# U.S. Office of Public Policy
# Washington Weekly

**Special Washington Update – Outlook for Higher-Income Taxpayers** **December 4, 2009**

**The UBS U.S. Office of Public Policy (the Office), located in Washington, D.C., publishes a weekly brief report on major public policy and political developments from Washington. The publication focuses on the public policy issues and debates that shaped Washington for the week, with a focus on financial services, tax and regulatory measures that affect UBS, its employees and clients. The report is written by the Office's bipartisan staff that lobbies on public policy issues every day and has decades of experience working in the Congress (for both Democratic and Republican members), the Executive Branch, White House and the financial services industry.**

Effective January 1, 2011, we expect a number of tax revisions to be put in place that will increase the tax rates applicable to higher-income taxpayers. Many of these new provisions will be debated and acted on next year in Congress, although some are under debate now. Most significantly, the marginal tax brackets, capital gains, and dividend taxes for higher-income taxpayers will very likely be raised from current levels as the existing lower rates enacted less than a decade ago are due to expire.

In separate debates this year, Congress has also proposed a number of surtaxes on higher-income taxpayers that, if enacted, would further increase the tax burden on this group. Although it is unclear how all of these debates will play out over the next year, it is clear to us that there is political support in Washington to enact further tax increases on wealthier taxpayers. Below we point out those tax increases that we believe are very likely, as well as those that are under active discussion in Washington and could possibly make their way into the tax code in the near future.

### Start planning for:

**Income tax rates.** Lower income tax rates enacted in 2001, applicable to all groups of taxpayers, expire at the end of 2010. The previous higher income tax rates are scheduled to be reinstated for calendar year 2011, unless Congress passes legislation to the contrary. President Obama and Democratic leaders in Congress have signaled support for extending the current lower tax rates for most earners, but will allow the top two tax brackets to snap back to higher pre-2001 levels. It is highly likely that individuals earning over $200,000, and families over $250,000, will be subject to top marginal income rates of 36% and 39.6% in 2011, as opposed to the current rates of 33% and 35%.

**Investment tax rates.** Long-term capital gains (held over one year) and dividend tax rates are currently set at 15% for most filers. In 2011, the long-term capital gains rate is set to be reinstated to 20% and dividends will be taxed at income rates as high as 39.6%. However, President Obama has proposed to set the maximum dividend rate at 20%, rather than higher income rates, and only apply the new 20% investment rates to individuals earning over $200,000. While we believe a 20% tax rate on investments for higher-income taxpayers is the most likely outcome, we also suspect that there could be budgetary and Congressional pressure to increase the rates beyond 20%, particularly for dividend income.

**Estate taxes.** Wealth transfer taxes are a confusing mess for anyone currently trying to engage in estate planning. Next year, estate taxes are set to disappear before returning in 2011 at high pre-2002 levels ($1 million exclusion and 55% rate). Congress is not likely to let that happen; it will approve an extension of current law ($3.5 million exclusion and 45% rate), or something close to it, before the end of this year. The length of an estate tax extension, short-term (1-2 years) or permanent, is the larger question being discussed in Washington. Congress will debate this during December, and it could be the last item they act on before recessing for the year in late December. Despite the expressed desire of leaders to permanently extend the estate tax and rid themselves of an expensive "to-do" item next year, we believe a short-term extension of current 2009 rates is slightly more likely, leaving the long-term battle for next year. Whatever they decide, competing pressures of politics and large deficits will limit the scope of estate tax options that Congress can approve.

**Deductions and exemptions.** The 2001 tax cuts phased out limits in the tax code on the value of personal exemptions and itemized deductions that higher-income taxpayers can claim. In Washington, these limits are sometimes referred to as "PEP" and "Pease" and are set to reappear in 2011, decreasing the value of personal exemptions and itemized deductions for higher-income taxpayers. We do not expect Congress to step in and prevent this snap back to previous deduction and exemption limits, effectively increasing the amount of income subject to taxes for many higher-income individuals in 2011.

**Who are the top 5% and 1% of earners in America?**
While White House officials have targeted individuals earning over $200,000 and families earning in excess of $250,000 for increased taxes, Congress has often targeted the top 5% and 1% of earners. For 2007 (latest available data provided by the IRS), the top 5% of taxpayers had adjusted gross income (includes investment gains) of $160,041 or more. The top 1% had AGI greater than $410,096.

## Increasingly likely

**Surtaxes.** 2009 has seen a proliferation of surtax proposals in Washington. They have been proposed to pay for a wide array of spending such as health care, infrastructure, and the war in Afghanistan, and would be applied to everything from the purchase of cigarettes and cosmetic surgery to income. The House-passed health care bill includes a 5.4% surtax on adjusted gross income over $500,000 for individuals and is effective in 2011. The Senate proposal includes a 0.5% increase in an individual's hospital insurance (Medicare) payroll tax on income over $200,000 and is effective in 2013. The Senate proposal also includes a cosmetic surgery tax, which we note because it is one of the few tax increases proposed for 2010. We believe some variation of these health care surtaxes is likely to become law early next year.

An old surtax with new life in Washington is a proposed transaction tax on securities trades. A new variation of the idea is being considered in the House of Representatives and would levy a 0.25% tax on the value of securities transactions, likely exempting trades in retirement accounts. The proposals raise a significant amount of revenue for the government, and this particular version could be used to fund the latest economic stimulus or "jobs bill" being considered in Washington. We do not currently believe enactment of a transaction tax is imminent, but it will remain a potential threat to investors as long as deficits are high and revenue for spending is needed.

**The "AMT."** The Alternative Minimum Tax has been lurking in the tax code for years and, because of its structure, would impact a larger share of taxpayers if not for yearly action by Congress to prevent its spread. As it stands now, the AMT is most heavily felt by taxpayers earning between $200,000 and $500,000, particularly those in high-tax states and with large families. When broader tax reform becomes a Washington agenda item, permanently reining in the AMT will be considered, but past proposals to do so also were linked to new surtaxes in excess of 4% on higher-income taxpayers to offset lost revenue at the government. For next year, the AMT will be contained to its current size, but for 2011 and beyond, Congress may consider tougher choices such as a surtax to offset future AMT limits.

**The Higher-Income Taxpayer's Share.**
In 2007, the top 5% of earners took in 37.4% of the income in the U.S. and paid 60.6% of income taxes. The top 1% made 22.8% of income and paid 40.4% of taxes. The recession, which began after this data was collected, will certainly change these numbers—as will the impending tax increases.

## Potential longer-term changes to keep in mind

**Social Security.** One of the larger tax increases on the horizon for higher-income taxpayers is an elimination of the limit on income (currently $106,800) subject to the 6.2% individual portion of the payroll tax that funds Social Security. Previously, President Obama had suggested Social Security reform would be on his 2010 agenda, but tackling another entitlement on the heels of health care reform will not be on the Congressional agenda next year, particularly in the heat of an election year. When Washington is forced to deal with Social Security—and that date looms—the President has suggested an additional 2%-4% tax on income above a set amount (likely $200,000) to fund the program. Some in Congress have suggested applying the full 6.2% to all income. Some increase in payroll taxes will become inevitable to stabilize the stressed Social Security program, but we do not believe that will happen before 2013.

**Value of itemized deductions.** Individuals can reduce their federal taxable income with certain deductions for things such as charitable contributions, state taxes, and interest paid (mortgage). President Obama's first budget included a proposal to limit the value of itemized deductions for higher-income taxpayers to a tax value of 28% as opposed to 36% or 39.6% depending on their tax bracket. That proposal was not well received on Capitol Hill, particularly after numerous charities quickly voiced opposition; the proposal currently remains sidelined. While we do not anticipate passage of this deduction limit soon, we do suspect it will remain part of the tax conversation and may reappear in future budgets.

Higher-income individuals should expect to see their tax burden increase beginning in 2011, possibly in a very significant way. Policymakers in Washington in both the executive and legislative branches will be under great pressure to find new revenue to pay for new policy programs for the foreseeable future, and higher-income individuals will continue to be targeted in different ways to provide that financing.