Long-Term Capital Gains Tax Expectations: Barack Obama vs. John McCain

By

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Long-Term Capital Gains Tax Expectations

Long-Term Capital Gains Tax (LTCGT) rates are likely to increase regardless of the outcome of this year's presidential election. This tax hike will be driven by the widening public budget deficit and the expiration in December 2010 of certain legal tax exceptions.

Candidates' Platforms on Taxes

Most Americans are worried about the economic situation and the measures required to restore stability and growth. On this issue—particularly on taxes—analysts concur that American voters will pay attention to each candidate's proposal.

Mr. Obama has pledged close to instill fiscal discipline by "repealing the Bush tax cuts for the wealthiest Americans," thereby restoring "fairness and efficiency" in the tax system. He promises to eliminate special-interest loopholes and deductions, particularly those within the oil and gas industry, and to revoke Bush's policies of offering tax breaks to the wealthy, which, he claims, will cost the nation over $2.3 trillion by 2010 −the year they expire.

In contrast, Mr. McCain is an anti-tax zealot. His plan is to maintain the capital gains rate at 15% by extending President Bush's income-tax cuts. He has promised to enact new tax breaks, such as raising the exemption for dependents, even though this could increase the budget deficit.

Presidential candidates comparative platforms on Taxing Wealth	
Mr. McCain	**Mr. Obama**
Preserve the 15% tax rate on carried interest - the cut private equity and hedge fund managers take when the funds they manage make a profit.	Tax carried interest as ordinary income rather than as an investment gain, thereby subjecting it to much higher tax rates than 15%.
Increase the amount of money exempt from the estate tax to $5 million.	Freeze the exemption amount of estate tax at $3.5 million -- where it will be in 2009.
Reduce the top estate tax rate to 15% from 55% - where it otherwise will be in 2011 under current law.	Freeze top estate tax rate at 45%.
Keep capital gains and dividend tax rates where they are.	Raise capital gains and dividend tax rates to at least 20% but under 28% for high-income investors.
Other sources of revenues to be reviewed i.e. Corporate Taxes, Oil, R&D, etc.	Other sources of revenues to be reviewed i.e. Corporate Taxes, Oil, R&D, etc.

Regardless of each candidate's economic platform, tax rates will likely increase because of the simple, yet undeniable, fact that, all else equal, excessive public spending creates economic imbalances, which, sooner or later, obliges fiscal austerity.

In addition, tax exemptions created by the Economic Growth and Tax Relief Reconciliation Act (EGTRRA), as well as all its provisions and amendments to the tax code, are set to expire in December 2010.

Fiscal Imbalance: Taxes and Revenues
Under President Bush, the federal debt has increased from $5.7 trillion to $8.8 trillion — a greater than 50% increase. The White House reported that total federal revenues declined in 2008, and that from 2008 to 2011 corporate income tax collections will be lower than the amount collected in 2007.

Also, the White House Budget Director Jim Nussle stated that the budgetary deficit could reach up to $482 billion in the 2009 fiscal year—the largest share of GDP since 2004—as total tax revenues continue their downward trend through 2011. Such economic imbalance will challenge the next president to raise government savings by increasing taxes and curbing spending.

The LTCGT rate may possibly be the lowest of all corporate taxes. It is 5% for investors in the 10% and 15% income tax bracket and 15% for investors in the 25% to 35% bracket. Moreover, in 2001, President Bush cut the LTCGT rate to 15% when he signed EGTRRA, which was extended in 2006 through 2011.

Economic Growth and Tax Relief Reconciliation Act (EGTRRA)
According to the EGTRRA, the LTCGT exemptions will expire after 2010. If EGTRRA provisions are not extended before 2011, LTCGT rates will revert to those established originally by the Omnibus Budget Reconciliation Act of 1990 (HR 5835; PL 101-508), approximately 28%.

In any event, either to maintain or to change the LTCGT rate, the next president of the United States will have to submit his proposal to Congress. Once there, it shall follow the ordinary legislative procedure meaning it will be sanctioned and voted on by legislators, most of which prioritize constituents' preferences over party affiliations. The next US President will likely have to compromise with Congress.

Today, politicians who seek to reinstate the higher tax rate aim to make the wealthiest Americans contribute more tax dollars. Those who strive to extend the current tax cuts claim it places an unfair burden on certain constituencies.

When the time comes for Americans to tighten their belts, increasing the LTCGT rate may well be parenthetically justified because it has been too low for too long and has been benefiting only the wealthiest Americans.

The LTCGT rate may climb simply as a consequence of the current economic situation and the official deadline of the EGTRRA provisions. This rise in taxes is an issue beyond political affiliation.

Conclusion

Today the US is facing increasing unemployment, declining equity and home mortgage markets, and upward pressure on interest rates. In its effort to stabilize a fragile and weakening financial system, the Federal Reserve has opted to cut interest rates aggressively, which undoubtedly is one major driving factor behind dollar depreciation and inflation. Yet despite such efforts job losses have continued and fiscal spending has not abated.

Worsening economic imbalances (a widening government deficit, dollar depreciation, rising inflation and inflation expectations, not to mention the country's existing trade deficit and social security quandary) make fiscal discipline a paramount objective. If Mr. McCain wins, Bush's tax cuts are set to expire in 2010, unless Congress extends the EGTRRA provisions. And in the event that Mr. Obama wins, he has pledged to raise the LTCGT rate.

The government has few options when it comes to addressing the budget deficit: increase taxes, increase debt, cut expenditures and/or a combination of the three. Being optimistic, we may hope for increasing taxes without cutting government expenditures. Being pessimistic, taxes will rise and public expenditures will decrease. In either case, to avoid major economic turmoil, taxes must increase.

For an organization contemplating a sale over the next few years, there could be a tax advantage to consummating a sale process sooner rather than later. A seller is likely to face higher LTCGT rates after 2010.

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Steven leads and co-founded Park Sutton Advisors. He has focused on middle-market M&A and strategic advisory work in the financial services sector for the past 12 years working with asset and wealth managers, broker-dealers, and fund administrators globally.

Prior to co-founding Park Sutton, Steven worked with three investment banking boutiques where he focused on strategic and transactional work in the securities and investment advisory industry. He was a partner with Cambridge International Partners which he joined from Millenium Associates where he led that firm's North American practice. Earlier, Steven worked at Putnam Lovell.

Steven holds a BA degree in Economics from Stanford University and an MBA in Finance from The Wharton School of the University of Pennsylvania. He is an alumnus of Stuyvesant High School. He is also a General Securities Principal.

Steven is a frequent speaker at industry conferences and seminars, and has been particularly active in the Speaker Retainer Program of the CFA Institute speaking on the topic of valuation of asset and wealth managers. He has served as an investment banking course instructor for Baruch College of the City University of New York. He is fluent in Spanish and prior to Wharton spent several years living in Mexico City.

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