

What if the 2011 tax rate is set late?

Wealthy investors will want to move income forward to this year, saving amount hit by hike

By Robert N. Gordon

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It is likely that nothing will be known about the tax rate for 2011 until after the November elections. History shows us that if everyone knows that taxes are going up, taxpayers will employ strategies to accelerate income into this year. When taxpayers are forewarned, they change their behavior to take advantage of a tax arbitrage opportunity.

The real question is whether the government will act so late in the year that the tax arbitrage effect becomes inconsequential.

There are pros and cons to having the government leave everyone in limbo until Dec. 31. Taxpayers accelerating income into 2010 would swell the government coffers in the short term but also reduce the amount of income taxed at the new higher rate in coming years.

Economists have studied taxpayer behavior when tax rates change.

In 1992, for example, when ordinary income rates were about to rise, there was a spike in the exercise of non-qualified stock options. In December of that year, BusinessWeek observed this outsize activity and labeled the behavior “the Big Flush.”

“Higher rates in 1993 led to a ... large increase in the exercise of stock options in the year before the tax change ... concentrated among executives at the top of the income distribution,” Austan Goolsbee concluded in his 1997 article, “What Happens When You Tax the Rich?” Yes, this is the same Mr. Goolsbee who was recently appointed head of the President’s Council of Economic Advisers.

According to Internal Revenue Service data, the top 1% of tax returns in 2007 were responsible for 40.4% of all federal individual-income taxes and 22.8% of adjusted gross income. The top 0.1% of tax returns (that is the top tenth of the top 1%) account for nearly 12% of the adjusted gross income and about 20% of the nation's federal individual-income tax receipts.

These are the people who have the position and wherewithal to time their income. Mr. Goolsbee also observed that executives without stock options are six times less responsive to changes in taxation than those with options.

This tax acceleration can happen with investors, too. The experience of 1986 provides a wealth of data on taxpayer behavior because that was the year that the tax on ordinary income dropped to 28%, from 50%, while the tax on capital gains increased to 28% from 20%.

Alan J. Auerbach of the University of California, Berkeley, in a 2000 paper "Capital Gains Taxation in the United States: Realizations, Revenue, and Rhetoric," wrote that "in 1985, individuals filing U.S. tax returns reported \$166.4 billion of long-term capital gains in excess of short-term capital losses. The following year, Congress enacted a significant increase in capital gains taxes effective in 1987, and capital gains realizations for 1986 nearly doubled to \$324.8 billion."

The purported wisdom of taking gains early isn't as clear as the benefit of taking ordinary income early, because individuals can hold positions until death and be forgiven any capital gains tax.

The most obvious type of income ripe for acceleration is ordinary income scheduled to be realized over the next year or two. Non-qualified stock options set to expire in 2011 are prime candidates.

The timing of bonuses and regular income is much harder to orchestrate unless the employee is high up in the corporate pecking order.

Investors could see their taxable bond portfolio as ripe for acceleration. If the investor owns a taxable bond paying interest in September and March, he or she will receive six months of interest in March 2011 taxed at 39.6%.

Instead, the investor could sell the bond late in December, bringing the accrued interest into 2010's taxable income at the current 35% rate. Of course, the taxpayer could subsequently repurchase the bond and realize only three months of interest in March 2011.

Taxpayers and their financial advisers must weigh the options in anticipation of any change now. I am afraid that by the time we know what is happening with taxes for 2011, it will be too late to do much about it unless you have planned ahead.

It is late enough in the year to think that the government won't raise taxes without giving taxpayers full warning. It should be hard for the government to ignore the short-term revenue gain that would accrue if the change were made with adequate time left in the year.

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