Updated Friday, August 31, 2012 as of 10:14 PM ET

Practice - Regulatory/Compliance

Advisors Must Prepare for Eventful Lame-Duck Session on Taxes, Spending

The horserace politics of the run-up to the November presidential election may be the order of the day, but just around the corner in Washington lurk what promise to be contentious debates over fiscal issues of major significance for financial advisors and their clients.

And they come with hard deadlines.

Andy Friedman, a tax expert and old Washington hand who currently serves as principal at Washington Update, tried to read the tea leaves about the coming fights over taxes and spending for financial advisors on a conference call and online presentation Thursday.

At issue are the Bush-era tax cuts, which will expire at the end of the year without congressional action, and a $2.1 trillion set of spending cuts that will take effect if Congress cannot reach an agreement on a deficit reduction plan.

Should lawmakers fail to act on either measure, the Congressional Budget Office and others have warned that the nation would tumble back into recession, giving rise to the term "fiscal cliff." But given the acrimony that attends present-day debates over taxes and deficits, and amid the hyper-partisanship of the campaign trail, it seems all but a metaphysical impossibility that any deal will emerge ahead of Election Day. That means that the brief window of legislative working days that follows in November and December looms as "the mother of all lame duck sessions," Friedman said on the Webinar, hosted by Sammons Retirement Solutions.

"Congress is not going to pass any legislation this year before the election," Friedman said. "We should have just turned out the lights on Capitol Hill."

But a favorite maxim in Washington holds that Congress seems only to respond to a deadline -- they'll be facing a couple when they do return -- and it might not matter much how the election breaks.

The implications for investors and advisors are significant. As a starting point, the financial sector can brace for a short-term period of tumult, Friedman said. Markets normally churn on the uncertainty that precedes a close presidential election, but this year, with the fiscal cliff on the horizon, advisors shouldn't count on the period of calm that typically follows. Then add in ongoing fears that symptoms of the European banking crisis could creep into U.S. markets, and the next few months look to bring a bumpy ride.

"I think the markets are going to be exceedingly volatile for the rest of the year," Friedman said. "I think we're in for a very volatile year."

The worst-case scenario, that Congress would let the Bush tax cuts lapse for all Americans and the full set of spending cuts take effect, is unlikely, according to Friedman, at least as a sustained condition.

He does anticipate a standoff between the Obama White House -- regardless of whether the president is a lame duck or gearing up for his second term -- and House Republicans, the large majority of whom have signed onto Americans for Tax Reform President Grover Norquist's pledge to oppose tax increases in any form.

President Obama has called for the renewal of the Bush tax cuts for all but the wealthiest Americans, setting the cutoff at a household income of $250,000. With White House advisors having signaled that the president would veto an across-the-board extension, as GOP members are advocating, Friedman anticipates that a hard-fought compromise might emerge that excludes top earners, but that the threshold might rise to a figure like $1 million in adjusted gross income.

Absent such a compromise, or Obama acquiescing to GOP demands that all the Bush tax rates be extended, rates for all payers would increase, a prospect that economists of all political persuasions warn will sap that economy.

"Maybe it is that risk that actually forces Congress to forge a compromise during the lame-duck session, but it's not going to be easy," Friedman said.

However, he noted that even if the House GOP should carry the day and the Bush tax cuts are extended across the board, a 3.8% Medicare surcharge on investment income included in Obama's health-care reform law will mean that the wealthy can expect their tax position to change in any political scenario.

"Either way, taxes on affluent Americans are going up next year," Friedman said.

A possibility remains that GOP members could finesse their commitment to the Norquist pledge by permitting the Bush cuts to expire. Then, with higher rates the law of the land, they could come back to the table in January and work out a deal that would cut rates for all but the top earners, wherever that threshold would be set. The vote they would have to cast on such a bill would not, technically, amount to tax cut.

Further muddying the debate over ordinary income taxes are calls from the White House to increase tax rates on capital gains and dividend income for the wealthiest Americans. That position seems less likely to prevail, Friedman said, though if investment income is not decoupled from the broader tax debate, all rates will increase if legislation stalls.

Friedman counsels that advisors evaluate their clients' investment strategies in the context of the looming tax deadline. For instance, advisors planning to sell off securities or rebalance a portfolio might want to move "sooner rather than later," Friedman said.

"As you're redeploying those assets, think of tax efficiency," he added, suggesting that municipal bonds might become a more attractive investment while warning of the potential "negative effects on dividend-paying stocks."

He also argued that it is unlikely that the tax exemption on gifts will remain at the current $5 million level, presenting a narrow window for investors considering that path for large transfers of wealth.

Friedman, who gives Obama a slight edge over former Massachusetts Gov. Mitt Romney in a close race that figures to turn on the independent vote, expects the post-election deadlines on taxes and spending cuts to pressure spur Congress into action.

"I think one way or another we're not going to see the full brunt of the fiscal cliff," he said.

At the same time, advisors should begin mulling their clients' options in light of the anticipated market volatility and tax rates that, for high-net-worth investors, seem likely to be on their way up in one form or another.

"I think you have to expect that you're going to have higher taxes," Friedman said. "I think the prudent thing to do is to plan for higher taxes, at least for affluent clients."

(?) What Do You Think?

What do you think? Will the lame-duck session impact you and your clients?

DISCUSS