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Top marginal tax rates may skyrocket

'Millionaires' are now expected to shoulder much of the burden of balancing the budget

By Robert N. Gordon

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The latest news from Washington isn't good. The political winds have shifted and "millionaires" now are expected to shoulder much of the burden of balancing the budget. The recently proposed 5.6% surtax on those with the highest income, added to the other scheduled changes in tax rates, would make for a substantial increase in the top marginal rate. For those with long-term gains, the tax rate could almost double from today's 15% rate.

Some tax increases are small but meaningful.

Starting in January 2013, the 3.8% Medicare tax will apply to investment income. Until then, that tax will be levied only on salary income.

As a result — even with no other rate changes — the tax on short-term gains will increase by 10.8% and the tax on long-term gains by 25%.

If the Bush tax cuts are allowed to expire, the tax on short-term gains will revert to 39.6% in 2013.

When you add the Medicare tax, the top short-term-gain rate becomes 43.4%. If the "millionaires'" tax of 5.6% is enacted, the top federal tax rate will be as high as 49% — 40% higher than the current 35% rate.

The effect of expiration of the Bush tax cuts on long-term gains would be even more dramatic. If the cuts expire, the tax on long-term gains will revert to 20% in 2013.

Add in the Medicare tax, and the maximum long-term-gain rate becomes 23.8%. Add the 5.6% millionaires' tax, and the top long-term gain rate reaches 29.4%, almost double the current 15% rate.

On the other side of the ledger, there is a proposal to limit the value of deductions to the equivalent of 28 cents on the dollar. The interactions of these changes would render leveraged investing much less attractive than under today's tax law.

Currently, if an investor uses a margin account and breaks even, pretax, he or she also breaks even after taxes, because profits and expenses are taxed at the same rates.

As a gap develops between the tax rate on profits and the tax rate on interest deductions, after-tax returns drop. In fact, a pretax return can turn into an after-tax loss.

Currently, for example, a client who incurs $100 of interest cost to produce $100 of short-term gain breaks even on both a pre- and post-tax basis.

Under the president's proposal to limit the value of deductions to 28%, the same investor would lose $7. The investor would lose $10.80 once the 3.8% Medicare tax kicked in, and $21 if the Bush tax cuts expired and the millionaires' tax were enacted.

If the same investor created $110 of short-term gains and spent $100 on interest, he or she would be making $10 pretax but wind up losing money after taxes under every possible future scenario.

Another way to look at the effect of new tax rates is to consider the rate of return an investor would need in order to equal his or her after-tax borrowing costs. Today, if an investor is able to capture a return equal to borrowing costs, he or she will break even in terms of federal levies, although state taxes can add another level of complexity.

Once the Medicare tax kicks in, and if the Bush tax cuts are allowed to expire, investors would need to make $127 in profits for every $1 in interest costs just to break even after taxes. If the highest marginal tax rate rises to 49% and interest is limited like other deductions, investors must earn 141% of their borrowing costs to break even after taxes.

That is quite a steep hurdle.

Although no one knows what will happen in Washington as it relates to taxes, one thing seems certain: Taxes on the wealthy are going up. As a result, financial advisers should start thinking through how tax increases will affect clients and their investing behavior.

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