



BROWN ADVISORY

# Strategic Advisory Letter

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## Holding Gain: Considering Imminent Shifts in Tax Policy

While many details remain uncertain, it is clear that federal tax policy is about to endure a major shift that will have the greatest impact on high-income taxpayers.

Early in his presidency, George W. Bush pushed for a series of tax reductions, including across-the-board rate reductions, that were granted by Congress. These rate reductions, coupled with the gradual reduction of phaseouts for personal exemptions and itemized deductions, resulted in meaningful tax savings for all individuals, especially for those individuals in higher tax brackets. However, these changes in the tax laws were designed to sunset at the end of 2010, with the rates and rules reverting to the laws in effect before 2001. As a result of this sunset provision and lack of

Congressional action in the last half of this year, all taxpayers face an increase in tax rates.

It appears untenable that Congress and the Obama Administration would allow the existing law to simply sunset, resulting in the severe impact of higher rates. If that were to happen, all wage earners would immediately experience a reduction in take-home pay as higher federal withholdings come into effect. Investors would also experience significant increases in taxes on their investments with the tax on long-term capital gains rising from 15% to 20% and the rate on dividends increasing from 15% to an investor's top marginal income tax bracket (up to 39.6%).

Currently, Congress is considering several proposals that would mitigate this impact. Most notably, the Obama Administration has proposed holding the Bush rate cuts intact with the exception of the tax rates for couples earning more than \$250,000 per year and individuals earning more than \$200,000 (See figure 1).

figure 1. Bush Tax Cuts, Sunsets and Administration Proposals

	Rate Through 2010	Rate After 2010	Administration Budget Proposal for 2011
<b>Dividends</b>	15%	Up to 39.6%	20%
<b>Long-term Capital Gains</b>	15%	20%	20%
<b>Individual Income Tax Rates</b>	10%	—	10%
	15%	15%	15%
	25%	28%	25%
	28%	31%	28%
	33%	36%	36%
	35%	39.6%	39.6%
<b>Estate Taxes</b>	Top rate fell from rate of 45% to 0% in 2010	55%	45%
<b>Gift Taxes</b>	Top rate fell from rate of 45% to 35% in 2010	55% Above \$1m	45% Above \$3.5m
<b>Carried Interest</b>	15%	20%	Up to 39.6%



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This same group of taxpayers would also experience the biggest impact from reinstated deduction phaseouts and possible further limits on itemized deductions.

At this point, there seems to be a consensus forming that will generally follow the Administration’s proposal with two major exceptions:

- The Administration initially proposed to limit the increase in the tax rate on dividends to 20% (the rate is currently 15%). However, many in Congress favor increasing the rate to as high as 39.6% – a rate that may have significant consequences for individual investors.
- The Administration has proposed taxing carried interest (investment earnings paid to hedge, private equity and real estate fund managers) as ordinary income – a significant departure from the current law, which taxes this income as long-term capital gains (15%). Current Capitol Hill debate suggests a

proportion of carried interest (at least 50%) would be taxed as ordinary income with the remaining balance taxed at the rate of long-term capital gains.

The estate tax laws are also the subject of much discussion. Absent Congressional action, the rate on estates greater than \$1 million will be 55% in 2011. It seems likely – but not certain – that the Administration’s proposal of a 45% estate tax rate on estates over \$3.5 million will be adopted. However, there could be changes to lifetime estate planning tools that would limit the effectiveness of traditional strategies such as Grantor Retained Annuity Trusts (GRATs) and transferring interests in family entities at a discounted value.

Taxpayers could also face additional taxes beginning in 2013 as a result of the health care legislation enacted earlier this year (See figure 2). That law provides for an increase in the Medicare tax from 1.45% to 2.35% on earned income over \$250,000 for couples and \$200,000 for individuals.

figure 2. Adding Together the New Rates, Plus State Taxes, Expected for 2010-2013

	2010	2011-2012	2013
<b>Regular Income</b>			
U.S. Federal	35.0%	39.6%	39.6%
Assumed State and Local Income Taxes	8.5%	8.5%	8.5%
Medicare Tax on Earned Income > \$250,000	1.5%	1.5%	2.4%
<b>Total</b>	<b>45.0%</b>	<b>49.6%</b>	<b>50.5%</b>
<b>Investment Income Currently Taxed at Lower Rates</b>			
Long-Term Capital Gains	15.0%	20.0%	20.0%
Assumed State and Local Income Taxes	8.5%	8.5%	8.5%
Health Care Surtax on Investment Income	—	—	3.8%
<b>Total Capital Gains Tax Rate</b>	<b>23.5%</b>	<b>28.5%</b>	<b>32.3%</b>
<b>Dividends</b>			
Dividends	15.0%	39.6%	39.6%
Assumed State and Local Income Taxes	8.5%	8.5%	8.5%
Health Care Surtax on Investment Income	—	—	3.8%
<b>Total Dividend Tax Rate</b>	<b>23.5%</b>	<b>48.1%</b>	<b>51.9%</b>
<b>Hidden Tax Increases (Incomes &gt; \$250,000)</b>			
Personal Exemption Phaseout (\$3,650)	None	Yes	Yes
Itemized Deduction Phaseout (real estate taxes, charitable contributions, etc.)	None	Yes	Yes



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In addition, there will be a new health care surtax of 3.8% on the lesser of:

- (i) net investment income (which includes capital gains); or
- (ii) the excess of modified adjusted income over the \$250,000/\$200,000 thresholds.

By historical measures, the proposed top tax rates both for dividend income and long-term capital gains are below the average top rates over the past 40 years. Nevertheless, these changes will result in significant tax increases for those with both high earned income and high investment income. By our estimation, in the "worst-case" scenario, the top rate for earned income and dividends will be 39.6%.

If the Administration's proposal to limit the value of itemized deductions to the 28% tax rate becomes effective, high-earning taxpayers will see their federal taxes increase by as much as 25% in 2011 compared to 2010, and the increase between 2010 and 2013 (when the additional health care taxes become effective) will be just under 30%. The situation is worse for those with high levels of investment income who have become accustomed to essentially a 15% tax rate, a typical scenario for wealthy retirees. For those investors, tax liabilities easily could rise approximately 35% in 2011 and could increase by almost 50% in 2013 compared to 2010 liabilities (See figure 3).

figure 3. "Worst-case" Taxpayer Scenarios

Sample Client A				
Family of 4 Earning \$500,000				
Wage Income	\$500,000	Itemized Deductions	\$75,000	
Investment Income	\$25,000 in Dividends \$50,000 in L-T Cap Gains	Personal Exemptions	4	
			<b>Federal Tax Liability</b>	
			<b>Increase from 2010</b>	
	<b>2010</b>	\$132,502	N/A	N/A
	<b>2011</b>	\$164,972	\$32,470	25%
	<b>2013</b>	\$170,072	\$37,570	28%
Sample Client B				
Family of 4 Earning \$2,000,000				
Wage Income	\$2,000,000	Itemized Deductions	\$300,000	
Investment Income	\$100,000 in Dividends \$200,000 in L-T Cap Gains	Personal Exemptions	4	
			<b>Federal Tax Liability</b>	
			<b>Increase from 2010</b>	
	<b>2010</b>	\$634,252	N/A	N/A
	<b>2011</b>	\$791,912	\$157,660	25%
	<b>2013</b>	\$819,062	\$184,810	29%
Sample Client C				
Retiree Couple with Significant Investment Income				
Non-Compensation Income (e.g. a required distribution from an IRA)	\$120,000	Itemized Deductions	\$75,000	
Investment Income	\$150,000 in Dividends \$150,000 in L-T Cap Gains	Personal Deductions	2	
			<b>Federal Tax Liability</b>	
			<b>Increase from 2010</b>	
	<b>2010</b>	\$49,820	N/A	N/A
	<b>2011</b>	\$66,754	\$16,934	34%
	<b>2013</b>	\$75,214	\$23,394	47%



## Planning Considerations:

Although the anticipated changes to tax laws will affect every client differently, here are some options that you and your financial advisor might consider:

- *Accelerate gains:* By selling stocks sooner rather than later, you can realize your capital gains with lower taxes. However, it is not wise to pay any taxes early with an immediate sale if you plan to hold investments for the longer term (4+ years).
- *Add to tax-exempt investments, such as municipal bonds in taxable accounts:* The higher tax rates do not apply to tax-exempt investments such as municipal bonds. This is not a call to invest all portfolio assets in tax-exempt investments, but such an investment rather should be considered as part of a broader investment approach that includes other growth-oriented asset classes that help maintain the purchasing power of the portfolio over the long term.
- *Review location of ordinary income investments:* Investments that produce ordinary income such as taxable interest, rents, etc. (with a high probability of including dividend income in this category beginning in 2011) should be reviewed for optimal location. IRAs or other deferral vehicles will allow an investor to capture the total return.
- *Convert to a Roth IRA:* Beginning in 2010, Roth IRA conversions became available to all individuals, with no income limitation. Roth IRAs have no mandatory distributions for IRA owners or their spouses and all withdrawals are tax free provided they do not occur within five years of conversion. Assets inside and/or distributed from a retirement account will not be subject to the 3.8% health care tax on investment income.
- *Accelerate receipt of taxable income:* Receiving as much taxable income as possible before 2011 may be a good way to avoid higher marginal tax rates for high net worth individuals. For example, executives may want to exercise non-qualified stock options, and business owners who have been contemplating a sale of business assets should move forward.
- *Review impact of deferring deductions:* Typically, deferring a deduction to a year when it would offset income subject to higher tax rates is prudent. However, deferring deductions should be thoughtfully considered (with the help of your accountant) given the proposed limits on deductions that may become law in 2011.
- *Act before limits are imposed on estate planning strategies:* Those with capacity to transfer wealth to future generations should review strategies currently available with their advisors. For example, Administration proposals detail a minimum term for Grantor Retained Annuity Trusts, but those put in place before a change would be treated under current law, which results in a higher likelihood of wealth-transfer success.

We recommend that you consult your tax and investment advisors to determine what, if any, changes should be made to your investment strategy. We encourage you to speak with your team at Brown Advisory to better tailor your portfolio to your particular circumstances.

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