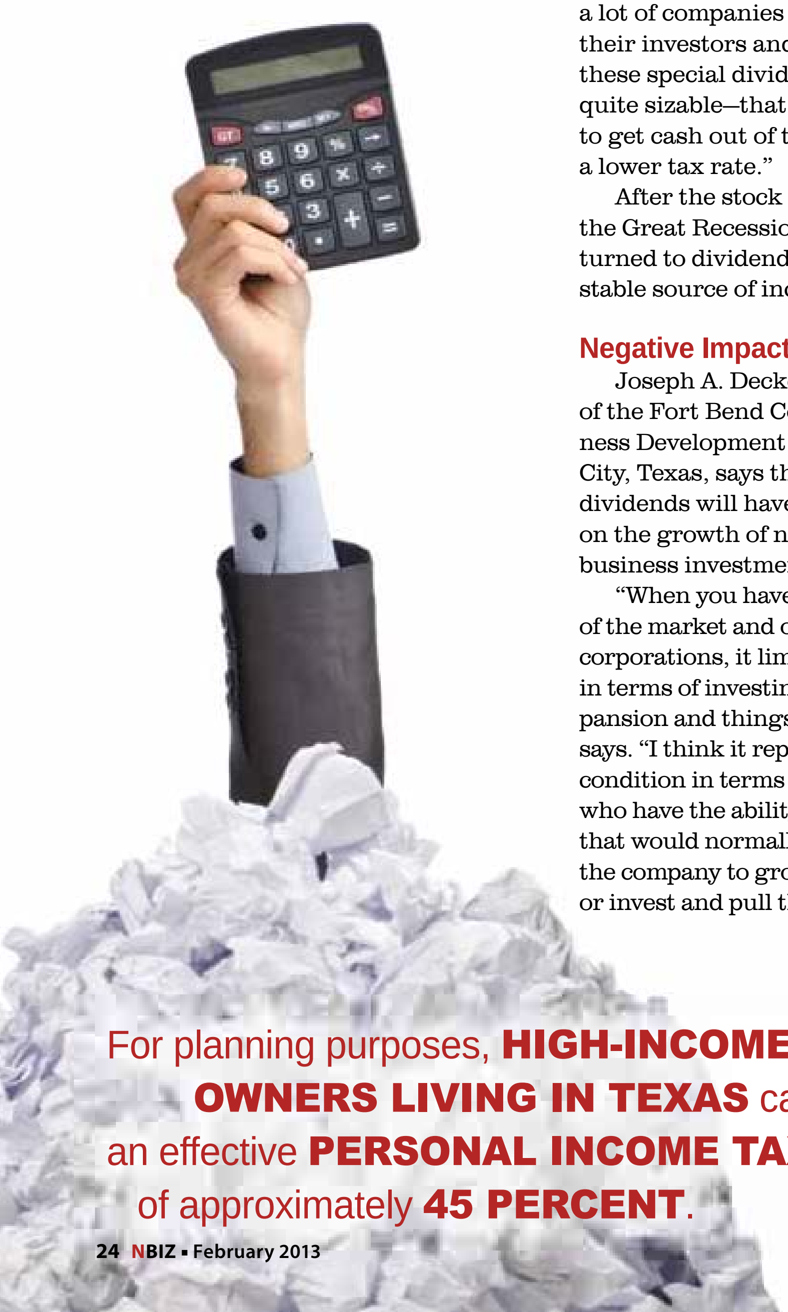
Lara Hoffmans, a vice president at Fisher Investments in Woodside, California and the co-author of the book *Plan Your Prosperity: The Only Retirement Guide You'll Ever Need, Starting Now—Whether You're 22, 52 or 82*, also says the increase in dividend taxes is a "marginal disincentive to invest in stocks paying a dividend."

But she says the impact is relatively more limited than initially feared.

"There's a long history of dividend tax rate changes, and no evidence, up or down, [that] there was ever a meaningful economic or market impact moving forward overall," Hoffmans says. "Still, higher dividend taxes can be an incentive for businesses to pay a small dividend or cut dividends. Some businesses pay dividends because it's one way to increase shareholder value. They pay taxes on the profit, then investors pay taxes on the dividend.

"If shareholders won't get as much value due to higher taxes, firms might decide to increase shareholder value in other ways—by not paying dividends or paying a lower dividend and instead buying back shares or even buying equipment, acquiring a competitor, et cetera. But I can't see swaths of businesses cutting dividends on this small and incremental increase in dividend taxes."

The tax-rate change, Hoffmans says, was relatively minimal and smaller than initially feared—and only impacts taxable accounts. Firms will continue paying dividends if they believe that doing so will increase shareholder value, Hoffmans says.



For planning purposes, **HIGH-INCOME BUSINESS OWNERS LIVING IN TEXAS** can now expect an effective **PERSONAL INCOME TAX RATE** of approximately **45 PERCENT**.

"On the margins, will this tax increase impact how some CEOs view shareholder value? Possibly. Some firms may choose to divert some cash from dividends to other activities, like share buybacks," Hoffmans says. "But my sense is we'd need a much bigger and broader increase in dividends to move the dividend-paying needle more materially. Make the dividend tax 30 percent across the board, and you'd probably see many firms opting to decrease or cut dividends.

"It's worth noting [that] dividends don't have a long history of special, preferential treatment prior to the Bush-era tax changes—they've often been taxed as income, pure and simple. So in the grand scheme of things, the current tax code treats dividends favorably still by historical standards."

Uncertainties

George Martinez, the chief executive officer at Allegiance Bank in Houston, says he doubts the tax increase on dividends will have much of an impact on the economy, but he's still concerned by the uncertainty created by the potential of future tax increases and the debt ceiling debate.

"There is still some uncertainty about the economy and where we're going, but Houston has been on the rebound for over a year now, and so we are adding jobs and the economy is slowly growing," Martinez says. "So I don't think this is going to trip up the trend we have going in Houston right now.

"We are in a good economy because of the petroleum demand and because we're the oil capital. A lot of businesses are thriving because of the oil prices. I believe our economy is going to continue to grow at a slow space—nothing very rapid, but [it will] continue to grow at a reasonably good rate compared to other parts of the country."

Ralph Gotto, a turnaround, profit-improvement, and business-streamlining specialist and the chief financial officer at the NRG Group in Minneapolis, Minnesota, says he's "50-50 relieved" by the Taxpayer Relief Act.

"One, it's not as bad as we thought it would be," Gotto says. "But it is going to put a damper on the economic recovery, and the relief part is that it's mainly only going to affect the high-income earners."

However, the "hidden albatross" in the measure is the fact that the president wants more government investment, yet the economy needs more private investment in order for the economy to grow, Gotto says.

"That's the fear," Gotto says. "If the government continues to expand at the rate they are at—a $1 trillion dollar annual deficit—it's going to put a crimp in the expansion of the economy, and if the economy doesn't regain itself, then you may have some dominos falling, like Europe is progressing toward now.

"If Spain or Italy buckles under, they are big enough that [it] could cause a banking crisis, in which you may even have a banking crisis worldwide, or the dollar may be really under pressure and be driven downward. So I think a lot of people are looking at 2014. That's when the rubber has to meet the road, because if we don't get the economy going this year, which I don't think we will, then in 2014 I think we'll see a dip back into recessionary mode. If the banks break due to Europe, then all bets are off on the economy growing until probably 2016."

Debt-Problem Concerns

Although President Obama claimed that the Taxpayer Relief Act will reduce the nation's $16.4 trillion deficit, Dubay wrote in a blog on The Heritage Foundation website that the measure increases spending by about $330 billion by extending unemployment benefits and other programs. He asserted that it will do little to tame the deficit.

In fact, the Congressional Budget Office concluded that, relative to the laws in place at the end of 2012, the legislation will reduce revenues and increase spending by more than $4 trillion over the 2013-to-2022 period.

"The biggest concern right now is that this will do nothing to address the debt problem," Dubay says. "The longer we wait, the harder it gets. With each passing day, it will get harder to reform our entitlement programs. And with the current situation in Washington, it seems unlikely it will be addressed anytime soon."

Dubay says it's still possible for the U.S. to avoid a "Greek-style crisis, but time is running short."

"That's the thing with debt crises," Dubay says. "You never know when it becomes too late until it is too late."

In a recent policy paper, "Trillion-Dollar Deficits are Sustainable for Now, Unfortunately," AEI resident scholar John H. Makin wrote that the U.S., with its very low borrowing costs, is not in immediate danger of a crippling crisis like the ones occurring in Greece, Spain and Portugal, where borrowing costs are much higher. Nevertheless, he is recommending a graduated reduction in the federal deficit to a more stable radio of debt to gross domestic product by 2015.

But if these steps aren't taken, Viard says, nobody really knows how long the U.S. can continue accumulating debt until it does trigger an economic crisis.

"The one main thing I would say is that, of course, ideally we do not want to wait until we reach some kind of doomsday point before we change things," Viard says. "'The sooner the better' is what we should keep in mind. I don't know how long we can go until we really reach the point where people won't buy our debt anymore. It's certainly not going to happen in the very near term. I think we probably do have some period of time."

In some ways, Viard says, it would be better for the nation if its debt load was "just immediately unsustainable, and we'd have to stop, but in fact that's not the case."

"We actually do have the option of continuing with these deficits for some time, and unfortunately we are going to stay at a $1 trillion deficit per year—it may come down somewhat from there—but the pattern is having large deficits where our debt continues to grow faster than the economy, and it looks like we are likely to stay on that path for some time.

"Unfortunately, I do think we have that option. We're the world's largest economy, we have the ability to borrow at our own currency, and so the markets really give us latitude they wouldn't give to some other countries. But of course it can't go on forever, and it probably won't be possible to predict in advance when things will kind of crash. Those things tend to happen unexpectedly." **N**

An award-winning journalist at the Los Angeles Daily News, *the* Press-Enterprise *and other newspapers for 20 years, Troy Anderson writes for Reuters, Newsmax,* Christianity Today, Bankrate Insurance *and many other magazines and online publications. He lives in southern California. For more information, visit www.troyandersonwriter.com.*