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Congress and Next President Face Trifecta of Tax Issues

As the presidential race heats up this year, culminating with the November general election, our next President and the next Congress will be faced with three tough policy and tax issues:

1. The Estate Tax is set to expire in 2010 then revert to pre-2001 rates and exemptions;

2. Income Tax Rate reductions, including Alternative Minimum Tax (AMT), are slated to sunset and revert to pre-2001 levels; and

3. Social Security needs to be addressed to ensure solvency and continued viability.

Changes in these tax laws will have a profound impact on business, particularly the Construction Industry. Economists can argue both sides of the issue as to whether significant changes in these areas will impact the continued expansion of the economy or trigger a recession. Moreover, the availability of credit and the pace of construction activity could also be impacted.

Background

In 2000, President Bush proposed and Congress passed the Economic Growth and Tax Relief Reconciliation Act of 2001. Among other things, this legislation reduced income tax rates. These changes were to be phased-in over a period of nine years. In 2004, Congress either eliminated or decreased the phase-in period resulting in the current top tax rate of 35% for individuals. And since most contractors are structured as S Corporations the individual tax rates are the rates to focus on when considering business taxes.

The estate tax rates were also reduced and the corresponding exemptions were significantly increased. The estate tax is schedule to actually leave the tax regime for one year in 2010.

These laws were passed with sunset provisions that are set to expire in 2010. The rates and exclusion amounts will revert back to prior legislation before 2001. The choice facing the new President and Congress will be whether to do nothing and let the law expire or to make the reductions - or a portion - permanent.

Concurrently, there has been no serious legislation to address reform of Social Security to prevent projected funding shortfalls. Some proposals addressed some of the issues but little has occurred.

Income Tax Rates

During 1993 the Clinton administration increased the highest individual tax rate to 39.6%. With phase-out of certain deductions the marginal rate in many cases exceeded 40%. The Bush Tax Bills reduced the highest rate by approximately 12.5% to 35%. Thus, the economic policy enacted enabled businesses and individuals to keep more of their money, thereby increasing investment.

Making the reductions permanent would be a continuation of this policy and may also possibly serve as a means to control government spending increases. While that may be hopeful thinking, the overriding point is: Without affirmative Congressional action, most Americans will face an automatic tax increase as we leave this decade.

And this doesn't even consider the Alternative Minimum Tax (AMT) for which the last two years Congress pushed through last minute year-end patches to prevent an estimated 20 million more Americans to be caught in the web of this added complexity. The arcane AMT needs to be eradicated as part of any tax change or reform.

Estate Tax

The 2001 Tax Act reduced the top estate tax rate and gradually increased the unified tax credit exclusion to qualify more estates for tax-free transfer. The top estate tax rate was diminished from 55% to 45% (for 2007 through 2009). And the exemption has been increased from $600,000 per estate to $2 million for 2007 & 2008. The exemption increases further to $3.5 million in 2009. The 2001 law ultimately eliminates the estate tax in 2010. That's right, under today's law - the best time to die to avoid this tax is during 2010.

However, there's a huge "BUT" to this: the estate tax is scheduled to be reinstated in 2011 at the higher rates and lower exemption amounts that existed prior to 2002. Not to sound politically incorrect, but I guess dying on New Year's Day 2011 would be a few too

continued on page 36

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continued from page 15

many hours late if you want to save on your family's tax bill.

While eliminating taxable transfers of wealth would encourage increased investment and all of the good things that would come from such a policy, Congressional action is required to avoid reinstatement of the old regime. Sounds like a broken record…"Congress must act".

Social Security

There have been no legislative changes to Social Security funding for a number of years. That is, other than annual indexing for inflation the maximum amount of wages that are subject to withholding for contributions into the system and also the threshold subjecting more of the benefits to income tax.

Due to strong public views regarding either an increase in tax payments or reduction in benefits received, no recent administration has made a serious effort to remedy this looming fiscal crisis. At the same time, there are numerous studies indicating that delay in addressing increased funding will increase the amount of future funding.

In its most basic form, there are three remedies or combination of remedies including:

- Do nothing or shift the burden to individuals (self funding and directed accounts)
- Increase taxes
- Reduce benefits

Passionate opinions have been expressed both for and against most proposals and as a result, legislation proposed last year stalled and died in Congress. It will take more determined and forceful leadership on this issue to address and remedy future funding shortfalls of our social security system.

Summary

Changes in income tax rates, the estate tax and remedying funding deficits in Social Security are tough decisions that will face the next Congress and President. While tax policy itself may not drive political elections, it will be important to listen to candidates' positions on reform for income tax, estate tax, and Social Security. The broken record tells us "Congress must act" and their upcoming action will impact ABC's member businesses and the Construction Industry.