

November 2, 2010

# Impact of Higher Tax Rates; More Dividends and Cash by Yearend, but Lower Asset Prices

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We think it is increasingly likely that Congress will not be able to pass many, or perhaps any, tax cuts in the lame duck session, leaving nearly 100 tax rates higher in 2011 than in 2010. The stronger the Republican showing in the election, the harder it will be for the lame duck session to arrange the necessary votes to reduce tax rates. We're skeptical that individual tax reform can be accomplished early in 2011 and think markets will have to price in permanently higher tax rates in many areas.

Our previous pieces have explained the legislative procedures that make tax cuts very difficult. This piece focuses on some of the impacts of a sweeping tax hike on January 1.

- We expect a flood of tax-related cash flows in December to take advantage of current tax rates. We expect most of the cash to get reinvested – in idle short-term near-cash investments in the U.S. and long-term job-creating investments abroad as investors look for growth and shelter from the declining dollar.
- Some of the extra cash will go into fourth quarter production and consumption, driving up Q4 GDP (we're at 3.5% real GDP for Q4 and note today's strong 56.9 ISM reading and very strong 71.0 prices paid index).
- We expect very big year-end dividend payouts. The risk that the dividend rate will jump from 15% to nearly 40% is high and rising, which should break through the normal reluctance of management and entwined boards to hold down dividends. Banks are sitting on huge cash reserves but most feel constrained by regulators to hold down their dividends as they build liquidity.
- We think many bonuses will be moved into December.
- We think payouts from some deferred compensation plans will be accelerated into December. The logic of deferred comp is to delay income hoping for a lower rate in the future or for inside buildup, neither of which is compelling now. (There's a precedent. Acceleration occurred in 1992 in anticipation of the Clinton 1993 tax hike; after that incident, the rules were changed to make it harder for a company to disband one plan and then start up a new one, which may reduce the number of accelerated payouts.)

- We think some older, wealthy individuals will make taxable gifts at the current 35% rate (for amounts over the \$1 million exclusion) rather than face higher gift and estate tax rates starting January 1. We're not tax practitioners but hear that there's no generation-skipping tax this year and gift taxes are creditable to estate taxes.
- **The long-term capital gains rate will probably increase to 20% from the current 15%, with the risk of an increase to 23.8% in 2013 when the medicare tax is scheduled to be extended to capital gains and dividends.** This is large enough to cause some tax-related selling in December. From an economic standpoint, the bigger impact is the future cost of capital. **As higher tax rates cause a higher cost of capital, the asset is worth less.** In combination with the expected increase in dividend and income tax rates, we think productive assets will be worth less under the new tax rates, with most of the impact priced into markets in November and December as the odds of Congressional inaction rise.

**There's a good chance the "tax extenders" will not be enacted in the lame duck session.** This leaves many programs up in the air.

- The huge federal ethanol subsidy expires. We don't think it will be renewed. Expiration of the subsidy harms companies that produce ethanol but benefits companies that use corn (e.g. cereal makers.)
- Solar and wind credits expire. They may not be renewed, given their cost and low energy production. This harms the companies dependent on these credits.
- The federal tax subsidy for Build America Bonds is set to expire at year-end. Strategists are already recommending investors sell the longer-dated bonds because liquidity in this asset class may plunge as new issuance dries up.
- The R&D tax credit has expired. We think this credit will be renewed, perhaps retroactively, but not until well into 2011. This may impact after-tax earnings expectations for companies using the credit.
- The patch for the alternative minimum tax has expired. The patch provides a large tax subsidy to high-tax states, particularly New York, California, New Jersey, Connecticut and Illinois. These states lean Democratic, so it's not clear how the patch will be resolved. In the meantime, we expect higher tax payments due April 15 for taxpayers with substantial property taxes.

Looking into 2011, we emphasize the unfavorable scoring system used in Washington that dominates legislative outcomes and creates a bias toward higher tax rates. Under that system, it will be very hard to reduce tax rates in 2011 in the face of the high fiscal deficit.

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