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Retirees Beware: Don't Worry About the British, "Taxmageddon" Is Coming

By Douglas A. Kahn and Lawrence W. Waggoner

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Retirees beware. The easy money policy of the Federal Open Market Committee and the 15% tax rate on qualified dividends have encouraged 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. According to Internal Revenue Service data for 2010 (the last year for which data are available), 53% of taxpayers age 65 or older with itemized deductions reported qualified dividend income amounting to 46.3% of the qualified dividend income reported by all taxpayers; 48% of taxpayers age 65 or older with itemized deductions reported net capital gains amounting to 27.8% of the net capital gains reported by all such taxpayers.

But, on January 1, "Taxmageddon" is coming.[1] Unless Congress extends the current rates or reaches an agreement on tax reform, dividends will then be taxed as ordinary income at a marginal rate as high as 39.6 % and net capital gains will then be taxed at 20%. For high-income taxpayers, a 3.8% Medicare surtax will be added to the taxation of net capital gains, dividend income, interest, and other investment income, bringing the highest marginal rate to 43.4%.[2]

The favorable tax treatment for qualified dividends and net capital gains is clearly under assault. The Simpson-Bowles Commission recommended that long-term capital gains and qualified dividends be taxed as ordinary income at marginal rates as high as 28% (31.8% with the Medicare surtax added). 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 30% tax rate on an individual's income in excess of $1 million.

We offer a compromise.[3] Instead of taxing dividends as ordinary income and net capital gains at 20%, 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, or ADCG for short. Although we don't propose specific rates, we do offer a sample schedule to illustrate the effect of a graduated rate system.

Our sample schedule takes the following form: 15% on the first $250,000 of ADCG, 20% on the next $250,000, 25% on the next $500,000, and 30% on ADCG above $1 million. The bracket ranges would be indexed for inflation. Under our sample schedule, the super-rich—including Warren Buffett, Mitt Romney, and especially the wealthy who did not earn their fortunes (such as trust-fund babies)—would end up paying 30% on their ADCG that exceeds the million-dollar mark. It seems to us that this simple compromise would satisfy those who want the super-rich 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.

[1] The term "Taxmageddon" refers to the dramatic increase in tax rates that are scheduled to take effect on January 1, 2013. The term was coined by David Leonhardt in his article, in *The New York Times*, "Coming Soon: 'Taxmageddon,'" *N.Y. Times*, Apr. 13, 2012, available at www.nytimes.com/2012/04/15/Sunday-review/coming-soon-taxmageddon.html?_r=1&pagewanted=all.

[2] Although the Obama Administration's proposed budget for 2013 supports taxing dividends as ordinary income and capital gains at 20%, a Democratic proposal in the Senate would tax dividends at 20% for high-income taxpayers for a one-year period. *See* Middle Class Tax Cut Act, S. 3412, 112th Cong. 2d Sess. (2012). The Senate passed the bill on July 25, 2012, by a vote of 51–48, but the House defeated it on Aug. 1, 2012, by a vote of 257–170.

[3] We have not sought to project the revenue effects of our proposal.

Although our proposal would apply to all investors, we focus on middle-income retired savers, because they 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 on Medicaid.

How would our proposal apply to various taxpayers?[4] We begin with the super-rich. Our super-rich exemplars are Mitt and Ann Romney. We chose the Romneys because, unlike others in that wealth category who are not running for political office, they have released their recent tax returns. The Romneys' 2011 federal income tax return shows ADCG of $9,032,132. As shown in the following table, their tax on that amount would be $1,354,820. If the currently scheduled post-2012 tax rates take effect, their 2013 tax on that amound would rise to $2,197,614. Under our sample graduated rate schedule, however, their tax would be even higher, rising to $2,622,140, because their ADCG is mostly composed of net capital gains, not dividends.[5] Their 2010 tax return shows ADCG of $15,446,388. On that amount, their tax under current rates would be $2,316,958, their 2013 tax under the currently scheduled post-2012 rates would be $3,698,051, and their 2013 tax under our sample graduated rate schedule would be $4,546,416.

We turn now to a prosperous retiree, say one with ADCG of $1.5 million. This retiree's 2012 tax would be $225,000. Under our sample graduated rate schedule, the tax would rise to $362,500. Under the scheduled 2013 rates, the tax could range from a low of $300,000 (if all of the ADCG were net capital gains) to a high of $550,548 (if all of the ADCG were dividends).[6]

Finally, we look at a moderately affluent retired saver with ADCG of $250,000 and a middle-income retired saver with ADCG of $100,000. The 2012 tax on the $250,000 would be $37,500 and on the $100,000 would be $15,000. Under our sample graduated rate schedule, their taxes would be the same. Under the scheduled 2013 rates, the taxes on the ADCG of $250,000 would range from $50,000 (if all of the ADCG were net capital gains) to $64,911 (if all of the ADCG were dividends). The scheduled 2013 taxes on the $100,000 would range from $20,000 (if all of the ADCG were net capital gains) to $19,005 (if all of the ADCG were dividends).

Our proposal for a graduated-rate system for ADCG appears to us to be a sensible compromise. A 30% tax rate on the ADCG of the very wealthy would not only double the current tax rate that they now enjoy but would also satisfy the objective of the Buffett Rule. Continuing the current 15% rate for those whose ADCG is far more modest would avoid the looming "Taxmageddon" that these retirees might soon experience.

The Super-Rich

Mitt & Ann Romney's Federal Income Tax Returns	ADCG	Current (Pre-2013) Tax	Post-2012 Tax If Congress Fails to Reach Agreement Before 2013	Post-2012 Tax Under Our Sample Graduated Rate Schedule on ADCG
2011 Return	$9,032,132	$1,354,820	$2,197,614	$2,622,140
2010 Return	$15,446,388	$2,316,958	$3,698,051	$4,546,416

[4] In making our calculations, we have not taken the Medicare surtax into account, because that tax would apply (or not) equally in all of the situations, and so would not alter the comparisons.

[5] Their 2011 qualified dividends were $2,221,956 and their net capital gains were $6,810,176. In this the Romneys are typical of the very wealthy, who, with their personal and professional contacts in the business and financial communities, have more investment vehicles available to them than ordinary investors. The Internal Revenue Service reported that in 2010 (the latest year for which data are available), 11,166 taxpayers with itemized deductions had adjusted gross income of $10 million or more: 10,500 of them reported qualified dividends averaging $2.57 million each; 10,925 of them reported net capital gains averaging $13.95 million each. The IRS also reported that in 2009, again the latest year for which this statistic is available, the 400 taxpayers with the largest adjusted gross incomes had 6% of all of the dividends but 16% of all of the net capital gains reported by all taxpayers. With a marginal rate of 39.6% on dividends and a flat rate of 20% on net capital gains, the ADCG of the wealthy will be even more likely tilted toward net capital gains if the 2013 rates take effect.

[6] In the interest of simplicity, the 2013 tax calculations regarding dividends for this and the next two retirees are made on the basis of a married taxpayer filing jointly whose outside (non-ADCG) income equals the taxpayer's deductions.