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ENJOY THE INVESTOR TAX CUTS – WHILE THEY LAST

As far as Washington is concerned, investors have rarely had it this good, despite "double corporate taxation" that has existed since 1916. Since then, corporate income has been taxed first at the company level and then a second time when individual shareholders take their profits. Currently, both corporate income and shareholder tax rates are very low by historic standards. When Gerald Ford was president in 1974, for example, the corporate income tax rate was 48 percent. Today it is 35 percent. Individuals paid 28 percent in long-term capital gains when Jimmy Carter was president. Now, they pay15 percent. They also pay only15 percent if they take income as dividends – the lowest dividend tax rate since the Depression.

Last Thursday, Congress extended both the maximum capital gains and dividend tax rates for two more years, until the end of 2010 instead of 2008. Unfortunately for investors, unless the House, Senate, and President again act, on December 31, 2010 these provisions will revert to a 39.6 percent top rate on dividends, and a 20 percent rate on long-term capital gains, both up from15 percent. It may seem churlish to worry about another extension before Bush signs the current one this Wednesday. However, the markets are machines that discount the future, and the direction of investor tax policy, post 2010, is foreseeable, and it is bad. The machine will do the discounting whether investors like it or not. The good times will prove temporary.

Even though they now control the Presidency, the Senate, and the House, Republicans cannot make investor-friendly tax cuts permanent because of Senate rules. Those rules state that temporary tax reductions can pass by majority vote under the "reconciliation" process, but tax reductions must sunset in ten years or less if this parliamentary process is used. All this is covered by the "Byrd Rule," named after Senator Robert Byrd (D-WV), and it was codified into federal law as Section 313 of the Congressional Budget Act of 1974.

Senate tax cutters interested in permanent change must use the conventional legislative approach which permits a determined Senate minority to block them if they can muster 41 votes to sustain a filibuster; it takes sixty out of 100 Senate votes to overcome one. Currently, the Senate has 55 Republicans, 44 Democrats, and 1 Independent. Last week, the Senate voted 54-44, one Republican and one Democrat were absent, to push back the expiration date of the 15 percent maximum tax rates on capital gains and dividends to 2010 instead of 2008, with 3 Republicans defecting to vote against the extension and 3 Democrats defecting to vote in favor. The prospect of acquiring sixty votes to make investor-friendly tax cuts permanent is a fantasy. Supporters are at least five votes short, and in fact, are probably much farther away than that.

If you think otherwise, consider this. The Senate GOP used "reconciliation" to extend the 15 percent rates on dividends and capital gains only until December 31, 2010. If 51 of 55 Republicans had wanted to do so, *they could have made the expiration date January 1, 2016 with just Republican votes.* But Senate Republicans used the "reconciliation" rules to extend them

only until December 31, 2010. Why should anyone believe Senate Republicans favor making investor-friendly tax cuts permanent when they voluntarily leave six years on the table?

In any event, it is almost "even money" that the GOP loses control of the House this November, and there will be fewer Senate Republicans after this fall's election. Faint hearted congressional Republicans will be replaced by Democrats who are hostile to investor tax cuts.

Investors Will Understand the Problem Better After the GOP Loses the 2006 Elections

The consensus prediction among professional elections observers is that the 2006 mid-term elections will be "normal;" the party holding the White House for the last six years will lose seats in the House and Senate. Opinions differ on the size of these losses.

Observers who believe a 1994-style wave is building expect that Democrats will pick up at least 15 House seats and perhaps many more, making Nancy Pelosi (D-CA) House Speaker this January, with Charlie Rangel (D-NY) becoming Chairman of the Ways and Means Committee, and Barney Frank Chairman of Financial Services. One thing seems certain. These leaders will not back extensions if they are in power, given their decades long hostility to "tax cuts for the rich." According to a widely followed "political futures markets," there is exactly a 50 percent chance they will come to power as part of a Democratic House majority. You can watch the tide of opinion flow by checking the political futures markets trading at http://www.tradesports.com/aav2/trading/tradingHTML.jsp?evID=41044&eventSelect=41044&updateList=true&showExpired=false#%20.

Even if House Republican candidates perform better than expected and keep their losses down to ten seats, it is no sure bet that a House of Representatives with only 222 Republicans and 213 Democrats will produce a majority in favor of another investor tax cut extension. The GOP's most liberal members would be the ones who hold the balance of power on the House floor in 2007 or 2008.

The GOP Senate also faces a likely loss of seats, although the probability of the GOP losing its Senate majority this fall is low; Republicans start with a 55-45 margin and only one-third of the Senate stands for re-election each cycle. In this cycle, six GOP-held Senate seats are considered "at risk." Only if Democrats win all six races while holding on to three seats where their candidates face some trouble will the GOP lose their majority. There will be GOP losses. The question is how many. If Rick Santorum (R-PA) survives, observers will be stunned. Furthermore, Conrad Burns (R-MT), Mike DeWine (R-OH), and Lincoln Chafee (R-RI) are in at best even contests. Jim Talent (R-MO) is in a difficult fight, but has an edge. Finally, there is an open Tennessee seat, since by Majority Leader Bill Frist (R-TN) is retiring. In a "large wave" election, all five endangered Senate GOP incumbents lose, and the GOP also fails to hold in Tennessee. This would turn their 55-45 majority turns into a 49-51 minority.

More probable, three GOP Senate incumbents lose, not five, and Republicans hold onto Tennessee. The likely final result of a net loss of three Senate seats is due to unpromising GOP

counterpunching chances. It has thirty to thirty-five percent chances in three races this cycle – against Democratic incumbents in New Jersey and Minnesota, and in taking the open Maryland seat. That is it. Would a 52-48 Republican Senate agree to an extension past 2010 when a 55-45 Senate would not agree to one now? There is sound reason to doubt it.

Senate Seats in Play in Election 2006

State -GOP Defending	GOP	Dem	Recent Poll	Turnover Chances
PA-(GOP)	Santorum 36%	Casey 49%	Quinnipiac April 6	80%
MT-(GOP)	Burns 46%	Morrison 40%	Mason Dixon Dec 15	60%
OH-(GOP)	DeWine 41%	Brown 44%	Hart Research 2/2-2/7	55%
RI-(GOP)	Chafee 40%	Whitehouse 34%	Brown University 2/4-2/6	50%
MO-(GOP)	Talent 43%	McCaskill 43%	Harstad Strategic Research 4/11-4/14	40%
TN-(GOP)	Bryant 50%	Ford 42%	Zogby Interactive Mar 30	25%
State-Democrats Defending	**GOP**	**Dem**	**Recent Poll**	**Turnover Chances**
NJ-(DEM)	Kean 37%	Menendez 42%	Fairleigh Dickinson 2/26-3/6	35%
MN-(DEM)	Kennedy 41%	Klobuchar 49%	Zogby Interactive Mar 30	35%
MD-(DEM)	Steele 39%	Cardin 49%	Zogby Interactive Mar 30	30%

This still leaves the actions of 2009 and 2010 to consider – years when the nation will be led by its 44th president. Possibly, the congressional GOP will recover from its likely losses in 2006 in November 2008 when the country selects Bush's successor, and this newly strengthened Congressional majority and a new president can extend the investor cut deadlines then.

Next, consider how the outcome of the 2008 presidential election might change things.

A Democratic President Can Easily Kill An Extension of Investor Friendly Tax Cuts

The upside to the reconciliation process for any Senate majority is that laws clear the chamber by simple majority vote. However, under the Byrd Rule tax cut laws sunset, with the laws in effect previously automatically resuming with full power. This "permanent law" gives dividends no special treatment, so they are taxed as ordinary income, up to 39.6 percent, and a tax rate of 20 percent applies to capital assets sold after they are held for at least one year. For permanent law to resume, all President Hillary Clinton or President Gore has to do is to veto any tax bill sent to the White House in 2009 or 2010 not to its liking – assuming one reaches the Oval Office in the first place. It will take only one-third of the House or Senate to sustain such a veto.

A Republican President *Might* Make a Difference

Then, maybe it will not. If the next president is Senator McCain (R-AZ), there is doubt whether President McCain will ask Congress to renew a policy of historically low tax rates on dividends and capital gains. In 2001, only he and the GOP's most liberal Senator, Lincoln Chafee (R-RI) , voted against Bush's first tax cut proposal. According to press reports, McCain said, "I cannot in good conscience support a tax cut in which so many of the benefits go to the most fortunate among us at the expense of middle-class Americans who need tax relief." This was during a time when budget officials projected record budget surpluses. In 2003, McCain also voted against the stimulus package that created the 15 percent dividend and long-term capital gains tax rates. Yet, last February, and again last week, McCain voted in favor of extending them. To paraphrase John Kerry, McCain has "actually voted against the tax cuts before he voted for them." Tax cut firebrand Grover Norquist put it this way recently, " He voted against tax cuts in 2001, 2003, 2004, and 2005, and this year he's for the tax cuts in the reconciliation bill. It looks like he did it for political reasons."

Given McCain's history, the probability of renewing the tax cuts in 2009 or 2010 are higher if McCain's likely nomination rivals, Senator George Allen (R-VA) or Governor Mitt Romney (R-MA) were commander-in-chief.

Then, there is the Senate again. In 2008, the GOP must defend 21 seats while Democrats defend only 12. Building on their gains this fall, a Democratic takeover of the Senate in 2008 is a realistic possibility even if the GOP retains the White House in 2008

Investors May Realize the Danger in 22 Months

Most presidential nominating contests end in February or March. For the next cycle, that means February or March 2008, just 21 or 22 months away. If McCain is the GOP nominee in February 2008, and he is the GOP frontrunner according to polls, then it is likely that *both* major party 2008 presidential nominees, Republican and Democrat, will be viewed as hostile to extensions. For investors, the danger in the mirror is closer than it appears.

Dow 8000?

Let us review the history of investor taxation and how it may affect stock market returns to gauge how important federal tax policy is to investors. The table below reflects the changes in tax policy over the years, per dollar of corporate income earned.

To show the combined tax rate on corporate income, we first subtract the "corporate tax"to arrive at after-tax corporate income. This is the amount that can be distributed to shareholders, and it is this lower amount which is subject to the "second tax" at the capital gains tax or dividend tax rate. Currently, shareholders keep 55.25 cents of every pre-tax corporate dollar. Shareholders in the top marginal income bracket in 1972 kept as little as 33.80 cents, and many investors kept only 38.88 cents in 1979. Since the shareholders' "take" has grown by 42 percent since 1979 – from 38.88 cents per pre-tax corporate dollar earned to 55.25 cents, it is

likely that stock market averages would be 42 percent lower now if the corporate income tax and capital gains tax rate reductions pushed through by Reagan and George W., and reluctantly agreed to by Clinton, hadn't happened. The Dow might be worth 8,000 now, not 11,400.

A similar analysis performed in 2004 by Jane Gravelle, a senior taxation specialist for the Library of Congress, finds that the combined federal tax rate on corporate investment fell from 60 percent in 1980 to 32 percent in 2003. Gravelle takes into account the impact of inflation, interest deductibility, and accelerated depreciation, in additional to statutory tax rates, in coming to her conclusion. Her figures imply that the share of pre-tax corporate income received by investors rose between 1980 and 2003 from 40 cents per pre-tax corporate income dollar to 68 cents per pre-tax corporate income dollar, a 70 percent increase in after tax rewards.

The March of Investor Returns Across Time

	1972	1979	1988	1997	2003
Pre-tax Corporate Income	$100.00	$100.00	$100.00	$100.00	$100.00
Top Corporate Rate	48.0%	46.0%	34.0%	35.0%	35.0%
After-tax Corporate Income	$52.00	$54.00	$66.00	$65.00	$65.00
Top Individual Rate -- Dividends	70.0%	70.0%	28.0%	39.6%	15.0%
Top Individual Rate -- Cap Gains	35.0%	28.0%	28.0%	20.0%	15.0%
After-tax Investor Income					
Per $100 of Dividends	$15.60	$16.20	$47.52	$39.26	$55.25
Per $100 of Capital Gains	$33.80	$38.88	$47.52	$52.00	$55.25

Without another extension, the investors' statutory take will fall from 55.25 percent to 52 percent, for income distributed as capital gains, and from 55.25 percent to 39.26 for income distributed as dividends. Can it get worse? It can, depending on who is elected in 2006 and 2008. Investors, enjoy the good times. They are unlikely to last.

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