THE FUTURE OF US TAXATION:
And how to prepare

BY NICK STOVALL, CPA/PFS℠, MBA

THE FUTURE OF US TAXATION: *And how to prepare…*

By Nick Stovall, CPA/PFS, MBA

As I write this article for your reading pleasure, I find myself being distracted by all the recent legislation submitted regarding debt reduction and tax reform. Just a few short weeks ago, we raised the debt ceiling so that our government "credit card" could buy more groceries because our current tax revenues cannot cover our obligations. Now, there are several new bills before Congress touting deficit reduction plans with a tax code overhaul, although none appear to be likely to pass Congressional differences in the near future.

Regardless of which legislation has been thrown at us, or which will be, the resounding message within them remains the same, increased taxes!

Sadly, we hear this same threat so often that it has begun to sound like the boy who cried wolf. The reason behind this lies in the fact that tax hikes usually do not take effect for two to three years after their introduction and subsequently get implemented through piece meal. The result of this prolonged implementation period can be equated to death by a thousand paper cuts.

Debt Ceiling – Cause and Effects

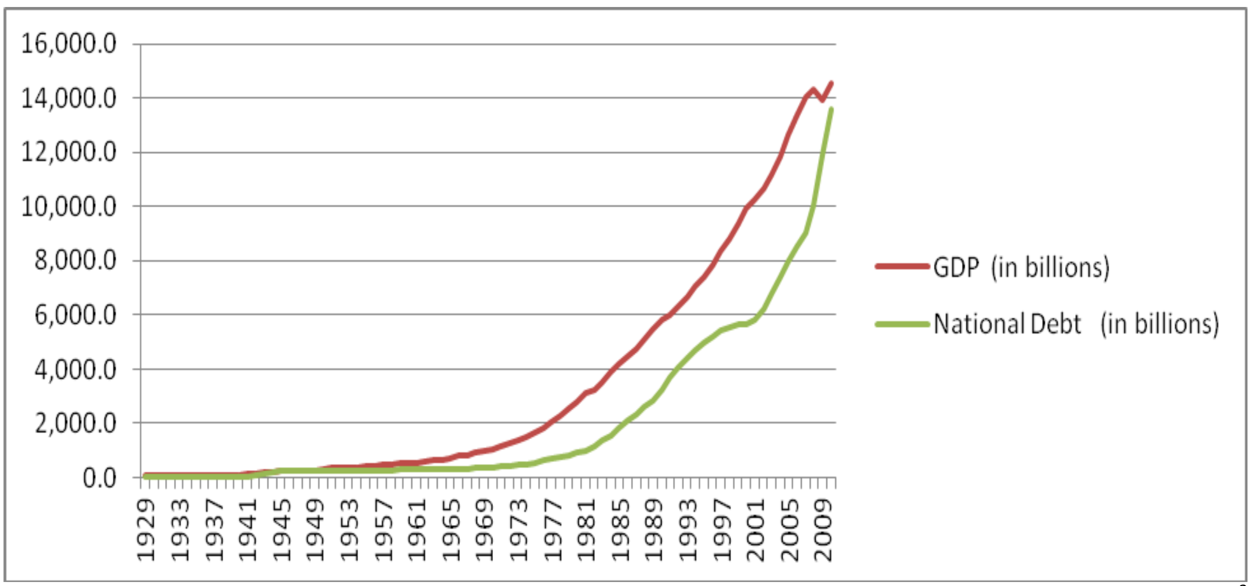
The raising of the debt ceiling has raised more than just the ability for our government to go further into debt; it has raised concerns and fears about the future of our economy. We are now seeing major swings in the markets with investors showing serious concerns over the future of investment valuations and their personal wealth. Unfortunately, the reasoning behind all of this uncertainty is preceded by the inability to see the full implications of what is in store. I say this because what is little talked about is the fact that coupled with all the discussions on raising the debt ceiling were discussions on major tax reform that is, and will be, required to correct the problems that lie beneath the need for the debt ceiling increase.

Increasing the debt ceiling was needed because the government "maxed out its credit card," which it has been living off of for quite some time. It is really not much different than what we have been seeing from the general public for the past few decades. Unfortunately, most of us do not have the ability to get a credit limit increase on our credit cards once we have reached the maximum limits unless we can show the ability to pay this balance back. The only way to pay this credit card back is by spending less and making more money.

This is exactly where the federal government is today. They have been given a higher credit limit, but they still need to find a way to decrease the spending while making more money. The only way the government makes money is by collecting taxes. Unfortunately at the current moment, the government is collecting approximately $120 billion less per month than it currently spends.[1] This helps explain why discussions for major tax reform have accompanied the discussions for the increased debt ceiling.

Debt and Earnings

Let us take a closer look at where we are today. The U.S. national debt is increasing at an unprecedented rate, rising to levels never seen before and threatening serious harm to the economy. Through the end of 2010, the national debt has risen to $13.6 trillion, averaging an 11.4 percent increase annually over the past five years and 9.2 percent annually over the past 10 years. To put this into perspective, the national gross domestic product (GDP) has increased to $14.5 trillion through the same time period, averaging a 2.9 percent annual increase over the past five years and 3.9 percent over the past ten years. At the end of 2010, the national debt level was 93 percent of the GDP. Economists believe that a sustainable economy exists at a maximum level of approximately 80 percent. Today the U.S. national debt is 100.19 percent of GDP with the debt at $15.082 trillion and the GDP at $15.054 trillion[2].

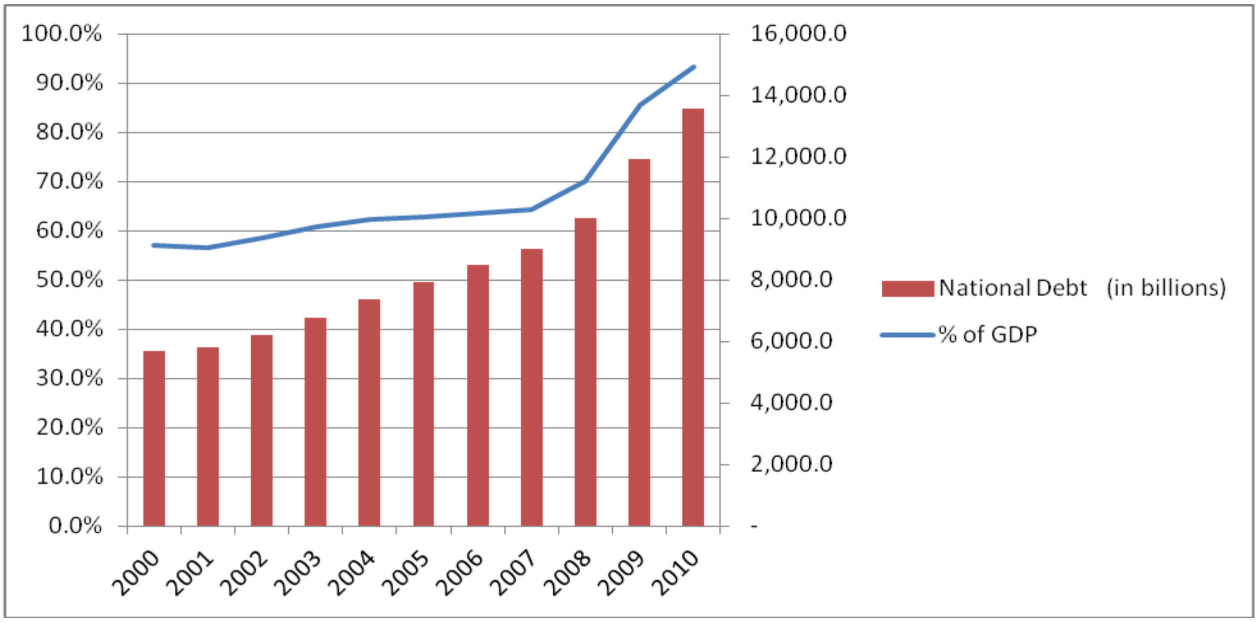


[3]

[1] CBO, Budget and Economic Outlook: Historical Budget Data, January, 2011

[2] http://www.usdebtclock.org/ 12/10/11

[3] Charts developed from data obtained through the Congressional Budget Office historical budget data



The significance of these two numbers lies within the contrast. The national debt is the amount that needs to be repaid; this is the credit card balance. Gross domestic product on the other hand is less known and represents the market value of all final goods and services produced within a country during a given period. Essentially, GDP represents the gross taxable income available to the government. If debts are increasing at a greater rate than the gross income available for taxation, then the only way to make up the difference is to increase the rate at which the gross income is being taxed.

Table S–1. Budget Totals

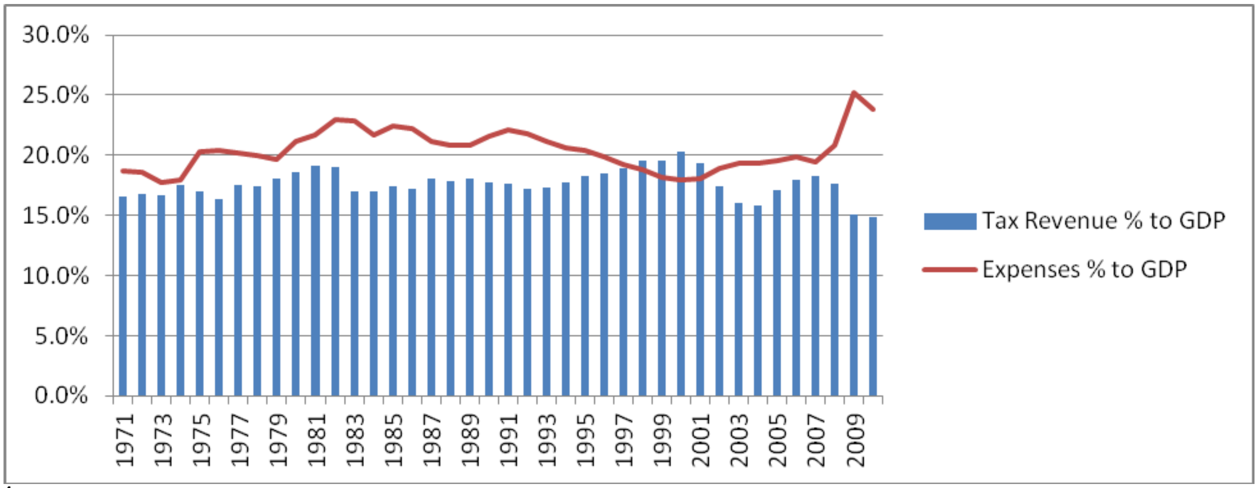
(In billions of dollars and as a percent of GDP)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Totals 2012-2016	Totals 2012-2021
Budget Totals in Billions of Dollars:														
Receipts	2,163	2,174	2,627	3,003	3,333	3,583	3,819	4,042	4,257	4,473	4,686	4,923	16,366	38,747
Outlays	3,456	3,819	3,729	3,771	3,977	4,190	4,468	4,669	4,876	5,154	5,422	5,697	20,134	45,952
Deficit	1,293	1,645	1,101	768	645	607	649	627	619	681	735	774	3,769	7,205
Debt held by the public	9,019	10,856	11,881	12,784	13,562	14,301	15,064	15,795	16,513	17,284	18,103	18,967		
Debt net of financial assets	7,894	9,505	10,585	11,344	11,988	12,595	13,243	13,869	14,488	15,169	15,903	16,677		
Gross domestic product (GDP)	14,508	15,080	15,813	16,752	17,782	18,804	19,791	20,755	21,679	22,624	23,608	24,633		
Budget Totals as a Percent of GDP:														
Receipts	14.9%	14.4%	16.6%	17.9%	18.7%	19.1%	19.3%	19.5%	19.6%	19.8%	19.9%	20.0%	18.3%	19.0%
Outlays	23.8%	25.3%	23.6%	22.5%	22.4%	22.3%	22.6%	22.5%	22.5%	22.8%	23.0%	23.1%	22.7%	22.7%
Deficit	8.9%	10.9%	7.0%	4.6%	3.6%	3.2%	3.3%	3.0%	2.9%	3.0%	3.1%	3.1%	4.3%	3.7%
Debt held by the public	62.2%	72.0%	75.1%	76.3%	76.3%	76.1%	76.1%	76.1%	76.2%	76.4%	76.7%	77.0%		
Debt net of financial assets	54.4%	63.0%	66.9%	67.7%	67.4%	67.0%	66.9%	66.8%	66.8%	67.0%	67.4%	67.7%		

THE BUDGET FOR FISCAL YEAR 2012

The most recent presidential budget shows a continuing trend in the disparity between growth in the national debt and GDP over the next two decades. Although the increasing disparity is a real concern and shows that, at least in the short run, the federal deficit will not be addressed to counteract the potential crisis ahead, it is the revenue collection that tells the story that is disconcerting. Over the past 40 years the average collection of GDP has been approximately 17.6 percent and currently collections are at approximately 14.4 percent of GDP.

As the presidential budget reveals, the projected revenues are estimated to be 20.0 percent by the end of the next decade; that is a 38.8 percent increase from the current tax levels. To put this into perspective, if you are currently in the top tax bracket of 35 percent and this bracket increases by the proposed collection increase, your tax rate will be approximately 48.5 percent. Keep in mind that even at this rate the deficit is projected to increase.



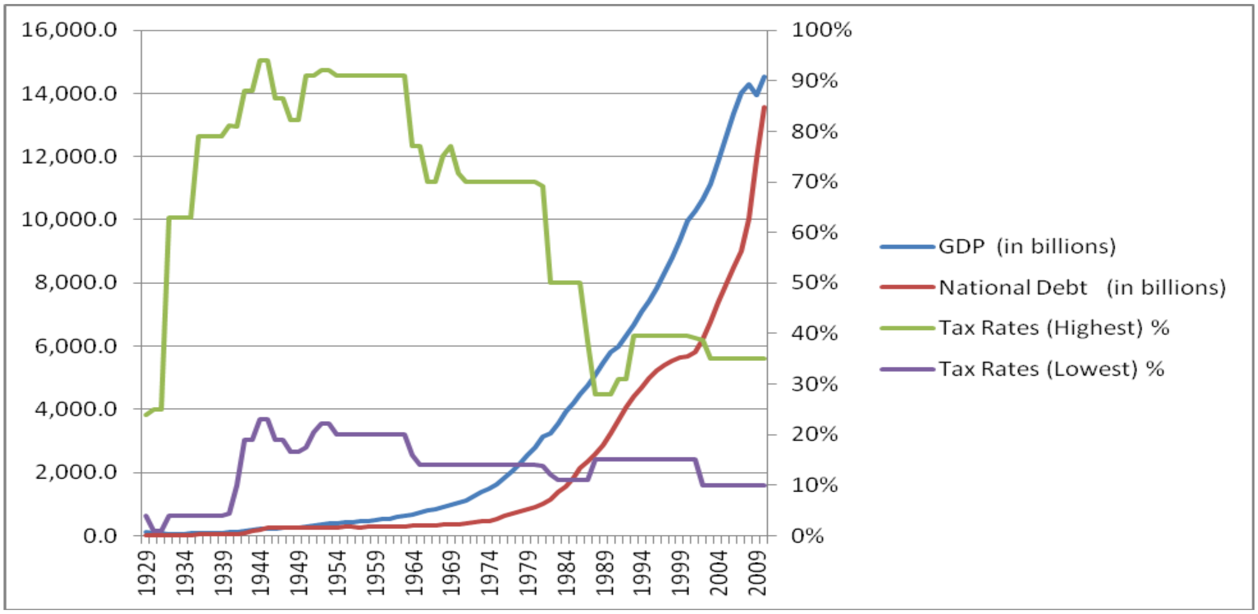
[4]

2013 – The End of an Era?

It is currently well known that the tax cuts from 2001 and 2003 are legislatively set to expire at the end of 2012. However the question is continually asked, will Congress actually let the tax cuts expire? The current presidential budget shows a 7.8 percent increase in collections over the sunset period, and it would appear from all practical perspectives that the intent, at least from the executive branch, is to allow such to happen.

From a historical point of view, taxes are extremely low. The last time the U.S. national debt was at the same percentage level of GDP as it is today was at the end of World War II and for several years following. The maximum tax rate at that point and through the years from 1944 through 1963 averaged 90 percent. Compare that to the maximum rate of 35 percent today, and it becomes very clear that there is a disparity of extreme proportion.

[4] Chart developed from data obtained through the Congressional Budget Office historical budget data



Taxes during this historical period were at extreme levels for nearly 20 years, during and following this level of debt-to-GDP. A significant point to note about the difference at that time versus where we are today is the economic activity.

The period of 1944 through 1963 previously mentioned was in the heart of both the industrial revolution and the births of the "baby boom" generation. Today, we are mired in extreme volatility with frequent periods of boom and bust accompanied by the beginning of the greatest retirement wave ever experienced within the U.S. economy.

To contrast these two time periods in respect to the recovery period is almost asinine as the external pressures from globalization and domestic unfunded liabilities did not exist or were irrelevant factors during the prior period.

To add insult to injury, U.S. domestic unfunded liabilities are currently estimated somewhere between $61.6 trillion[5] and $116.7 trillion[6]. These liabilities exist outside of the annual budgetary debt discussed above and are due to items such as Social Security, Medicare, and government pensions. The most concerning part of this goes back to the previous discussion of being on the cusp of the greatest retirement wave in U.S. history as the baby-boom generation begins retiring and expiring the unfunded Social Security for which they currently have entitlement. Over the long-run, expenditures related to healthcare programs such as Medicare and Medicaid are projected to grow faster than the economy overall as the population matures.

To put unfunded liabilities into perspective, consider these as off-balance-sheet obligations similar to those of Enron. Although these are not listed as part of the national debt, they must be paid just the

[5] USA Today, U.S. funding for future promises lags by trillions, 06/13/2011

[6] http://www.usdebtclock.org

same. The difference between Enron and the U.S. unfunded liabilities is that if the U.S. government cannot come up with the funds to pay all these liabilities through revenue generation then they will print the money necessary to pay the debt.

What does the solution look like?

Unfortunately, the general public is in a no-win situation for this solution to the problem. Printing money does not bode well for economic growth as this action creates inflationary pressures that devalue the U.S. dollar and make everyone less wealthy. Cutting the entitlements that compose this liability leaves millions of people without benefits they have come to expect. The only other option, and one that the government knows all too well, is increased taxes. In fact, according to a Congressional Budget Office paper issued in 2004[7], unfunded liabilities are addressed as follows:

"The term 'unfunded liability' has been used to refer to a gap between the government's projected financial commitment under a particular program and the revenues that are expected to be available to fund that commitment. But no government obligation can be truly considered 'unfunded' because of the U.S. government's sovereign power to tax – which is the ultimate resource to meet its obligations."

A balanced budget is going to be required at some point and with this will come higher taxes. We already have uncertainty surrounding tax rates to come at the end of 2012, when the extensions put in place back in December 2010, for the Bush era tax cuts are set to expire. I would say that we are likely to see some tax increase at this point. Whether it is only on the top earners or unilateral across all income levels is yet to be seen, but an increase of some sort is most certain to occur.

How do you prepare?

Why do I want to spend so much time reassuring you that taxes will increase? Because you have an opportunity to take action. Now is the time to prepare for what is to come and structure countermeasures for the good, the bad, and the ugly of each of these legislative nightmares through tax-free retirement planning.

You make more money by saving on taxes than you do by making more money.

I love to use the phrase; you make more money by saving on taxes than you do by making more money. The simplistic logic in the statement really makes sense when you discover it takes a $1.50 in earnings to put that same dollar saved in taxes back into your pocket[8]. This simple concept becomes extremely valuable to people in retirement and those living on fixed incomes.

As simple as it sounds, it is much more difficult to execute. Most people fail to put together a plan as they near retirement, beginning with a simple cash flow budget. If we have not analyzed our proposed

[7] CBO paper, Measures of the U.S. Government's Fiscal Position Under Current Law, September, 2004

[8] Assuming a 33 percent effective tax rate

income streams and expenses, we could not possibly have taken the time to position these cash flows and other events into a tax-preferred plan.

Most people will state, “I have a plan” and thus, they do not need any further assistance in this area. The truth in most instances is that people could not show you their plan, and of the few that could, they would not be able to show you how they have executed it. In this regard, they may as well be Richard Nixon stating, “I am not a crook” for as much as they state, “I have a plan.” The truth lies in waiting.

As we approach or begin retirement, we should be looking at what cash flows we will have. Do we have a pension? How about Social Security? How much additional cash flow am I going to need to draw from my assets to maintain the lifestyle that I desire?

We spend our whole lives saving and accumulating wealth but very little time determining how to distribute this accumulation to keep it. We need to make sure we have the appropriate diversification of taxable versus non-taxable assets to compliment our distribution strategy.

The Benefits of Diversification

Heading into retirement, we should be situated with a diversified tax landscape. The point to spending our whole lives accumulating wealth is not to see how big the number is on paper, but rather, it should be an exercise in how much we put in our pocket after removing it from the paper.

To truly understand tax diversification, we must understand what types of money exist and how each of these will be treated during accumulation and, most importantly, during distribution. The following is a brief summary of our money:

1. Free money
2. Tax-free money
3. Tax-deferred money
4. Taxable money
   a. Ordinary income
   b. Capital gains and Qualified dividends

Free Money

Free money is the best kind of money regardless of the tax treatment, because in the end you have more money than you would have otherwise. Many employers will provide contributions toward employee retirement accounts to offer additional employment benefits and inspire employees to save for their own retirement. With this, employers often times will offer a matching contribution in which they will contribute up to a certain percentage of an employee’s salary, generally three to five percent, to that employee’s retirement account when the employee contributes to their retirement account as well. For example, if an employee earns $50,000 annually and contributes three percent ($1,500) to their retirement account annually, the employer will also contribute three percent ($1,500) to the employee’s account. That is $1,500 in free money. Take all that you can get!

Tax-Free Money

Tax-free money is the next best thing to free-money. Although you have to earn tax-free money you do not have to give part of it away to Uncle Sam. Tax-free money comes in three basic forms that you can utilize during your lifetime; four if prison inspires your future, but we are not going to discuss that option.

The most commonly known form of tax-free money is municipal bonds, which earn and pay interest that could be federally tax-free, state tax-free, or both state and federal tax-free. There are several caveats that should be discussed in regard to the notion of tax-free income from municipal bonds. First, you will notice that tax-free has several flavors from the state and federal perspective. This is because states will generally tax the interest earned on a municipal bond unless the bond is offered from an entity located within that state. This severely limits the availability of completely tax-free municipal bonds and constrains underlying risk and liquidity factors. Second, municipal bond interest gets added back into the equation for determining your modified adjusted gross income (MAGI) for Social Security and could push your income above the thresholds subjecting a portion of your Social Security income to taxation. In effect, if this interest subjects some other income to taxation then this interest is truly being taxed. Last, municipal bond interest may be excluded from the regular federal tax system, but it is included for determining tax under the alternative minimum tax (AMT) system. I will not go into details on what the alternative minimum tax system is here, but the one thing everyone should know about AMT is that it is bad. In its basic form, the AMT system is a separate tax system that applies if the tax computed under AMT exceeds the tax computed under the regular tax system, the difference between these two computations is the alternative minimum tax.

Tax-Free Money: Roth IRA

Roth accounts are probably the single greatest tax asset that has come from Congress outside of life insurance and are well known of, but rarely used. Roth IRAs were first established by the Taxpayer Relief Act of 1997 and named after Senator William Roth, the chief sponsor of the legislation. Roth accounts are simply a retirement account that can be in the form of an individual retirement account or an employer sponsored retirement account that allow for tax-free growth of earnings and thus, tax-free income.

The main difference between a Roth and a traditional IRA or employer sponsored plan lies within the timing of the taxation. We are all very familiar with the typical scenario of putting money away for retirement through an employer plan, whereby they deduct money from our paychecks and put it directly into a retirement account. This money is taken out before taxes are calculated so we do not pay tax on those earnings today. A Roth account on the other hand takes the money after the taxes have been taken out and then puts it into the retirement account, so we do pay tax on the money today. The other significant difference between these two is taxation during distribution in later years. With our traditional retirement accounts when we take the money out later it gets added to our ordinary income and gets taxed accordingly. Additionally, by including this in our income it subjects us to such things mentioned above for municipal bonds with Social Security taxation, AMT, as well as higher Medicare premiums. A Roth on the other hand gets distributed tax-free and does not contribute toward negative impact items such as Social Security taxation, AMT, or Medicare premium increases. It essentially comes back to us without tax and other obligations.

The best way to view the difference between the two accounts is to look at the life of a farmer. A farmer will buy seed, plant it in the ground, grow the crops, and harvest it later for sale. Typically, the farmer would only pay tax on the crops that have been harvested and sold. Let me ask the question however, if you were the farmer, would you rather pay tax on $5,000 worth of seed that you plant today or $50,000 worth of harvested crop later? The obvious answer is $5,000 worth of seed today. The truth to the matter is that you are a farmer, only you plant dollars into your retirement account instead of seeds into the earth.

So why doesn't everyone have a Roth retirement account if things are so simple? There are several reasons, but the single greatest reason has been the constraints on contributions. If you earned over certain thresholds (MAGI over $125,000 single and $183,000 joint for 2012), you were not eligible to make contributions, and until last year if your modified adjusted gross income (MAGI) was over $100,000 (single or joint) then you could not convert a traditional to a Roth. Outside of these contribution limits, most people save for retirement through their employers and most employers are not offering Roth options within their plans. The reason behind this is because Roth accounts are not that well understood and people have been educated to believe that saving on taxes today is the best possible course of action.

Tax-Free Money: Life Insurance

As I previously mentioned, the single greatest tax asset that has come from Congress outside of life insurance is the Roth account. Life insurance is the little known or discussed tax asset that holds some of the greatest value for our financial lives both during life and upon death and is by far the best tax-free device available. We traditionally view life insurance as a way to protect our loved ones from financial ruin upon our demise and it should be noted that everyone who cares about someone should have life insurance. By purchasing a life insurance policy our loved ones will be assured a financial windfall from the life insurance company when we die to help them with our final expenses and carry on their lives without us comfortably. The best part about the life insurance windfall is the fact that nobody will have to pay tax on the money received. This is the single greatest tax-free device available, but it has one downside, we do not get to use it … only our heirs will.

The little known and discussed part of life insurance is the cash value build-up within whole life and universal life (permanent) policies. Life insurance is not typically seen as an investment vehicle for building wealth and retirement planning, although we should discuss briefly why this thought process should be re-evaluated. Permanent life insurance is generally misconceived as something that is very expensive for a wealth accumulation vehicle as there are mortality charges (fees for the death benefit) that detract from the returns that are available and further, those returns do not yield as much as the stock market over the long run. This is why many times you will hear the phrase "buy term and invest the rest," where "term" refers to term insurance.

Let us take just a second to review two terms just used in regard to life insurance: term and permanent.

Term insurance is what most people are familiar with, you purchase a certain death benefit that will go to your heirs upon your death and this policy will be in effect for a certain number of years, typically ten to twenty years. The ten to twenty years is the term of the policy and once we have reached that end we no longer have insurance unless we purchase another policy at that point.

Permanent insurance on the other hand has no term involved, it is permanent as long as the premiums continue to be paid. Permanent insurance generally has higher premiums than term insurance for the same amount of death benefit coverage and it is this difference that is referred to when people say "invest the rest."

The cash accumulation value can be used for tax-free income…

Simply speaking there are significant differences between these two policies that do not get taken into consideration when providing a comparative analysis in the numbers. One item that gets lost in the fray when comparing term and permanent insurance is that term usually expires before death, in fact insurance studies show less than 1 percent of all term policies pay out death benefit claims. The issue arises when the term expires and the desire to have more insurance is still present. A term policy with the same benefit will be much more expensive than the original policy and many times life events occur with illness such as cancer or heart conditions that make it impossible to acquire another policy, leaving our loved ones unprotected and tax-free legacy planning out of the equation.

Another aspect and probably the most important piece in consideration of the future of taxation is the fact that permanent insurance has a cash accumulation value. Two aspects stand out with the cash accumulation value. First, as the cash accumulation value increases the death benefit will also increase where term insurance is level. Second, this cash accumulation offers value to you during your lifetime rather than just your heirs upon death. The cash accumulation value can be used for tax-free income during your lifetime through policy loans. Most importantly, this tax-free income is available during retirement for distribution planning, all while offering the same typical financial protection to your heirs.

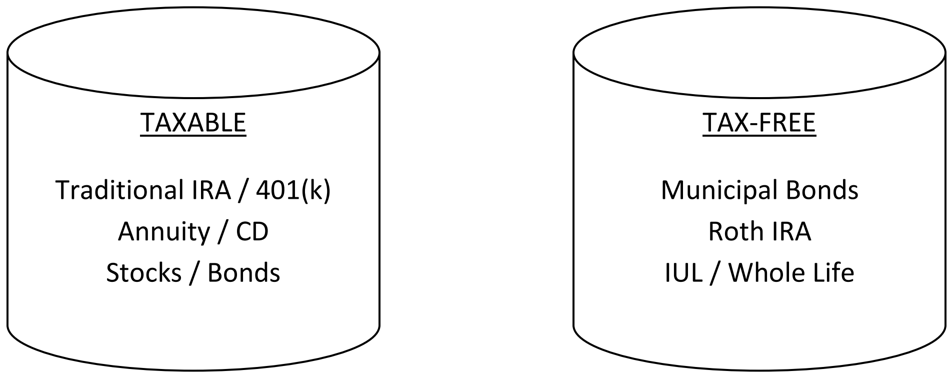
Tax-Deferred Money

Tax-deferred money is the type of money from which most of us are familiar and has been reviewed briefly already, so I will not spend much time reviewing them here. Tax-deferred money is typically our traditional IRA, employer sponsored retirement plan, or a non-qualified annuity. Essentially we put money into an investment vehicle that will accumulate in value over time and we do not pay taxes on the earnings that grow these accounts until we distribute them. Once the money is distributed taxes must be paid and in addition to the taxes, the same negative consequences exist toward additional taxation and expense in other areas as previously discussed.

Taxable Money

Taxable money is everything else and is taxable both today and later, whenever it is received.

Of these four types of money, they really come down to two distinct classifications; taxable and tax-free.



The greatest difference in discussing comparison between taxable and tax-free income is a function of how much money we keep after tax. For help in determining what the differences should be, exclusive of outside factors such as Social Security taxation and AMT, a tax equivalent yield should be used. Below is a taxable equivalent yield table that will show how much taxable earning will be needed to break-even with a tax-free yield given your incremental tax bracket.

Taxable Equivalent Yield Table					
	Federal Marginal Tax Bracket				
	15 percent	25 percent	28 percent	33 percent	35 percent
Tax-Free Yield	A Taxable Investment Must Have This Yield or Higher				
4 percent	4.7 percent	5.3 percent	5.6 percent	6.0 percent	6.2 percent
5 percent	5.9 percent	6.7 percent	6.9 percent	7.5 percent	7.7 percent
6 percent	7.1 percent	8.0 percent	8.3 percent	9.0 percent	9.2 percent
7 percent	8.2 percent	9.3 percent	9.7 percent	10.4 percent	10.8 percent
8 percent	9.4 percent	10.7 percent	11.1 percent	11.9 percent	12.3 percent

Tax-Free in the Real World

To put the tax equivalent yield into perspective, let us look at an example:

Bob and Mary are currently retired and in the 25 percent tax bracket living on Social Security and interest from investments. They have a substantial portion of their investments in municipal bonds yielding 6.0 percent, which in today's market is quite comforting. The tax equivalent yield they would need to earn from a taxable investment would be 8.0 percent, a 2.0 percent gap which seems almost impossible given current market volatility. However, something that has never been put into perspective is that the interest from their municipal bonds is subject to taxation on their Social Security benefits [9](at 21.25 percent). With this, the yield on their municipal bonds would be 4.725 percent[10], and the taxable equivalent yield falls to 6.3 percent leaving a gap of only 1.575 percent.

In the end, most of us spend our lives accumulating wealth through the best, if not only vehicle we know, a tax-deferred account. This account is most likely a 401(k) or 403(b) plan offered through our employer and may be supplemented with an IRA that was established at one point or another. As the years go by, we blindly throw money into these accounts in an effort to save for a retirement that we someday hope to reach.

The truth is we all have an age selected for when we would like to retire but spend our lives wondering if we will ever be able to actually quit working. To answer this question, we must understand how much money we will have available to contribute toward our needs. In other words, we need to know what our after-tax income will be during this period.

All else being equal, it would not matter if you put your money into a taxable, tax-deferred, or tax-free account as long as income tax rates never change and outside factors are never an event. The net amount you receive in the end will be the same. Unfortunately, none of this will ever be the circumstance. We already know that taxes will increase in the future with the likely forecast of being higher in retirement than during our peak earning years.

Regardless, saving for retirement in any form is a good thing since it appears from all practical perspectives that future government benefits will be cut and taxes will increase. We have the ability to plan today for efficient tax diversification and maximization of our after-tax dollars during our distribution years. Don't let your opportunity become Uncle Sam's socialized retirement.

---

[9] Assuming each dollar of interest subjects a dollar of Social Security income to taxation at 85 percent

[10] 6.0 percent - (6.0 percent - 21.25 percent) = 4.725 percent