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For wealthy, a hard fall off the cliff

The president and Congress are looking at further tax increases to help balance the budget

By Robert N. Gordon

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For those who make more than $450,000 a year, New Year's Eve brought no good news. These high-income individuals were hit with almost all the tax increases associated with the fiscal cliff. The top rate on investment income increased 24% to a top rate of 43.4%, from 35%, after including the Medicare tax.

In addition, a portion of these taxpayers' itemized deductions will be disallowed through the reinstatement of the Pease limitations. More on that later.

The maximum tax rate on long-term capital gains increased 58.69%. The maximum rate under the Bush-era tax cuts was 15%; it is now 23.8%.

The only good news is that dividends will continue to be taxed as if they were long-term gains, not ordinary income.

The tough work of cutting spending has been put off for a few months.

When the budget process is restarted, we expect that President Barack Obama and Congress will be looking for new sources of revenue, including revisiting money-raising proposals included by the president in each of his previous budgets.

The proposal that would affect investors most aims to limit the value of deductions. The president observes that a $100 charitable contribution saves the richest $39.60 in taxes. If a low-income taxpayer made the same $100 contribution, he or she might be saving only $28 or even less.

The president's four budgets have proposed limiting deductions to a maximum of 28 cents on the dollar.

Since 2001, the Congressional Budget Office has looked at a maximum of 15 cents on the dollar. The Republicans suggested a hard cap that would render deductions above the cap valueless.

These proposals would affect leveraged investments the most, as expenses would be deducted at a lower rate than profits would be taxed.

We also expect a change in the taxation of carried-profits interest and a lengthening of the minimum term for grantor-retained annuity trusts.

We suggest that families interested in wealth transfer look at GRATs now while a GRAT with as little as a two-year life is deemed acceptable. We also point out that the Section 7520 rate is at a historic low — 1% — making now an even more attractive time to fund a GRAT.

There has been much noise over whether the “new” tax regime will retard taxpayers' charitable largesse. Our analysis concludes that for those in high-tax states, the after-tax cost of a charitable donation hasn't gone up and actually may have decreased.

The American Taxpayer Relief Act of 2012 reinstated the Pease limitation on deductions. Under the restrictions, allowed deductions have to exceed 3% of a taxpayer's adjusted gross income (minus $300,000). Once deductions exceed this 3%, the further deductions aren't limited in any way.

These were in place from 1990-2005, and charitable giving wasn't affected. No other limits were placed on deductions in this recent tax legislation, though the concept of limiting deductions had been embraced roundly by both parties during the presidential campaign.

Taxpayers who live in low-tax states and claim few deductions, besides their charitable giving, could see their after-tax cost of giving rise dramatically. But this is no different than it was for those taxpayers from 1990-2005.

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