

December 10, 2008

Dear Clients and Friends:

It has been almost a month since the presidential election ended and for that conclusion I am still thankful. President-elect Obama and his transition team over the last month has been working with the Bush administration to determine what campaign promises can be kept. With one month left in 2008, let us look at President-elect Obama's campaign promises regarding taxation and the realities he now faces.

As you may recall in the campaign, candidate Obama proposed the following tax changes:

1. Repeal President Bush's tax cuts in 2009 for the top two brackets by reinstating the 36% rate for the 33% rate and the 39.6% rate for the 35% rate.
2. No tax increase for those making less than \$200,000 (excluding approximately 97% of all taxpayers).
3. Increase tax rates on long-term capital gains from 15% to 20% (lowered from his previous rate of 28%).
4. Increase the tax rate on dividends from 15% to the ordinary income tax rates (for highest tax brackets that would be 35% and 39.6%). As the campaign progressed, candidate Obama indicated the increase on dividends might be limited to 28%.
5. Rather than repeal the alternative minimum tax ("AMT"), prevent its spread through legislation that keeps the exemption amount at current inflation adjusted levels.
6. Remove the cap on earnings for the FICA tax thereby increasing the top marginal rate on earned income to 47.25% (39.6% + 7.65%)
7. Freeze the 2009 estate tax exemption at \$3.5 million with a top rate of 45%.

Conditions impacting campaign promises. When the Presidential campaigns were entering their national conventions, there already existed a budget deficit. While the federal government had been averaging tax revenues of slightly more than 18% of GDP since the 1980's, deficits up to 2008 had ranged from 1% to almost 4% of GDP. As the national conventions for each National Political Party

concluded and the campaigns began, the capital markets became extremely volatile, credit froze, and world economies headed toward recession. So now, President-elect Obama has to face increasing deficits (the deficit for 2009 could pass \$1 trillion) due to unprecedented government spending to calm capital markets and thaw a credit freeze.

Crystal Ball: This economic quagmire has forced Mr. Obama's advisors recently to suggest a withdrawal from Candidate Obama's pledge to immediately repeal the tax cuts at the top 2 rates and reinstate the higher rates of 36% and 39.6%. Most advisors originally thought the top two ordinary tax rates would be increased in 2009 and made retroactive to January 1, 2009. Just because Mr. Obama's advisors suggest caution, one must remember that over the last 30 years, there have been five major tax increases. Three of those five tax increases occurred during recessionary environments.

So what does this mean for the current 15% rate on long term capital gains? An increase here to 20% is likely with some announcement in 2009 of such legislation with a retroactive effective date of January 1, 2009, to minimize a sell-off. Politically, this rate increase on capital gains does not affect a large group of taxpayers. Most recent data reveals that for income tax returns filed in 2005, only 14 million taxpayers reported capital gains.

The lower tax rate of 15% on dividends will likely see an early exit in 2009. So will a preference rate for dividends continue? Given the recent comments of Mr. Obama's advisors, I think that the tax rate on dividends may increase to no more than 28% with an effective date, like long term capital gains rate, retroactive to January 1, 2009. For those already in the 28% bracket or lower, the new administration would likely retain the lower tax rate of 15% on dividends, thereby keeping its pledge to those with less than \$200,000 of taxable income.

Originally the AMT was designed in 1969 to guarantee that high income individuals paid some minimal level of tax. This tax is realized by the denial of certain tax preferences (deductions considered excessive for regular tax calculations). Since AMT exemptions were never indexed for inflation, the targeted coverage for AMT went from 20,000 taxpayers in 1970 to over 20 million taxpayers in 2007. This AMT has now encroached on middle income taxpayers with the top two "preferences" consisting of personal exemptions and state and local taxes. A repeal of the AMT would dig a deeper hole of over \$650

billion in the budget over a 10 year period. In addition a repeal benefits largely upper income and some middle income taxpayers. With this dilemma, President-elect Obama is likely to continue to ask Congress for annual inflation adjusted "patches" to the AMT exemption.

The upward adjustment of the ceiling (or removal of same) on earnings subject to the FICA tax is a tempting target for revenue. To keep his campaign promises of no tax increase for those earning \$200,000 or less, Mr. Obama and Congress would likely give a credit for the extra FICA tax paid. While we may not see this FICA ceiling adjustment in 2009, it is certain to be on the list as the economy improves.

The promise most likely to be kept is estate tax reform because there is already agreement on both sides of the Congressional political aisle. Under current law, the estate tax is scheduled for repeal for one year only in 2010. For 2008, the exemption of \$2 million will increase to \$3.5 million in 2009. It is at this amount that President-elect Obama and Congress may want to settle permanently (with inflation adjustments) with a top estate tax rate of 45%.

What does that mean for you? Over the long haul of this new administration, we will see more government involvement in such areas as retirement plans. Furthermore to attain a level of perceived fairness, we may eventually see more use of tax credits that will not be available to higher income groups.

For the end of 2008, it is important to continue to examine the timing of payment of certain deductible items like real estate taxes to avoid the imposition of AMT. Before making other deductible payments such as charitable contributions, one benefits from examination of income for 2008 versus that for 2009, to get the maximum tax benefit of the payment.

Those of you inclined to make annual exclusion gifts (currently \$12,000 per donee per year for 2008 and to increase to \$13,000 in 2009) should review your estate and gift planning to insure utilization of the exclusion before the year ends. If you have not made gifts in the past, you may want to discuss with us the types of gifts that will qualify for the exclusion.

The year of 2008 in Houston has been one to remember with the unsteadiness of the capital market and a raucous visit from Hurricane Ike. We thank you for your confidence in us over the years and remain ready to help you in your tax and financial planning. Our entire firm wishes you a joyous season and certainly a healthy and prosperous 2009.

Very truly yours,



Joseph W. Thomson

In accordance with the requirements imposed on professionals who practice before the Internal Revenue Service, we advise you that any tax advice contained in this communication (including any attachments) is not intended to be used, and cannot be used, for purposes of (i) avoiding penalties imposed under the United States Internal Revenue Code or (ii) promoting, marketing or recommending to another person and tax-related matter.