InvestmentNews
The Leading News Source for Financial Advisers

Investors and Obama's tax plan

The specifics are released in the Treasury Department's "Green Book", and it could get ugly

By Robert N. Gordon

May 31, 2009

The Department of the Treasury's recently re-leased "Green Book" describes in detail the revenue proposals contained in the president's budget for fiscal-year 2010.

Some proposals are simply the scheduled sunset of the Bush tax cuts. For example, the maximum 35% tax rate would revert to 39.6% in 2011 for married couples making $250,000 or more, and the 15% rate on capital gains would increase to 20% for taxpayers in the top two tax brackets.

Interestingly, the Obama administration shares a concern for the multiple layers of tax on corporate earnings/dividends. Dividends, rather than reverting back to being taxed at the maximum rate, would be taxed at a 20% rate like long-term gains.

Coming back in 2011 also would be the limitation on itemized deductions and the personal exemption phaseout. In addition, a new proposal on deductions could wreak havoc on the after-tax returns available from leveraged investments.

You see, the Obama administration believes it is inequitable for someone in a higher tax bracket to get more tax savings from a dollar of deduction than someone in a lower tax bracket. The purpose of the offending proposal is to allow only a 28% benefit for deductions that would be allowed after working through the various limitations. This would include interest expenses.

For example, if an investor in a margin account earned 10% on borrowed money, she would keep 6% after federal taxes. But if she paid interest at the same 10% rate and could deduct that cost after the investment expense limitation, the borrowings would cost 7.2% after tax; not exactly a break-even. Our investor would need to earn 120% of her borrowing costs just to break even after tax.

A few 2008 rulings (*InvestmentNews*, Aug. 4) make it clear that this headache affects hedge fund investors. Ruling 2008-12 states that interest expense incurred by a hedge fund should not be netted against other income when reporting to investors but instead should be broken out as a separate item on the K1 form. This appears to be the IRS' stance even if a hedge fund is classified as a "trader."

For those in New York state, the after-tax challenges will be even greater. Although some states have denied a deduction for interest, there has not been a single state that has denied deductions of any kind. But in its recently passed budget, New York did just that to all residents making “too much money.” It also increased the tax rate.

For those of you thinking this is preposterous, up until now, New York state denied half of all deductions to those lucky enough to “make too much.” A New York City-based investor would pay 39.6% federally plus about 12% to the city and state, keeping about 48 cents on the dollar.

If the interest deduction were worth only 28% and interest cost 72 cents on the dollar, an investment would need a return in excess of 150% of the borrowing cost to make sense.

In the estate tax area, the president's proposal would extend permanently the current maximum tax rate of 45% after a $3.5 million per-person exemption. The Green Book includes proposals that would limit the discount in valuing a family limited partnership for estate tax purposes.

Although the Obama proposals are not as onerous as legislation put forth by House Ways and Means Committee member Earl Pomeroy, D-N.D., the proposals certainly would curtail the formation of such entities.

Also, the attractiveness of grantor retained annuity trusts as a wealth transfer mechanism would be challenged by requiring a minimum 10-year life for a GRAT. A typical GRAT now has a two or three-year term. If the grantor's death occurs before the GRAT's term has run, the assets are still in the grantor's estate, and the GRAT will not have accomplished its goal. It is also believed that longer time frames smooth returns and thus limit possible outsize benefits in estate tax savings.

Please remember that these proposals are not final but do need to be followed so that investors can be best-situated when change does occur.

Robert N. Gordon is chief executive of Twenty-First Securities Corp. of New York and an adjunct professor at New York University's Leonard N. Stern School of Business. He can be reached at bob@twenty-first.com.