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Taxes on dividends may nearly triple

Investment income will take a huge hit to help pay for health care reform

By Robert N. Gordon

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Under current law, the Medicare payroll tax applies only to wages. Beginning in 2013, however, a new 3.8% Medi-care tax will be imposed on high-income earners and will be applied to investment income.

The current 35% tax on investment income, because of the expiration of the Bush tax cuts, will rise to 39.6% in 2011 (a 13% year-over-year increase). In 2013, an additional increase of 3.8% as a result of the health bill will increase the top rate on investment income to 43.4% (a further 9.5% increase).

In just a few years, therefore, the top rate will go to 43.4%, from 35%.

The change is significant for high-income investors.

As an example, if an investor were to earn 8% annually over 20 years on a $1 million investment, he or she would wind up with $144,000 less after paying the new surcharge. If the Bush tax cuts were continued and the 35% tax rate stayed as the maximum rate, our investor would have kept $331,000 more over the same time period.

This 3.8% tax will be levied on income from long-term gains too, translating into an increase in the long-term capital gains tax rate of more than 50% between now and 2013. Now at 15%, the rate will go to 20% in 2011 and to 23.8% in 2013, reflecting the 3.8% surcharge — a 58.6% increase in the long-term gains rate in just three years.

The worst hit will be on qualifying dividend income. Under the best-case scenario, the tax on dividends will increase by more than 50%.

Until President George W. Bush changed the law, dividends were taxed like other investment income even though the company's earnings had already been taxed at the corporate level. Further taxation of the dividend is forgiven in most countries.

The Bush administration wasn't generous enough to waive all taxation of dividends, but it did reclassify dividends as income to be taxed at long-term gains rates instead of investment income tax rates. If the Bush tax cuts expire this year without a new tax bill being passed, we will revert to pre-Bush tax rates and classifications.

President Obama's proposed budget includes a continuing break for dividends that would keep qualifying dividends on par with long-term gains. But without a new tax bill, dividends revert to being taxed at the highest rate.

Under the best-case scenario, dividend taxes will increase by more than 50% by 2013 to 23.8%, from 15% this year; under the worst-case scenario, dividend taxation will almost triple to 43.4% in 2013, from 15% this year.

It is noteworthy that the definition of “investment income” won't include municipal bond income, income from life insurance, income from a trade or business, or distributions from individual retirement accounts or other qualified plans. The new 43.4% tax on investment income makes deferral strategies that much more important.

Robert Keebler of the accounting firm Baker Tilly Virchow Krause concludes that insurance products, because of their tax-deferred growth and death benefits, should get a big leg up because of this change.

Separately, there is still an active effort under way to stretch out grantor-retained annuity trusts to a minimum of 10 years and thus make them less attractive. As I noted in my Oct. 5 column, if you are ever going to do a GRAT, do it now.

Also, a fix to the estate tax that I discussed in a Feb. 8 column is still not imminent. The feeling is that a fix may not be coming at all this year, or that if one is made, it will come so late in the year that it might not be made retroactive.

We are hearing that if a fix is made retroactive, the government will give estate trustees a choice about whether they opt for retroactivity for those who passed away this year.
With gift taxes at 35% and no generation-skipping tax in place this year, a rush of taxable gift giving is expected once the estate tax scenario is made clearer.

Stay tuned.

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