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Capital Sources

Wealth managers console clients nervous over Obama's tax plan

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Despite campaign rhetoric that made their clients jumpy, wealth management professionals aren't expecting a wrenching revision to the nation's tax code after Barack Obama takes office in January.

Still, tax attorneys, wealth advisers and certified public accountants are bracing for significant changes from Obama and a mostly like-minded Democratic Congress.

Among the possibilities:

• A rise in the capital gains tax rate, best-known as the levy on the profits from stock transactions, from 15 percent to at least 20 percent.

• About a 10 percent hike in the marginal income tax rate.

• An increase from $2 million to $3.5 million on the assets that are exempt from estate taxes, which are assessed on a dead person's property when it transfers to heirs. The change goes into effect in January.

Currently, the estate pays taxes at a 45 percent rate on the inherited wealth above the exempt amount. Although the exemption is increasing, opponents of the tax had hoped to see it repealed in 2010.

"Those are the big three," said Carl Gadinsky, tax director at Kane & Co., a Miami CPA and business advisory firm, of the estate, income and capital gains tax issues.

Gadinsky is urging clients to account for any income they can in 2008 — arranging to receive a bonus in December, for example — before any tax hikes kick in.

"We're simply just advising clients to [account for] whatever income they can into 2008, and then just deferring any deductions possibly into 2009.

Louis Nostro, an estate-planning attorney and partner with Shutts & Bowen, said that keeping the estate tax alive with a $3.5 million exemption was Obama's position during the campaign and — more importantly — it's the position of the U.S. Senate.

"You need 60 votes in the Senate to pass anything in this area," he said. "The Senate considered a number of different proposals early this year and never got close to 60 votes on anything, but they had a budget resolution earlier this year, and voted 99 to 1 for extending the $3.5 million for four or five years and then deal with it later on."

There's a chance, of course, that much of what Obama proposed on the campaign trail may not come to pass at all.

The new president will have to manage a delicate balance between the need to raise revenues and the realities of a deep recession, said Cathy Pareto, founder and president of the eponymous Coral Gables financial planning firm.

"He's going to be hard-pressed to push all of those initiatives through," she said, with the exception that, "I would suspect that the capital gains tax would be an easy target."

That's because the public perceives it as a tax targeting high-wealth individuals with large stock portfolios or other assets that have appreciated over time.

The estate tax is causing considerable confusion for many high-net-worth clients, Nostro said.

Through a quirk of 2001 tax reform legislation the estate tax is due to expire in 2010, only to re-emerge in 2011 at 2001 levels, which has the first $1 million of assets exempt from taxation.

"We tell clients exactly what the law is now, and they give you a bemused look as if you're the one that invented this — where if nothing happens, you have no estate tax if you die in 2010, but then it goes back to a $1 million exemption in 2011."

Nostro said he is planning for the exemption to be $3.5 million.

"As we prepare documents, we do them with formula provisions to cover all of the alternatives because clients aren't going to come back every year to re-do their estate plan if they can avoid it."

"Portability" is another issue in the estate tax debate, which Nostro said would have a "huge, positive impact" on clients.

For clients with estates of $7 million or more, advisers want to be able to use both spouses' exemptions to shelter $7

million plus appreciation from the estate tax.

“What we have to do now is have clients typically separate assets between husband and wife and direct that on the first spouse’s death that the amount that could have gone tax-free to kids instead goes into a special trust for the lifetime benefit of the surviving spouse, and then apply the first spouse’s exemption to it,” Nostro said. “We’re jumping through a bunch of artificial hoops to be able to take advantage of both exemptions.”

Obama has said he favors making the exemption portable. The American College of Trust and Estates Counsel and different bar associations have also backed the proposal, Nostro said.

On the income tax front, Nostro expects a return to the old Clinton-era maximum tax rate of 39.6 percent, from the current 35 percent.

“The joke is, I wish we found clients with capital gains any more,” he said. “That’s not as big an issue, but we know in our office that there are transactions that people are scrambling to close by year-end to take advantage of the current 15 percent rate.”

The urgency stems from the usual congressional practice of making income tax changes retroactive to the first day of the calendar year. (Miami Dolphins owner Wayne Huizenga, for example, reportedly wants his sale of the team closed before year-end to take advantage of current — and likely lower — tax rates).

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Gadinsky said capital gains tax changes usually are not made retroactive, which should give investors more time to plan on that front.

Nostro said Social Security taxes are another critical component of Obama’s plans for high-income taxpayers, “because right now there is basically the payroll, or FICA, tax of 12.4 percent from zero up to $102,000 of wages,” Nostro said. Under Obama’s proposal, there would be no FICA taxes on income beyond the first $102,000 and below $250,000, but any income beyond $250,000 would have an additional 4 percent tax rate.

“Those pretty much are the same people that will be in the 39.6 percent bracket,” Nostro said of those earning more than $250,000. Pareto said the proposed changes will influence the way people think about the types of products they’re putting in their portfolios.

Click play to listen to Cathy Pareto

“It really behooves investors to hold tax-sensitive products like index mutual funds or exchange traded funds,” Pareto said. “In some cases, you may want to opt for a tax-managed fund if you’re a mutual fund investor.”

The bottom line is clients will pay taxes either way, she said, so why not arrange to pay those taxes now when rates are relatively low.

“Taxes should be managed, not simply avoided,” Pareto said. “Have the best portfolio you can. Taxes are important, but it ought to not be the No. 1 driving decision in your strategies.”

Surprises could come in many forms, including unforeseen proposals in the House and Senate to deal with volatile economic conditions.

That’s one reason wealth managers like Coconut Grove Bank’s Philip Gassman are taking more of a wait-and-see approach.

“It’s too early for us to establish any kind of policy for our clients,” he said. “It all depends on who [Obama] surrounds himself with. That’s what everybody’s waiting for.”

However, “Among turmoil comes opportunity,” Gassman said. “One of the things trust and estates attorneys are looking at and are talking to their wealthy clients about is that right now is a terrific time ... to start transferring some of the wealth to the other generations,” as a means of lowering estate taxes, because market values are so depressed right now.

Communication is always crucial, Gassman said.

“You can talk about what we think we’re going to have to pay attention to, but to start making all of these crazy moves right now is probably knee-jerk,” he said.

With a flood of calls from concerned clients coming in, Nostro says that “most of what we do — I don’t want to say it’s damage control, but it’s really setting the record straight. Taxes are going up, but they’re not going up as dramatically as some of our clients think they are.”

With estate taxes, for example, “We’ve all seen our houses come down at least 20 percent in value, and we’ve had our portfolios drop by about a third,” Nostro said. “A person today that has a $7 million net worth, this time last year they had a $10 million net worth.”

There are plenty of things that you can do on the planning end beyond that to avoid or minimize those taxes.”

He also mixes in some historical perspective.

“When I started practicing in 1982, the estate tax rate had just dropped during the Reagan administration from 70 percent to 55 percent,” Nostro said. “We had marginal tax rates back then of around 50 percent.”

The Obama plan will result in some higher taxes, he noted, “but this is not revolutionary.”

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