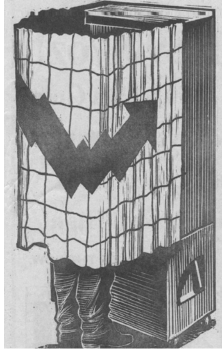
business forum

Plan now to shrink tax increases' bites

• Taxes may rise no matter who wins the election. In historical terms, the many tax rates seldom have been so low.


New York Times

Get ready to pay higher taxes.

Over the next year or two it's highly likely that tax rates on income, capital gains and dividends will go up. That's unfortunate, especially for people politicians consider "rich."

Rising tax rates are a virtual certainty if Barack Obama wins the election this fall. But even if he doesn't, the next 10 to 20 years will likely bring higher tax rates because of the current budget deficit and the looming Medicare and Social Security financial shortfalls. To fund those programs, we'll either have to raise taxes or cut benefits – or both.

Fixing the inequities in the Alternative Minimum Tax won't be cheap either, and we're not even contemplating the impact on taxpayers if the government has to step in to save Fannie Mae and Freddie Mac.

On a relative basis, we've been both spoiled and lucky over the past 20 years. The government has kept tax rates low, allowed government spending to grow too fast and deferred a sustainable fix for Social Security and Medicare.

The current top federal marginal tax rate on income of 35 percent is well below the average in U.S. history, and is near the lowest it has been since the 1930s. The top rate was as high as 90 percent in the 1940s and 1950s, dropped to about 70 percent in the 1960s and 1970s and to 50 percent in the early 1980s. We have been lucky to have had a top tax rate on income of between 30 percent and 40 percent since the late 1980s. From a historical perspective, there's lots of room for that top tax rate to go up.

The same is true for the current 15 percent tax rate on capital gains and dividends. Typical capital gains tax rates in U.S. history since the 1940s have been in the 20 to 40 percent range. If nothing happens, the Bush tax cuts will expire in 2011 and capital gains and dividend tax rates will jump back up automatically.

McCain and Obama on taxes

For families earning more than $250,000 a year, Barack Obama is calling for higher taxes across the board – ordinary income tax, capital gains tax, dividend tax, and Social Security taxes – with the top ordinary income tax rate increasing to 39.6 percent from 35 percent. He says he will not raise your taxes if your income is under $250,000 and "chances are you will get a cut."

He also wants to raise the tax rates on capital gains and dividends for "rich" people from the current 15 percent rate to somewhere in the 20 to 28 percent range. On estate taxes Obama is proposing a $3.5 million exclusion for 2010-2011 and beyond, and a top estate tax rate of 45 percent, unchanged from the current rate.

John McCain wants to make permanent the current federal income tax rates and cut corporate tax rates to 25 percent from 35 percent. He opposes the Obama plan to lift the earnings cap on the Social Security payroll tax, and wants to keep the current 15 percent tax rate on long-term capital gains and dividends.

With a likely Democratic-controlled Congress, he may have to compromise and the capital gain and dividend tax rates may go up to the 20 percent level. On estate taxes, McCain proposes raising the exclusion to $5 million for 2010-2011 and beyond and cutting the estate tax rate to only 15 percent.

Of course, all political campaign promises and tax plans from both sides should be taken with a big lump of salt.

Tax strategy suggestions

If higher tax rates are coming, what can you do about it now? Here are some suggestions:

• If you have an asset with a large long-term gain that you were thinking about selling anyway over the next several years, sell it while tax rates are low.

• Use Roth IRA or Roth 401(k) accounts if you qualify. Roth accounts are taxed now and tax-free later when you start withdrawing the assets, when rates are likely to be higher. Problem is, Roth IRA accounts are limited to individuals with a modified adjusted gross income below $116,000 and couples of $169,000. Under current law, investors of all income levels will be allowed to roll over their current IRAs into Roth IRAs in 2010.

• Keep giving assets with large capital gains to charities. You get the full value of the asset as a deduction regardless if the capital gains tax rate is 15 percent or 25 percent. If income tax rates go up, your charitable deduction is actually worth more against your income taxes.

• Factor in higher tax rates in your long-term financial planning. The bottom line: You will need to save more, spend less, work longer and invest smarter to make up for the higher future tax rates.

This is especially true if most of your net worth is in tax-deferred IRAs and 401(k)s, which are taxed at the full ordinary tax rates when withdrawn in retirement.

• Buy tax-exempt municipal bonds. They typically benefit when ordinary income tax rates rise. Don't buy them in your tax-deferred 401(k) or IRA accounts.

• Spread your deferred compensation payments over 10 years or more if you are planning to move from Minnesota to a lower-tax state in retirement.

A Minnesota law change for 2008 now will tax deferred compensation on former Minnesota residents. This tax applies to nonqualified deferred compensation payments and from income that results from the exercise of nonqualified stock options. This Minnesota tax does not apply if the deferred payments are spread over a time period of 10 years or more.

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