Cannon Insights
A Monthly Publication by Cannon Financial Institute

Taxes—Obama Unveils Budget Proposal

The Obama Administration unveiled its 2014 budget proposal on April 10, and the proposal contains at least three changes that should be of concern to Advisors and their high-net-worth and affluent clients.

First, one proposal that is of no surprise to anyone, and that has surfaced and been defeated in the past, has to do with the estate tax. The President's budget would increase the rate for the top estate tax bracket from the current 40 percent to 45 percent. In addition, the President's budget would decrease the current estate tax exemption from $5 million (as indexed for inflation to $5.25 million) to $3.5 million.

Second, the President would cap the amount that individuals can accumulate in retirement accounts such as IRAs and 401(k) plans. Currently, while there are limits on the amount and restrictions on the deductibility of contributions to these accounts, there is no limit on the amount that can be accumulated on a tax-deferred basis. The President's budget proposal would require that IRAs and other tax-preferred retirement savings accounts provide no more than $205,000 in annual retirement income. For someone retiring today that is estimated to amount to about $3 million. Apparently, amounts in all retirement accounts would be aggregated in reaching the cap. It's unclear from the proposal exactly how excess accumulations would be treated—they might be taxed currently, or might have to be distributed immediately.

Note that the cap on tax-deferred retirement accumulations is in addition to a current income tax on distributions, penalties on premature distributions, minimum distribution requirements, and an estate tax on balances remaining at the participant's death.

Some have argued that the cap will not result in additional revenue, as the President hopes, but will instead merely divert retirement savings into other tax-advantaged vehicles such as non-qualified annuities and life insurance. Alternatively, some may choose to invest in traditional investment accounts that result in capital gains (taxed at lower rates) rather than ordinary income upon liquidation.

Third, the Obama Administration's budget proposal calls for a limit on the benefit of charitable deductions. Under current law, for a taxpayer in the maximum income tax bracket of 39.6 percent, a charitable contribution of $100 results in an after-tax cost of only about $60. Under the administration's plan, the same contribution would be deductible against a maximum rate of only 28 percent, resulting in an after-tax cost of $72.

Some argue that the increased cost of charitable gifts will result in a decrease in charitable activity. Others point out that most charitable contributions are motivated less by taxes and more by philanthropic interest anyway, and that taxes play a relatively small role in charitable giving.

Bottom Line

With Congress sharply divided on most issues, including the budget, it's likely that the President's proposals will have a rough time being enacted in their current form. However, as leaders in both parties seek a "grand bargain" on the budget that would include both revenue enhancement and spending reduction, it's hard to predict what we'll be left with when the dust settles.

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