

## Tax Rates Will Rise in 2009 – What Should You Tell Clients in 2008?

You likely will be able to do your clients a large favor and afford them the opportunity to save significant sums of federal income tax late this year, if you can effectively arbitrage between the current tax rates (15 percent maximum on dividends and 35 percent on ordinary income) and steeper rates expected to be enacted in 2009. It has not been since World War I that the dividend rate was only 15 percent. Virtually the entire practicing tax bar at the national level expects the dividend rate to rise in 2009, as well as the ordinary marginal brackets. For the balance of 2008, clients will have a historic window of opportunity to take pro-active steps and get their hands on money at what may seem to be cheap tax rates next year.

President-elect Barack Obama and the new Congress confront a \$482,000,000,000 deficit for the current year and the highest national debt in the history of the country and the world. The dollar is weak because outside of the United States, the smart money does not perceive buying America's IOUs (a more polite term would be the securities issued by the U.S. Treasury to finance and refinance the debt) as a sound investment.

The new president and Congress will have to raise taxes. The only question is how much. Ignore campaign rhetoric. Perhaps a more realistic starting position will be the extensive overhaul of the tax system released last year by the chairman of the Committee on Ways and Means of the U.S. House of Representatives, Charles Rangel. See H.R. 3970.

What should clients do? Historic year-end tax advice is to a) accelerate deductions, and b) defer income. If rates are the same the following year, that is usually sound advice. Historically, when Congress increased ordinary income rates, it did so either a) retroactively to January 1 of that year or b) with a blended, higher rate for the year of transition. Capital gain rate increases were effective as of a

date a little before the legislation was enacted. Prospective effective dates were not used to avoid turmoil in capital markets.

Today, one has some idea of the magnitude of the tax increases. That might be a particularly good time to look at taking out sums of money that are available, such as retained earnings in C corporations, at historically cheap dividend rates. To the extent there are liquidity issues in doing so, client companies with solid balance sheets and cash flow have gone to banks, borrowed large sums of money, and paid special dividends. A simple example illustrates this: In a 15 percent dividend tax rate, one has to pay a gross dividend of \$1.18 so that the shareholders, net of federal income tax, receive a \$1.00. If the rate capital gain rate goes to 25 percent, the company would have to pay a dividend of \$1.33, or almost twice as much for tax effect, for the taxpayer to net one dollar. If the rate went to 35 percent, then the company would have to pay a gross dividend of \$1.56 to net \$1.00.

Next year will also be interesting on the deduction side. Higher rates mean that a \$1.00 deduction is more valuable. There are also strong legislative proposals such as Chairman Rangel's bill to repeal the individual alternative minimum tax, or AMT, in 2009 and pay for that via higher regular tax rates. Thus, an individual deduction could be far more valuable in 2009 than this year.

The 2008 stimulus legislation contained one-time bonus depreciation for machinery and other qualifying equipment, including some software, placed into service by December 31, 2008. Equipment must be new and have a 20-year or shorter depreciable life as well as meet other criteria. Clients purchasing a new computer system or other qualifying property in the near future, if they act promptly and place it into service by December 31, 2008, can generally fare more

favorably from a federal income tax perspective.

There will, no doubt, be numerous opportunities, particularly those with closely held businesses, to take advantage of one last bite of the historically low tax rate apple. Stay tuned, it will be interesting.



*Paul L. B. McKenney of Varnum Riddering Schmidt & Howlett LLP, Novi, specializes in Federal taxation. He is Vice-chair of the Sales, Exchanges*

*and Basis Committee of the Taxation Section of the American Bar Association, and a member of the Taxation Section of the State Bar of Michigan. Mr. McKenney has also served as Chairman of the Taxation Committee of the Detroit Bar Association as well as of the Oakland County Bar Association's Taxation Committee. He previously was a member of the Taxation Section Council of the State Bar of Michigan. Mr. McKenney was an adjunct professor in the graduate taxation program at Walsh College. He has published numerous articles and is a frequent lecturer on tax topics before ICLE, the American Bar Association Taxation Committee, and other organizations. Mr. McKenney authored the taxation chapter in *Torts: Michigan Law and Practice (ICLE 2d ed.)*.*