Parametric Tax Update

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President Obama has called for shifting the tax burden towards people earning more than $200,000 a year. The budget plan put forward on February 1st calls for a rise of $1 trillion in taxes collected from people at those income levels over the next ten years.

The tax code has become a collection of expiring provisions; each with a complex array of competing political interests attached. Advisors and investors will need to stay abreast of these changes as they evolve over the next year.

The bulk of these changes do not require any legislative action as the Bush tax cuts are set to expire at the end of this year:

- Top income tax brackets will revert from 33 and 35 percent to 36 and 39.6 percent.
- Long-term capital gains and dividends will be taxed at 20 percent, instead of the current 15 percent.

The administration also assumes several additional measures in its budget (although these require cooperation from Congress, which is by no means assured):

- The 2001 and 2003 tax cuts would be extended for lower-and middle-income taxpayers.
- The estate tax would be frozen at 2009 levels – that is, an exemption of $3.5 million ($7 million for married couples) and a top rate of up to 45 percent.
- The AMT exemptions adopted for 2009 would be extended and indexed for inflation going forward.
- The value of deductions would be limited (including mortgage and charitable deductions) to 28 percent instead of the current 39.6 percent.
- Funds managers using a partnership structure would see their general partnership profits taxed at ordinary income rates, rather than the lower capital gain tax rate.
- The use of family trusts to lower estate-tax liabilities would be limited.

In anticipation of higher tax rates, many taxpayers will want to consider accelerating deferred compensation, realizing capital gains on investments that are highly appreciated, and structuring their portfolio to be more tax-efficient.

The key areas of the tax code that allow for tax management in a portfolio remain the same: holding an investment for longer than a year qualifies it for a favorable tax rate, realized losses can be used to offset realized gains, and excess realized losses can be carried forward to future tax returns. In all the provisions being contemplated right now a Tax-Managed Core portfolio will be a valuable tool for investors.

References:

"Tax Cuts to Expire for Top Earners," by Martin Vaughan, Wall Street Journal, February 2, 2010.
"Tax News & Views (Special Edition) 14 of 18," Deloitte Touche Tohmatsu. Vol. 11, No. 6, 2010.

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