How the Tax Stalemate Might Play Out

By Editor Test *Wed, Oct 27, 2010*

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Death and taxes are equally inevitable, said Andy Friedman, author of the political website, theWashingtonUpdate.com. The only difference, he quipped, is that “death doesn’t get worse whenever Congress meets and taxes do.”

Friedman, an entertaining impromptu pundit with no discernable political affiliation, spoke at the IRI conference in Chicago this week and delivered a humor-laced forecast of how the current stalemate over the Bush tax cuts might play out.

Regarding those tax cuts, which are set to expire at the end of this year and which Congress delayed acting on until after next week’s election, Friedman predicts “we’ll see a permanent extension of the lower income tax, capital gains tax and dividend tax rates for middle class families.”

But the income tax rate for wealthy individuals and families will go to almost 40% from 35%, the long-term capital gains tax rate will go to 20% from 15% and dividends will be taxed as ordinary income—instead of at 15%.

Friedman thinks Congress might offer some sweetener to individuals making more than $200,000 (or households making over $250,000) by extending current rates to 2012 or raising the income threshold for exclusion from lower rates to $500,000 or even $1 million.

The president has also left open the possibility of capping the tax on dividend income at 20%, Friedman said, but that would cost the government an estimated $100 billion in tax receipts. (The wealthy also face a 3.8% Medicare contribution tax on investment income, starting in 2013).

As for the estate tax, Friedman believes Congress will reinstate it with a $3.5 million exclusion ($7 million for couples) and a 45% tax rate. “Everybody wants that,” he said. If Congress doesn’t act on the estate tax either this year or retroactively in 2011, the estate tax will automatically return in 2011 at a $1 million exclusion level ($2 million for couples) and a 55% rate.

High-income taxpayers would be smart, Friedman said, to harvest their long-term capital gains before the tax rate goes up, defer their gifts to charity until tax rates go up, and accelerate their ordinary income if possible. As tax rates rise, tax-deferred vehicles like variable annuities and tax-exempt instruments like municipal bonds will become more appealing, he added.

Contrary to Tea Party assertions that government spending is “out of control,” the Obama administration and the Democrats have been in a deficit reduction mode since last spring, Friedman said. That’s one reason why they haven’t thrown more stimulus money at the unemployment problem.

"Four or five months ago, there was a big shift that didn't get much attention in the media," Friedman said: Right before Memorial Day and shortly after the Greek debt crisis, the Democrats balked at an extension of unemployment benefits and declared, "We have moved from stimulus to deficit reduction."

But deficit reduction is harder than it looks, Friedman said, because there's not much discretionary spending at the federal level. Only 12% of the $3.5 trillion that the government now spends each year goes to fund government agencies, from the Centers for Disease Control to the Bureau of Land Management.

By contrast, over $2 trillion goes to Social Security, Medicare and other entitlements, $782 billion goes to defense, and then there's interest on the ever-mounting national debt. Tax revenues are about $2.1 trillion a year. Even if Congress cut discretionary spending by a third, Friedman said, it would reduce overall spending by about four percent.

"You can't solve this problem by cutting spending alone. We're going to have to raise taxes. Taxes are going up," he added.

Entitlement reform is inevitable. "Sometime soon all eyes will have to turn to Social Security reform," Friedman said. Raising the retirement age will be politically "hard to do," but expect the FICA wage base limit to either go up or disappear entirely and for Social Security benefits to be means-tested—that is, reduced or eliminated for the wealthy.

In sum, Friedman believes that our growing fiscal imbalances are due in part to circumstances beyond our control, and beyond the control of governments around the world. "We don't have a budget problem," he said. "We have a demographic problem: the aging of the Boomers." Our fractured politics may simply be a symptom of that.