The Largest Tax Increase in US History (Part Two)
by Gary D. Halbert

Soak the Rich?
Of course, the ready answer that most Democrats have for raising more tax revenue is to further tweak the taxation of the rich, again defined as those making more than $250,000. That is precisely why the Democrats only want to raise the top two brackets: 33% would go to 36% and 35% would go to 39.6%

The problem with that is raising the top two brackets only won't generate nearly enough revenue to make a meaningful dent in the budget deficits (not that it matters all that much to Obama, apparently). Since current proposals for raising taxes on only the "wealthy" don't do enough to help bring down the trillion dollar deficits, we are hearing more ideas for additional taxes on the rich.

Ideas range from phasing out income tax deductions, to a "war surtax," to a so-called "millionaire surtax" for those individuals and households that have incomes of $1 million or more in any given year. **This could easily raise the income tax rates on the wealthy to 45% or more.**

Think I'm kidding? Hardly. The healthcare reform bill that passed in the House of Representatives (HR 3962) on November 7th includes a surtax of 5.4% on households with incomes of $1 million or more. **39.6% plus 5.4% gets you to 45% *without* a war surtax or a millionaire surtax.** If either is enacted, tax rates on the wealthy could easily top 50%.

I could spend the rest of this article discussing why significant tax increases for only the rich don't solve our problems, and in fact create some new ones. Likewise, a huge healthcare tax increase of 5.4% on only 0.3% of the population doesn't get us there either.

However, I'll leave you with just one thought regarding soaking the rich: many wealthy individuals enjoy an advantage called the **"elasticity of taxable income."** In other words, many wealthy individuals can choose how and when they take their income, usually basing such decisions on the various levels of taxation associated with each.

While most of us think of income as wages, commissions or self-employment income, many wealthy individuals have additional options available to them such as stock options, deferred compensation and others that allow them to select the timing and composition of their income. The result almost always is that a large number of wealthy individuals shift to alternative forms of income to mute the effects of any tax increases.

Taxes on Capital Gains & Dividends to Rise Also
Prior to the Bush tax cuts, capital gains were taxed at 20% and stock dividends were taxed at your ordinary income rate (up to 39.6%). Bush lowered both rates to 15%. This,

among other things, contributed to the impressive, multi-year bull market in stocks following the 2000–2002 bear market.

During the presidential campaign, candidate Obama said he would likely raise the capital gains and dividends tax rates from 15% to around 20%. Now, however, with trillion dollar budget deficits as far as the eye can see, it would not surprise me to see him let those rates lapse back to the 28% rate applicable before 1997, if not even higher.

But it gets worse. The House healthcare reform bill (HR 3962) applies the 5.4% surtax to capitals gains and dividends, as well as ordinary income. Depending on whether the capital gains rate goes to 20% or 28%, the additional healthcare surcharge would take the cap gains rate to either to 25.4% or 33.4%. The jump from 15% to 25.4% would amount to an increase of 69%, while a jump to 33.4% would amount to a more than doubling of the capital gains tax rate. Such a disincentive to investing risk capital could prove to be devastating to the fragile economic recovery now underway, not to mention the re-election campaigns of those who vote to enact it.

When More Equals Less

The increase in capital gains tax rates may also have another nasty side effect – a negative pressure on tax revenues – which is the exact opposite of the desired result. A recent Wall Street Journal article noted that capital gains tax revenues actually fell after an increase in the tax rates brought about by the Tax Reform Act of 1986. However, capital gains tax revenues increased in the years following Bill Clinton signing legislation reducing the rate to 20% in 1997, and again under the Bush tax cuts that lowered the capital gains tax rate down to its current 15% level in 2003.

The reason tax revenues can vary so much is that capital gains taxes are paid only when appreciated assets held more than one year are sold and the gains are realized. Investors often time the decision of whether or not to hold appreciated investments based on the prevailing income tax rates. Thus, if Obama is successful in increasing the capital gains tax rate significantly, revenues may actually fall in the short term.

The same Wall Street Journal article noted that IRS statistical data from 2007 (latest available) show that 58% of overall capital gains revenue was reported by taxpayers with adjusted gross incomes of over $1 million. As a general rule, wealthy individuals such as these do not need to sell appreciated assets to live on, so it's entirely possible that they might hold onto appreciated property to see if tax rates go down in the future.

Supporters of increasing the capital gains tax rate point to estimates from the Congressional Budget Office and Joint Committee on Taxation predicting that changes to the capital gains tax rate is expected to have little impact on long-term revenue projections. While this is doubtful, one thing is for sure: capital gains tax rates are anything but stable over the long term.

Considering the frequency of recent changes in the capital gains tax rate (three different tax rates since 1996 with another one on deck for 12/31/2010), wealthy investors may be more than willing to hold onto appreciated assets and wait out any increase in tax rates until the next election cycle.

Targeting the Middle Class

Thus far, I have tried to point out how simply targeting the "rich" to pay for all of Washington's spending indiscretions will not necessarily work to significantly lower the huge budget deficits. Couple this with the lack of expected revenue from the cap-and-trade legislation and you get too little revenue to cover ever-increasing spending.

So, how do you think the Democrats and Obama administration will cover the gaps in an effort to try to live up to the promise of reducing out-of-control deficits? Increase the corporate income tax rate? Maybe, but the US already has one of the highest corporate income tax rates in the developed world. The government would probably realize more corporate tax revenue if they decreased the rate, but that's a story for another article.

About the only resource left to raise tax revenues is to reduce the income thresholds on many of the provisions meant to tax the rich, which would result in middle class taxpayers helping foot the bill for Obama's spending spree. Of course, you won't find this in any current proposals from the Obama administration or the Congressional Democrats. Such an admission could be political suicide, but they may do it anyway in the future. After all, the House and Senate both passed versions of healthcare reform legislation despite widespread public disapproval.

What's a "Fair Share?"

In respect to Congress, sometimes doing nothing is the best thing you could hope for. This is especially true in regard to the recent healthcare legislation "debate," where bribes and payoffs for votes were common, and neither the Senate nor House bills are fully understood. However, in the case of the Bush tax cuts, congressional <u>inaction</u> could lead to one of the largest tax increases in history.

Even worse, if all of the Bush tax cuts are allowed to lapse for all taxpayers, lower-income individuals would be hit much harder than the upper income taxpayers so popularly demonized by liberals. In closing this article, I want to share some thoughts that I saw while researching materials for this article. Many Internet articles now include responses from readers, but I usually never read them. This time, however, I took the time to read some responses, and they proved to be very telling of the national mood.

First, there is little sympathy for Wall Street fat cats and deservedly so. These villains that nearly bankrupted the US economy were bailed out with your and my tax dollars just over a year ago. Given access to virtually interest-free money from the Fed, they are now running record profits and paying out billions of dollars in bonuses. Oh, and don't forget that part of your tax money is being spent on lobbying efforts that have, so far, successfully stalled any meaningful regulatory reform that would prevent future economic meltdowns.

Related to that, however, is a general resentment of the wealthy, which the Obama administration has conveniently defined for us as anyone making over $250,000 per year. I wish I had a nickel for every comment saying, in effect, ***"it's about time the rich pay their fair share of income taxes."*** Oh really?

I have reproduced below a chart that I have mentioned many times in my writings. It is based on IRS income tax data from 2007 (latest available) and shows the percentage of income taxes paid by various demographic groups based on adjusted gross income:

Summary of Federal Individual Income Tax Data, 2007

	Number of Returns with Positive AGI	Group's Share of Income Taxes	Income Split Point
All Taxpayers	141,070,971	100%	-
Top 1%	1,410,710	40.42%	> $410,096
Top 5%	7,053,549	60.63%	> $160,041
Top 10%	14,107,097	71.22%	> $113,018
Top 25%	35,267,743	86.59%	> $66,532
Top 50%	70,535,486	97.11%	> $32,879
Bottom 50%	70,535,485	2.89%	< $32,879

Source: The Tax Foundation and Internal Revenue Service

Notice that the top 1% of income earners - adjusted gross income of more than $410,096 - pay over **40%** of all income taxes paid. How is 40% not their fair share? Next notice that the top 25% pay over **86%** of all income taxes paid. Notice further that the top 50% of taxpayers pay over **97%** of all income taxes paid. Yet politicians believe they should pay even more.

Compare those percentages with the bottom 50% of taxpayers who pay less than **3%** of all income taxes. Actually, the term "taxpayers" is probably a misnomer, since separate data from the IRS show that, of the 141 million-plus tax returns filed in 2007, approximately 47 million either owed no tax or actually received refundable credits that resulted in a negative tax rate.

If the top 50% of taxpayers are responsible for paying over 97% of all income taxes, I find it hard to imagine what their "fair share" should be if this isn't sufficient.

In the past, some have responded to this information saying that those in lower income brackets pay Social Security and Medicare taxes, which (they say) unfairly loads the cost of that program on the backs of lower-paid taxpayers. The problem with this argument is that it compares apples and oranges. Income tax revenues are designed to fund the functions of government while payroll tax revenues were originally designed to build a "safety net" retirement payment.

Conclusions

Having watched the healthcare bill "debate" process, I can't help but get an ill feeling when I consider what might happen to tax policy in general, and the expiration of the Bush tax cuts in particular. Congressional tweaking of the income tax code invariably results in an even more complex document that most of our elected officials can't understand. Of course, that's not likely to keep them from doing something, even if it's wrong.

My greater fear, however, is that Congress goes through the motions of pretending to want to extend the Bush tax cuts for lower-paid individuals while socking it to the wealthy, but then having time run out and the tax cuts fade into the sunset, literally. The House and Senate need take no action for one of the largest tax increases in history to fall upon us come January 1, 2011. Will they muster the political will to do it? Who knows?

On the other end of the spectrum, however, are rumblings about scrapping the entire tax code in 2010 and replacing it with something better. Back in 2009, House Speaker Nancy Pelosi admitted on The Charlie Rose Show on PBS that a "value added tax" (VAT) was on the table for consideration. This is not the first time alternative tax code proposals have been made. The value added tax, "Fair Tax," and "Flat Tax" proposals have been buzzing around Washington for years.

What the income tax code will look like at the end of 2010 is anybody's guess, but it's going to be an interesting process to watch. Stay tuned to my future articles as I will be bringing updates as they happen over the course of the year.

Gary D. Halbert is the president and chairman of Profutures, Inc. Subscription rates for Forecasts & Trends is $197 for 12 issues and may be obtained by visiting his website at www.profutures.com.