



TAX REPORT

By TOM HERMAN

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Your Tax Bill: How McCain, Obama Differ

Capital Gains Rates Are Likely To Rise, No Matter Who Wins; Far Apart on Estate Taxes

Get ready for higher capital-gains taxes.

As the presidential campaign heats up, investment and tax advisers are issuing that warning to upper-income clients. Underpinning this view is Sen. Barack Obama's early lead in the polls, as well as speculation that Democrats will increase their majority in Congress.

Today's capital-gains tax rates "are probably the lowest we'll see" for decades to come, says Nadine Gordon Lee, president of Prosper Advisors LLC, a wealth-management firm in Armonk, N.Y.

So should you be rushing to sell your investment winners now to take advantage of today's historically low tax rates? While some investors say they are considering it, very few say they are doing anything different right now. Election Day still is more than four months away, an eternity in American politics -- and even if lawmakers do enact higher taxes next year, nobody knows how much higher they will be or what the effective dates will be. Moreover, investors seem far more worried about the economy and the slumping stock market than about tax rates.

"There's no question in my mind the next president will raise the capital-

gains rate. It's just a question of when," says David Anderson, a retired banker living in Darien, Conn. But Mr. Anderson sees "no rush" to sell investments immediately, especially in view of the stock market's sinking spell this year. He also notes the adage that you shouldn't make investment moves solely for tax reasons and says there still appears to be "plenty of time" to take action before any capital-gains tax-rate changes become effective.

Sen. Obama is calling for higher taxes on families making more than \$250,000 a year. That includes increased taxes not only on ordinary income such as salary but also on capital gains and most corporate dividends. The Illinois senator also is calling for higher Social Security taxes on many upper-income workers.

Sen. John McCain has staked out a strong antitax stance. That includes extending President Bush's income-tax cuts and enacting new breaks, such as raising the exemption for dependents.

Here is a look at the still-evolving plans of Sens. Obama and McCain, as well as thoughts from financial advisers and tax lawyers on what, if anything, to consider doing this year.

Income taxes. Sen. Obama is calling for higher taxes on the wealthiest Americans but lower taxes on lower- and middle-income households. "It's time for folks like me who make over

\$250,000 to pay our fair share," Sen. Obama said in a speech last week. "If you are a family making less than \$250,000, my plan will not raise your taxes -- not your income taxes, not your payroll taxes, not your capital-gains taxes, not any of your taxes. In fact, chances are you will get a tax cut."

For example, the Illinois senator wants to raise the top ordinary income-tax rate, now 35%, to 39.6%. For 2008, the top federal rate of 35% in most cases applies to taxable income of more than \$357,700. (The 2009 income threshold won't be announced until later this year.)

The Obama plan also includes imposing higher Social Security taxes on workers making over \$250,000. However, the senator hasn't given precise details, such as how much more those people would pay. Under current law, the maximum amount of earnings subject to the Social Security tax for 2008 is \$102,000.

In contrast, Sen. McCain wants to make permanent the current federal income-tax rates. He also opposes Sen. Obama's plan to lift the earnings cap on the Social Security payroll tax. Such a move would be bad news for the economy, says Douglas Holtz-Eakin, senior policy adviser to Sen. McCain and a former Congressional Budget Office director.

If the Obama plan becomes law, investment advisers agree that among the biggest winners could be tax-exempt municipal bonds, which are issued by state and local governments. Tax-exempt bonds typically benefit when ordinary income-tax rates rise. But be careful before you jump into the muni market: Even though these bonds typically are known as tax-exempts, some pay interest subject to the alternative minimum tax, which ensnared about four million investors last year. If that includes you, be sure to check with your broker whether the bonds you're considering are "AMT bonds."

One New Jersey investor says she recently purchased her first muni bond -- \$5,000 of hospital bonds. She says part of the reason was her expectation of higher tax rates in 2009.

Even though investment advisers say most clients aren't doing anything different, some should be thinking about making changes. "For an investor with a low-basis, large concentration in a publicly traded company, a family business or some other illiquid asset, taking steps to diversify in 2008, before a potential capital-gains rate increase, could result in significant tax savings," says Dan Schrauth, wealth adviser with JPMorgan Private Bank in San Francisco. Many clients are taking "a serious look" at the potential for higher capital-gains rates as a relevant factor in determining when to diversify out of a concentrated position, he says.

But Michael Holland, who heads a New York-based investment firm bearing his name, says: "I don't hear anyone talking about doing anything" right now in anticipation of higher capital-gains taxes. "If we had a huge run-up [in stock prices] between now

and December, I think you'd then begin to hear" talk about selling this year, he says. "I don't hear any of that right now."

Investment income. Under current law, the top long-term capital-gains rate on stocks, bonds, mutual-fund shares and other securities typically is 15%. ("Long term" means investments held more than one year.) If you make a profit by selling stocks or other securities you've owned for a year or less, that's considered a "short-term" gain and is subject to tax as ordinary income.

Sen. Obama wants to raise the long-term capital-gains rate for families making more than \$250,000 to around 20% or somewhat higher -- but not above the 28% level it reached during the Reagan presidency, an Obama economic adviser says. The same rate would apply to most dividend income for these investors.

Sen. McCain wants to keep the current structure of tax rates on capital gains and dividends. But many wealth advisers believe that if he won the presidency, he would be forced to compromise with the Democrats in control of Congress and eventually would agree to a capital-gains rate increase.

Capital-gains rates are likely to "go up by more -- and possibly earlier" if Sen. Obama wins, says Thomas D. Gallagher of International Strategy and Investment Group. But rates "still probably go up under McCain," he says, noting that the 15% rate is set to rise automatically after 2010 if Congress takes no action.

Bob Willens, president of a tax-advisory firm in New York bearing his name, agrees the capital-gains rate is

going up next year. "It's something you need to resign yourself to," he warns. But he says there's no reason to rush to sell today, since lawmakers aren't likely to make tax-rate increases retroactive to the start of next year. He sees the effective date more likely as sometime around mid-2009.

Estate taxes. Neither candidate wants to kill the estate tax permanently, as President Bush has proposed. Instead, both favor a compromise, but Sen. McCain's plan would be far more beneficial for wealthy heirs than the Obama plan.

Under current law, the federal estate-tax exemption this year is \$2 million, and the top rate is 45%. (Transfers from one spouse to the other typically are tax-free.) Next year, that exclusion is set to rise to \$3.5 million, with the rate remaining at 45%. In 2010, the federal estate tax is scheduled to disappear completely, only to return again in 2011 with an exclusion of \$1 million.

Sen. McCain proposes raising the exclusion to \$5 million and cutting the tax rate to 15%. Sen. Obama proposes a \$3.5 million exclusion while keeping the top rate at 45%. In either case, the basic strategy is the same: If you're wealthy and care about how much your heirs get, make sure to keep breathing at least through the end of this year to take advantage of 2009's higher exclusion.

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