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# What lurks in the president's budget

## Most disappointing provision would triple the top rate on dividends to more than 43%

By Robert N. Gordon

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With the big exception of dividends, President Barack Obama's 2013 budget looks very much like his 2012 budget. In fact, many of the tax changes affecting individuals that were proposed in the 2012 budget and not enacted show up again in the 2013 budget.

For investors, there are several points to note in the proposal.

It calls for the Bush tax cuts to expire, meaning the top tax rate would increase to 39.6%, from 35%. Then there is the 3.8% Medicare tax on investment income, making 2013's top federal tax rate 43.4%.

With the tax rate on long-term capital gains reverting to 20%, the addition of the Medicare tax makes the total tab 23.8% — more than a 50% increase. The estate tax would revert from the 35% rate with $5.12 million exclusion to the 55% rate in 2001, but with a $1 million exclusion.

Other proposals in the budget include a lengthening of the minimum term of grantor-retained annuity trusts to 10 years, from two years, and a proposal addressing valuation discounts on estates. A new proposal would affect the use of intentionally defective grantor trusts.

The biggest change would come in the area of dividends. The president's previous budgets all proposed letting the Bush tax cuts fade away, but made an exception so that the "preferential" rate applied to qualifying dividends would continue.

That isn't the case this time, and it is very disappointing.

The administration's 2013 budget calls for a near tripling of the top tax rate on dividends, sending it to 43.4%, from 15% under current law.

We no longer see encouraging signs that the president understands the inequity of taxing dividends.

Our tax system is especially harsh in its treatment of corporate profits.

First, profits are taxed at the corporate level at 35%. Then, when the 65 cents that is left over is paid out to shareholders, it is taxed again.

Most countries make adjustments for this double taxation. In these integrated tax systems, corporate profits are taxed only once.

In Australia, “franked” dividends (that is, those that are paid from already taxed earnings) are received tax-free by individual taxpayers. France and the United Kingdom give credit to shareholders for the taxes that the companies pay on the owners' behalf.

The total integrated tax rate on dividends in the United States would become 63.21%, up from 44.75%. A recent Ernst & Young report found that of 38 developed and BRIC (Brazil, Russia, India and China) countries, none has a combined tax as high as 63.21%. The average combined tax on dividends for the G-7 countries (excluding the United States) is 48%; for the developed countries, it is just 45%.

Another idea repeated in the new budget is the concept that deductions should be worth the same amount to a “rich” taxpayer as to an “average” taxpayer, who is presumed to be in the 28% tax bracket.

The proposal therefore limits the value of $1 in deductions to 28 cents. That compares with the 43.4 cents that would have been saved by rich taxpayers in the new top tax bracket.

Limiting deductions would dramatically lower after-tax returns on leveraged investments. If the money coming in the door is taxed at a much higher rate than the deduction allowed for the money going out the door, havoc ensues.

Under tax rules, an investor taking in $100 of interest on a leveraged investment while paying $100 in interest expense would break even on both a pretax and after-tax basis.

If interest income is taxed at 38.8% and interest expense is deductible only at 28%, the pretax break-even turns into a $10.80 after-tax loss. In other words, returns on a leveraged investment must exceed 117% of the interest cost before a taxpayer starts making money post-tax.

If the Bush tax cuts expire as well, the gap would widen to 43.4%, from 28%. Under this scenario, a leveraged asset would need to return more than 127% of the interest cost to break even after being taxed.

Sticking my political finger into the wind, my best bet is that deductions will be limited in 2013. No matter who wins the White House this year, limiting deductions will be more politically palatable that an outright increase in tax rates.

Since limiting the value of deductions to 28 cents on the dollar “counts” as raising more than $500 billion over the next 10 years, without any increase in tax rates, that seems likely. And it is fully one-third of the total of $1.4 trillion that the president is asking for from those making more than $250,000 a year.

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