Retirees Beware: Don't Worry About the British-- 2013 is Coming

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Retirees Beware: Don’t Worry About the British — 2013 Is Coming

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In this article, the authors propose a compromise for dividends and capital gains taxation. Instead of taxing dividends as ordinary income and most long-term capital gains at a flat 20 percent rate, their compromise would apply a progressive tax rate schedule to both. They would aggregate all net capital gains and qualified dividends into a single figure.

2013 Taxation of Dividends, Net Capital Gains

Retirees beware.1 The easy money policy of the Federal Open Market Committee2 and the 15 percent tax rate on qualified dividends3 have encour-

aged retirees, especially middle-income retired savers, to reorient their nest eggs away from certificates of deposit, treasuries, and money market funds to dividend-paying stocks and mutual funds.4 According to the IRS, 43 percent of taxpayers age 65 or older reported qualified dividend income amounting to nearly half of the qualified dividend income reported by all taxpayers.5 By contrast, 46 percent of taxpayers age 65 or older reported net capital gains amounting to 30.5 percent of the net capital gains reported by all taxpayers.6

But 2013 is coming, and unless Congress extends the current rates or reaches an agreement on tax reform,7 dividends will be taxed as ordinary income at a marginal rate as high as 39.6 percent and most
days in the 121-day period beginning 60 days before the stock became ex-dividend for that dividend. Some dividends are disqualified from the capital gains tax rate and so are taxed at ordinary income rates. For example, dividends from tax-exempt corporations and mutual savings banks are disqualified.

As John Snow, Treasury secretary from 2003 to 2006, points out: “Corporations responded to the lower rates on dividends by paying out more of their profits, which raises the returns to those holding stock and thus increases equity prices. Both trends strengthen Americans’ retirement savings.” He also noted that higher tax rates on dividends and capital gains is “just what we should choose” if “one intended to . . . lower the value of retirement savings for working Americans.” John Snow, “Taxmageddon Is a Real Threat,” The Wall Street Journal, May 14, 2012, available at http://online.wsj.com/article/SB1000142405270230477904577382371561326132.html?mod=hp_opinion.

3Qualified dividends are currently taxed at capital gain rates. See section 1(h)(11). In general, a dividend is qualified if made by either a domestic corporation or a foreign corporation that either is incorporated in a possession of the United States or is eligible for benefits under an income tax treaty with the United States. Moreover, for a dividend to be qualified, the stock on which the dividend was paid must have been held for at least 60 days prior to the ex-dividend date.

Footnote continued in next column.

1According to Wikipedia: “Starting in 2011, about 10,000 baby boomers turn 65 years old every day. About 60 percent of them are expected to retire — that is, about 6,000 per day.” See Wikipedia, “How Many People Retire Every Day?” available at http://wiki.answers.com/Q/How_many_people_retire_each_day.

2The Federal Open Market Committee’s latest press release states: “The Committee decided today to keep the target range for the federal funds rate at 0 to 1⁄4 percent and currently anticipates that economic conditions . . . are likely to warrant exceptionally low level for the federal funds rate at least through late 2014.” Press release, Federal Reserve (June 20, 2012), available at http://www.federalreserve.gov/newsevents/press/monetary/20120620a.htm.


net capital gains will be taxed at 20 percent.

For those whose modified adjusted gross income exceeds a specified amount (for example, $250,000 for a married couple filing jointly and $200,000 for an unmarried individual), a 3.8 percent Medicare tax will be added to the taxation of their net capital gain, dividend income, interest, and other investment income, bringing the highest marginal rate to 43.4 percent.

And then there’s the Obama administration’s proposed budget for 2013, supporting the scheduled post-2012 tax rates — that is, taxing dividends as ordinary income and capital gains at 20 percent.

On March 28 the House defeated a bill that incorporated much of the administration’s budget by a vote of 414 to 0, and on May 16 the Senate defeated a similar bill by a vote of 99 to 0.

And then there’s the Simpson-Bowles commission. Although Congress never brought the commission’s recommendations to a vote, the commission recommended that long-term capital gains and qualified dividends be taxed as ordinary income.

And then there’s the “Buffett rule.” Warren Buffett’s New York Times op-ed, “Stop Coddling the Super-Rich,” set in motion a national debate about whether there should be a minimum effective tax rate for individuals with very high incomes (often referred to as “millionaires and billionaires”). The statements of the Buffett rule do not indicate exactly how it would operate, but the tenor of the proposal is that the effective tax rate of an individual earning more than a specific amount of income (generally thought to be $1 million) should be 30 percent. The only attempt to date to enact the Buffett rule is the Paying a Fair Share Act of 2012, a bill that was introduced in the Senate but defeated on April 16 by a vote of 51 to 45. Because the Buffett rule has sometimes been misunderstood, we end this article with an addendum on that rule.

Although the Senate bill implementing the Buffett rule and the administration’s 2013 budget proposal were defeated when they came to a vote, and the Simpson-Bowles recommendation never came to a congressional vote, the favorable tax treatment for qualified dividends and net capital gains is clearly under assault. If Congress takes no action,
the current preferential rates for qualified dividends and net capital gains will expire after December 31 of this year.

**A Compromise Proposal**

In this article, we propose a compromise for dividends and capital gains. Instead of taxing dividends as ordinary income and taxing most net capital gains at a flat 20 percent rate, our compromise would apply a graduated tax rate schedule to both. We would aggregate all qualified dividends and net capital gains into a single figure, which for convenience we refer to as aggregated dividends and net capital gains (ADCG). Our proposal would not add a surtax to the code. Rather, it would provide a maximum tax rate applicable to that amount of a taxpayer’s ADCG that otherwise would be taxed under the regular tax schedule at a higher rate. While our proposal of graduated rates is a change from prior treatment, it is not that great a departure since the current system also employs different rates to qualified dividends and net capital gains.

We don’t propose any specific progressive rate schedule for ADCG. We set forth a sample schedule to illustrate the effect of a graduated rate system. Congress can choose an appropriate schedule after examining the revenue impact of various schedules. For example, out of a concern for the effect on capital investment, Congress might choose to adopt a lower maximum rate on net capital gains than the 30 percent rate in our sample.

Our sample schedule takes the following form: 15 percent on the first $250,000 of ADCG, 20 percent on the next $250,000, 25 percent on the next $500,000, and 30 percent on ADCG exceeding $1 million. The bracket ranges would be indexed for inflation. Under this sample schedule, the superrich — including Buffett, Mitt Romney, and especially the wealthy who did not earn their fortunes (such as trust-fund babies who live in Palm Beach and elsewhere) — would end up paying 30 percent on their ADCG that exceeds $1 million. Also, the wealthy who earn much of their income from wages would continue to be taxed at the prevailing rates on ordinary income. Any perceived abuses in the treatment of their income or deductions may already be addressed by the alternative minimum tax. If not, it can and should be addressed separately to determine if it is truly an abuse.

The proposed compromise would provide a higher tax rate on the ADCG of the very wealthy while applying a 15 percent rate for those whose ADCG is more modest. The proposal constitutes a compromise in that it provides a higher tax on the very rich than otherwise would apply, but also provides needed tax relief to those trying to support themselves in their senior years from the earnings on their savings. It seems to us that this simple compromise would satisfy those who want the superrich to pay higher taxes and also satisfy a quite different constituency: retirees who worked for a living, saved as much of their after-tax dollars as they could, and invested their nest eggs in dividend-paying stocks or mutual funds.

Although our proposal would apply to all investors, we focus on the impact it would have on what we call middle-income retired savers, because they, like all retirees, are at the point in life when they no longer live on earnings from their human capital. They are also experiencing an increase in longevity and are often in fear of outliving their assets and becoming a financial burden on their families. They are also aware that the costs of nursing home care can exhaust their assets quickly and force them onto Medicaid.

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17Our proposal would be quite easy for the IRS to implement, because qualified dividends and net long-term capital gains are already reported separately: Form 1040 line 9b for qualified dividends and Schedule D line 15 for net long-term capital gains.

18In the interest of simplification, we would eliminate the 2 percentage point reduction for property held for more than five years, and we would eliminate the 28 percent and 25 percent rates for some specified properties. We would also eliminate the lower rate for low-income taxpayers, but that could be retained if Congress preferred.

Many retirees live partly and maybe substantially on their earnings from whatever invested capital they managed to accumulate while they were still working. Investment income is sometimes derisively described as “unearned,” but the retirees we are talking about already paid taxes on the earnings that they managed to save and invest during their working years. Some individual investors, whether retired or salaried, work very hard researching what stocks or mutual funds to invest in, and others pay financial planners to do that work for them. We think it unfair to ignore the source of their capital in characterizing the earnings from their nest eggs as unearned. That seems especially so since a significant portion of the earnings on their savings is merely replacing the loss of purchasing power from inflation.

In the absence of congressional action, dividends will be taxed at ordinary income rates in post-2012 years, even though dividends constitute a significant portion of the income of retirees and middle-income investors who are saving for retirement. There is controversy over the appropriateness and the economic desirability of taxing both corporate income and the disbursement of that income. Dividends are paid from a corporation’s earnings and profits, which typically have already been taxed. One objective of adopting the current 15 percent rate on qualified dividends was to reduce the effect of double taxation. Another was to break ground toward integrating corporate and personal income taxation.

A capital gains tax is a maximum tax — that is, it sets a ceiling on the marginal tax rate that can apply to the covered income. Consequently, the capital gains tax rates do not apply to net capital gains or qualified dividends that otherwise would be taxed at a lower rate under the applicable regular tax schedule. Our proposed schedule for ADCG operates in the same manner. It serves as a maximum marginal rate for that income.

Applying the Compromise Proposal

We set forth eight examples of taxpayers having different amounts of ADCG in order to show the effect of our proposal and to compare it (using our sample graduated rates) with the tax treatment that would apply under current tax law and under the scheduled post-2012 tax law. In making these calculations, we have omitted the 3.8 percent Medicare tax, since it would apply (or not) equally in all of the situations, and so would not alter the comparisons.

Also, to keep the calculations as simple as possible, we have not taken into account the application of lower tax rates to that part of a taxpayer’s ADCG that would be taxed at lower rates under the regular tax schedule; and we have assumed that each retiree is married, files jointly, and has outside ordinary income equal to the amount of that retiree’s deductions. In calculating the post-2012 tax under the currently scheduled system, we use the brackets provided for 2012, since the 2013 brackets are not yet available. The tax rates we use are those that are scheduled to apply in 2013.

Projecting post-2012 taxation is complicated, because the tax rates on dividends and net capital gains are scheduled to be different. One would need to know the percentage of a retiree’s ADCG that constitutes dividends and the percentage that constitutes net capital gains. The ADCG of the wealthy (who, with their personal and professional contacts in the business and financial communities, have more investment vehicles available to them, such as hedge funds, private equity, IPOs, business interests, etc.) is already tilted more towards net capital gains than dividends. With a marginal rate as high as 39.6 percent on dividends but a flat rate of 20 percent on net capital gains, the ADCG of the wealthy will be even more likely tilted towards net capital gains.

What about middle-income retirees, those whose portfolios have been tilted more towards dividends? Taxing dividends as ordinary income will put them to what may be called the retirees’ dilemma. Their marginal rate on dividends will rise to 28 percent (for taxable incomes up to $142,700) or 31 percent (for taxable incomes up to $217,450). Consequently, some of them might feel tempted to abandon their capital-preservation instincts and reorient their portfolios once again, this time to riskier investments in order to be taxed at the 20 percent net-capital-gain rate. Others, however, might maintain their emphasis on dividends despite the higher tax rates. Dividends provide a steady stream of income, whereas seeking income from capital appreciation requires liquidating shares, sometimes when the market is down, causing a loss of capital that can be hard to recoup.

Our focus is on comparing the taxation of a taxpayer’s ADCG under current rates, the rates that are scheduled to take effect in 2013, and our sample graduated rate schedule. In the absence of empirical
data on the mix between dividends and net capital gains, we set forth two calculations for purposes of the rates that are scheduled to take effect in 2013: one in which all of the retiree’s ADCG consists of dividend income.

Before examining the tax status of the six hypothetical retirees we have chosen, we illustrate the effect that our sample tax schedule would have on the superrich by applying it to two tax returns of Mitt and Ann Romney (see Table 1 above). We chose the Romneys because, unlike others in that wealth category who are not running for political office, they have released their tax returns.

For hypothetical retirees, we use individuals whose ADCG ranges from $2 million to $100,000. Table 2 above shows that our sample graduated rate schedule would cause the current (pre-2013) tax on the ADCG of all those retirees to increase except those whose ADCG is $250,000 or lower.

Conclusion

A 30 percent tax rate on the ADCG of the very wealthy would not only double the current tax rate that they now enjoy but also satisfy the objective of

27Warren Buffett, the source of the Buffett rule, is not running for public office and has not released his tax returns. 

28These retirees may have other sources of retirement income — pension benefits, 401(k)s, and IRAs. Payments or withdrawals from those accounts are taxable as ordinary income. They may also draw Social Security retirement benefits, which are partly taxable as ordinary income.

29Theoretically, our sample graduated tax rate structure would produce a higher tax than the current (pre-2013) rate structure once the taxpayer’s ADCG exceeds $250,000 even by a dollar, but, because of rounding, the precise level is actually $250,003.
the Buffett rule. Our sample graduated rate schedule would continue the current 15 percent rate for those whose ADCG is far more modest, thus avoiding the looming “Taxmageddon”30 that retirees (such as retirees 5 and 6) might soon experience. At the same time, our sample graduated rate schedule would impose a higher tax rate on wealthier retirees (such as retirees 1 through 4) than their tax rate under current (pre-2013) law.

Our proposal for a graduated rate system for ADCG, ranging from 15 to 30 percent, appears to us to be a sensible compromise. We hope that it appears sensible to Congress, sensible enough to make the compromise permanent, so that small investors who are saving for retirement and those who have already retired will not constantly be in doubt about the future taxation of their nest eggs.31

Addendum: A Primer on the Buffett Rule

As indicated in the text, the Buffett rule has sometimes been misunderstood. To address that problem, we add this addendum to explore just how the Buffett rule could be implemented if it were adopted. The rule would likely apply only to a taxpayer who has AGI exceeding $1 million in a tax year. Indeed, the defeated Senate bill32 applied only in that circumstance.33 The Buffett rule would establish a minimum amount of tax for high-income taxpayers. Consequently, the likely form in which it would be applied is similar to the form used for the AMT provision.34 Accordingly, the rule is likely to apply so that the taxpayer will pay either the taxpayer’s regular tax or the Buffett tax, whichever is higher. The Buffett tax likely would be 30 percent of all of the taxpayer’s AGI.35

Congress, however, would not adopt a minimum tax that would apply a 30 percent rate to a taxpayer’s entire AGI if the taxpayer’s AGI exceeded $1 million by a small amount. Take the case of a taxpayer whose AGI exceeded $1 million by a dollar. Under such a Draconic rule, that additional dollar of income would increase the taxpayer’s tax burden by thousands of dollars. No one would want a system that operated like that. So the Buffett rule’s minimum tax would have to be scaled from virtually nothing to a 30 percent rate as the amount by which the taxpayer’s AGI rises above $1 million. The defeated Senate bill that sought to implement the Buffett rule dealt with that issue. When the taxpayer’s AGI exceeds $1 million, the Senate bill applied only a fraction (not to exceed 1) of the 30 percent rate to the taxpayer’s AGI. The fraction had a numerator of the amount of the taxpayer’s AGI that exceeded $1 million, and the denominator was $1 million.36 Thus, once the taxpayer’s AGI reached $2 million, the full 30 percent rate would be applied. So, for example, if a taxpayer had AGI of $1.5 million, only half of the 30 percent rate would be applied, and the taxpayer would have a minimum tax equal to 15 percent of AGI. It is interesting to note that although the Buffett rule was heralded as imposing a higher minimum effective tax rate on persons having more than $1 million of income, it would not establish a minimum tax rate greater than the current 15 percent rate on net capital gains and dividends until the taxpayer’s AGI exceeds $1.5 million.37

The true purpose of the Buffett rule stems from the belief (advanced by Buffett himself) that some of the superrich are paying a smaller rate of tax than that borne by average wage earners. If any of the superrich are in that position, it is because their income consists primarily of net capital gains and dividends, which are taxed currently at a 15 percent rate. Consequently, the ultimate target of the Buffett rule is the topic of this article: the preferential tax rate on dividends and net capital gains currently enjoyed by the wealthy.

30See Snow, supra note 4; Leonhardt, supra note 7.

31We reiterate that we offer our sample graduated rate schedule merely as an illustration. Congress may prefer different rates or different brackets.

32Paying a Fair Share Act of 2012, supra note 16.

33In a May 7 television interview on CNBC, Warren Buffett said that he wrote to the senator who introduced the Paying a Fair Share Act (Sen. Sheldon Whitehouse, D-R.I.) saying that he, Buffett, was fine with the bill, but also indicated that he would have preferred two rates: a 30 percent tax on income exceeding $1 million and a 35 percent rate for income exceeding $10 million. (Recorded video copy of the CNBC interview on file with the authors.)

34Section 55.

35The defeated Senate bill would have reduced the AGI of taxpayers by the amount of their deductible charitable gifts that are in excess of their share of the limitation on the amount of itemized deductions.

36The $1 million figures would be adjusted for inflation.

37Although the title of the defeated Senate bill focused on paying a fair share, the preamble stated that its purpose was “to reduce the deficit by imposing a minimum effective tax rate for high income taxpayers.” The revenue effects of the Buffett rule, however, are unclear. An Internet search of “the revenue effects of the Buffett rule” turned up posts with far different conclusions.