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Pity the poor folks making $1M plus

They already pay most of the taxes, and it’s going to get worse if the feds enact health “surtax”

By Robert N. Gordon

September 6, 2009

High-income earners are in the government's cross hairs — at both the federal and state levels — and there is little sympathy for those so targeted.

In high-tax states like New York, the situation is particularly bad, especially for those earning $1 million or more a year. These taxpayers are going to pay more taxes than ever on “phantom” income. Let me explain what that means.

New York state denies all deductions for those lucky enough to earn real net income in excess of $1 million. (If you're lucky enough to earn more than $500,000 but less than $1 million, New York denies only half your deductions.)

Once you hit the magic $1 million mark in the Empire State, there are no deductions allowed in determining how much income is to be taxed by Albany — not even a mortgage interest deduction.

A New York taxpayer with $1 million in gross income and $200,000 in deductions, therefore, will pay taxes on $1 million in the state while paying federal taxes on $800,000. The $200,000 difference is what we are defining as “phantom income.”

New York is not alone, of course, in its discriminatory tax structure. On the federal level, there already are stealth taxes on the wealthy in the form of the alternative minimum tax and limitations on miscellaneous itemized deductions.

In the latter case, for example, investment management fees are categorized as a miscellaneous deduction and thus are usually not deductible for high-income taxpayers.

Currently, the administration's health care proposals are scheduled to be paid for by a surtax on the rich.

This surtax will top out at 5.4% on amounts above $1 million of *modified*-adjusted-gross income.

Traditionally, we have been taxed on adjusted-gross income. The new modified-adjusted-gross income standard allows “above the line” deductions, but not what are commonly referred to as “itemized” deductions.

The principal itemized deductions are those for mortgage interest on a personal residence, investment interest expenses, state taxes, charitable contributions, non-business casualty and theft losses, investment expenses, medical and dental expenses and certain employee expenses.

For many taxpayers, modified-adjusted-gross income will be much greater than adjusted-gross income. According to the IRS Statistics of Income for 2006, those who earned $1 million or more had taxable income equal to 89% of their gross income before exemptions and deductions.

This means that those earners would be paying a 5.4% surtax on the 11% of gross income that normally would go untaxed. Also note that state taxes (which are not deductible in arriving at modified-adjusted-gross income) are increasing at the same time, further exacerbating the problem.

The surtax would also increase the tax on long-term gains and qualifying dividend income for those in the highest earning category.

According to the same 2006 IRS statistics, people with adjusted- gross income in excess of $1 million captured 43% of their income as long-term gains or qualifying dividends.

This income is taxed at a maximum of 15% this year and probably at 20% next year, as long as you don't add the surtax. But this preferentially taxed income would be included in modified-adjusted-gross income, making it subject to the 5.4% surtax — and increasing the expected rate of tax from 20% to 25.4%.

That's a big difference from today's 15% tax rate.

If the surtax becomes law, these projections should be incorporated in any tax planning for the future. Remember, almost half of the income earned by these high-income earners is in this preferential bucket.

Because these taxes are far from obvious and are going to be levied on a class of citizens no one feels sorry for, the proposals are not garnering a lot of attention. New York already has done its damage and you haven't heard much about it.

Those of us serving the ultra-high-net-worth market must monitor the situation in Washington closely and be prepared to eventually face the inevitable: the “rich” are going to pay more.

The higher stated-maximum-tax rate (39.6% vs. 35%) is only the tip of the iceberg.

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