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Rationalizing at the Cliff: “We Have to Let Taxes Go Up So We Can Cut Them”

Unless Congress acts with unaccustomed swiftness, on December 31, 2012 the Bush era tax cuts will sunset as scheduled, and 2013 will reset to the Clinton era tax structure, with some twists.

What does this mean?

- Top rate goes from 35.0% to 39.6%;
- Medicare tax goes from 2.9% to 3.8% for higher bracket taxpayers, with net investment income becoming subject to the tax (not just earned income);
- Qualified dividends no longer qualify for favorable treatment (15% max rate), but will be taxed as ordinary income;
- Long-term capital gains rate rises from 15% to 20% (or 18% in certain instances);
- Lifetime gift and estate tax exemption drops from \$5.12 million to \$1 million per person and top rates go from 35% to 55%.
- Absent any inflation-adjusting patch of the alternative minimum tax for 2012, a vast swath of unsuspecting taxpayers will be thrown, very soon, into the maddening twilight zone that is the AMT.

On this last point, we believe Congress will act in time to patch the AMT and scale it for inflation so they don't incur the wrath of multitudes. As for the rest of the items above, they promise to be a bucket of cold water in the face for the economy and the markets.

While we like the timeworn notion that “you can't raise taxes in a recession,” too many investors mistake it for iron law. Congress indeed *can* raise taxes in a recession. What's more, we think they just might.

Here's an internal monologue I imagine for some

of our legislators on either side of the aisle:

- 1) We need revenue, but raising taxes can cost me my shot at re-election. (*I need to manage my career risk.*)
- 2) Heading off the automatic levitation in tax rates will demand legislative action, and in a divided Congress, that will demand compromise; I can't be seen by my political base to have compromised on a core principle like tax policy. (*Partisan optics.*)
- 3) The higher tax levels for 2013 were mostly baked into the cake a decade back; who's to say what Congress decided all that while ago is my fault? Even if I was a member then, and voted for it, well, those were different times and since then I have changed and seen the light. (*Plausible deniability through temporal distancing.*)
- 4) All this bad stuff is scheduled to occur during *this* session of Congress, about to end – but it will be “*last Congress*” come January. (Again, *temporal distancing*).
- 5) What would be a bad thing in the session about to end (getting my fingerprints on any program that involves taxes going up, even if they go up less than scheduled) in 2013 will warp into a good thing... a chance to *lower* taxes from the automatically restored Clinton era levels, and yet have revenues *higher* than the year before so long as we cut just to rates higher than Bush era levels. (*Framing effect.*)
- 6) We'll have our cake and eat it too – tax cuts plus higher revenues. (*Fiscal magic!*)

Hence our guess: a tax structure “fix” will come in the next session, when it can be dressed up as victory for either party. It may be temporary and based partly on magical thinking, but it will come. Unless it does? Cold water.