TAX PLANNING IN TODAY'S ECONOMIC ENVIRONMENT

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As you plan for retirement, you face choices as to how you invest your money. Should you participate in an employer-provided plan? Should you set up an IRA, and if so, does a Roth IRA make sense? Should you simply invest in stocks and bonds without using a retirement vehicle? How much should you invest in municipal bonds versus corporate stocks or bonds? Should you buy permanent life insurance or annuities?

These questions and countless others are often difficult to answer. When you are trying to decide how to invest your money, start with figuring out why you're investing, for example:

- Retirement
- Family legacy
- Charity

If you're investing primarily to create a comfortable retirement, you'll want to choose investments that one day will help maximize your retirement income. Part of maximizing means planning to deal with taxes.

Knowing when your income will be taxed is only half the battle. You also need to know what the tax rate for your future income will be. Unfortunately, it is impossible to accurately predict the future tax rates to which your money will be subject.

To get a better idea of where the tax rates might be headed, we'll look at the current economic landscape, particularly the rising national debt. Additionally, we'll look at a brief history of U.S. tax rates.

FEDERAL DEFICIT AND DEBT

The national debt is how much the United States owes to its creditors, while the deficit represents the yearly growth of the national debt — i.e., by how much more it spends than earns.

Consider Esther, who brings home $3,300 per month from her job. Let's say she is in debt for $17,000 on her credit card, and spends $4,000 per month on various expenses including rent, consumables, interest payments on her outstanding debt, assistance to her elderly parents, health care and tuition.

Since she is spending $700 more than she earns every month — i.e., her monthly deficit — she puts it on her credit card. She is quickly approaching her credit card limit, but her bank allows her to increase this limit as necessary since she has never defaulted. How long can she continue this type of spending before she must increase her revenue by working more hours?

This is a similar situation to the U.S. government.

If the government reaches its debt ceiling, it will no longer be able to borrow money to meet its obligations. It can either reduce the deficit by a combination of increased tax revenue and decreased spending, or it can default on any number of its obligations. A default would be disastrous, resulting in a hit on its credit rating, higher interest rates, higher prices on consumables and inflation. This is why Congress increases the debt ceiling as the national debt reaches this level.

However, just because Congress allows the government to borrow as much as it can doesn't mean there isn't a limit. If the government's debt becomes too high in relation to GDP, its credit rating might get lowered, resulting in problems similar to those associated with a default. Does this mean a tax hike or budget cuts are imminent?

Not necessarily. Let's go back to Esther. Assume that of the $4,000 she spends every month, $3,000 goes toward consumption that doesn't yield any return. For example, when she pays rent or gives money to her elderly parents, she doesn't expect to get any of this money back, and it's not creating an asset that will make her more money in the future.

However, $1,000 is spent on tuition, which she hopes will help her find a better job, leading to an increase in her income to $4,500 per month — a $1,200 increase. If her assumptions are correct, she would now have a monthly surplus of $500 in the future, and could use this to either pay off some of her debt, or invest it elsewhere to further augment her monthly pay. At any rate, she would be operating on a surplus instead of a deficit, so she would no longer have to increase her hours worked or reduce spending to meet budgetary constraints.

Similarly, the government spends money in a variety of ways. Some of it funds public consumption (e.g., Social Security, Medicare and Medicaid) while other expenditures fund economic growth. Theoretically, the investments in economic growth would increase the gross domestic product, resulting in more tax revenue and more sources from which the government can borrow funds. This is known as "supply-side economics."

The U.S. national debt currently (as of February 2022) sits at over $30 trillion,[1] while the gross domestic product was just above $24 trillion in the fourth quarter of 2021.[2] The current debt-to-GDP ratio is at approximately 125% ($30 trillion divided by $24 trillion).[3] What does that mean? There is no clear answer, but experts contend that the debt-to-GDP ratio should be no higher than 80% to 90%[4] — and probably closer to 60%.[5]

Assuming the GDP doesn't grow at a fast enough rate to bring the debt-to-GDP ratio down to an appropriate level, the U.S. government would have to increase tax revenue to decrease or even eliminate the yearly deficit.

There are two primary means of increasing tax revenues: (1) increase the tax rate; or (2) broaden the tax base. Many believe that because the national debt has reached such enormous levels, tax rate increases are imminent since the debt needs to be paid off with tax revenue.

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[1] *Erin Duffin. Statista. March 14, 2022. "United States - public debt 2021/22, by month." https://www.statista.com/statistics/273294/public-debt-of-the-united-states-by-month/. Accessed April 26, 2022.*

[2] *Bureau of Economic Analysis. Feb. 24, 2022. "Gross Domestic Product, Fourth Quarter and Year 2021 (Second Estimate)." https://www.bea.gov/news/2022/gross-domestic-product-fourth-quarter-and-year-2021-second-estimate. Accessed April 26, 2022.*

[3] *Federal Reserve Bank of St. Louis, U.S. Office of Management and Budget. "Federal Debt: Total Public Debt as Percent of Gross Domestic Product." https://fred.stlouisfed.org/series/GFDEGDQ188S. Accessed April 26, 2022.*

[4] *Reuters. Oct. 22, 2013. "Fitch: 80%-90% Debt to GDP Usually Maximum for 'AAA' Sovereign Ratings." https://www.reuters.com/article/fitch-80-90-debt-to-gdp-usually-maximum/fitch-80-90-debt-to-gdp-usually-maximum-for-aaa-sovereign-ratings-idUSFit67222220131022. Accessed April 26, 2022.*

[5] *Anis Chowdhury and Iyanatual Islam. VOX. "Is there an optimal debt-to-GDP ratio?" http://voxeu.org/debates/commentaries/there-optimal-debt-gdp-ratio. Accessed April 26, 2022.*

HISTORY OF DEBT, GDP & TAX RATES

Federal income tax rates are still relatively low compared to historic rates. For example, between 1982 and 1986, the income tax rates reached as high as 50%. Before that, the top tax rates reached 70% and as high as 94%, largely due to World War II.

Historically, there has been a correlation between the national debt-to-GDP ratio and the tax rates. For example, the debt-to-GDP ratio increased due to World War I, and the federal income tax rates followed. Then the roaring '20s arrived and the debt-to-GDP ratio decreased along with the income tax rates. The Great Depression followed, along with World War II, bringing higher debt-to-GDP ratios along with higher tax rates (reaching levels over 90%). The tax rates stayed relatively high (70% for top earners) as the debt-to-GDP levels decreased until the early 1980s.

This is where the correlation begins to weaken. Since the early 1980s, the debt-to-GDP ratio has generally continued rising, but the tax rates have decreased or stayed level, with one exception in the 1990s when the highest tax rates increased from 31% to 39.6% and the debt-to-GDP ratio declined temporarily.

In the 2000s, the United States faced wars and a major recession. We're currently seeing the highest debt-to-GDP ratio since the aftermath of World War II. However, our tax rates are currently less than half what they were then. While there are many more political and economic factors that affect our tax rates, the trends and history suggest that tax rates must rise.

TAX CHANGES SINCE 2013

In 2013, Congress both increased the tax rates and broadened the tax base with respect to a number of taxes when it enacted the American Taxpayer Relief Act (ATRA).

Income Taxes After ATRA

By enacting ATRA, Congress increased the top income tax rate to 39.6% for high-income taxpayers.[6] This was up from 35% in the previous years.

The top tax rate for capital gains also increased for high-income taxpayers in 2013, from 15% to 20%. Additionally, the qualified dividend tax rate saw an increase from 15% to 20% for high-income taxpayers.

Medicare Surtax

As part of the Affordable Care Act, Congress had broadened the tax base by implementing a new 3.8% Medicare surtax in 2013 on investment income for high-income taxpayers. The tax applies to the amount of net investment income in excess of the threshold when net investment income is added to other income.

The threshold is $250,000 for married taxpayers filing jointly, $200,000 for single taxpayers and $125,000 for married taxpayers filing separately.

Tax Cuts and Jobs Act

In late 2017, the Tax Cuts and Jobs Act (TCJA) was enacted, effective for tax years beginning in 2018.

As a result of the TCJA, the standard deduction has increased significantly — from $12,700 in 2017 for a married couple to $25,900 in 2022. As a practical matter, that means that fewer taxpayers itemize deductions, choosing instead to claim the standard deduction. As a consequence of the increase in the standard deduction, itemized deductions such as mortgage interest or charitable gifts have become less valuable for many. To further lessen the value of itemized deductions, the mortgage interest deduction and state and local tax deduction have also been curtailed.

While the standard deduction has been substantially increased, the personal deduction — $4,050 in 2017 — has disappeared.

To further complicate matters, rates and tax brackets have all changed as a result of TCJA. For most taxpayers, tax rates imposed by TCJA are lower than they were before the law's enactment.

The TCJA also created a special tax credit available for many small businesses taxed as pass-through entities.

Advocates of the TCJA were optimistic that the economic stimulus provided by the new rules would ultimately lower the debt-to-GDP ratio. So far, that hasn't happened.

Without legislative action, many of the changes in the TCJA are set to expire after 2025 and revert to the pre-2018 tax rates.[7]

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[6] *William Ruane. Office of Associate Chief Counsel (Income Tax & Accounting). Internal Revenue Service. Oct. 25, 2016. "26 CFR 601.602: Tax forms and instructions." https://www.irs.gov/pub/irs-drop/rp-16-55.pdf. Accessed April 26, 2022.*

[7] *Tax Policy Center. "How did the Tax Cuts and Jobs Act change personal taxes?" https://www.taxpolicycenter.org/briefing-book/how-did-tax-cuts-and-jobs-act-change-personal-taxes. Accessed April 26, 2022.*

WHAT DOES THIS MEAN?

Why spend so much time discussing the economic landscape, recent legislative history and new tax rates? It shows that taxpayers can't necessarily count on tax rates to stay the same as they are currently. Individuals may want to implement strategies that are designed to lower their taxable income in the future.

You can never be completely sure what item of income or wealth will be taxed and by how much it will be taxed. For example, Congress could decide to broaden the tax base by taxing life insurance proceeds as ordinary income to the beneficiary.

If you believe tax rates will only increase, one potential strategy is to invest in currently taxed assets to avoid future tax liability. Or you may want to look into tax-free income options such as life insurance or municipal bonds. Keep in mind, though, that certain tax advantages often come at a cost.

TAX-FREE & TAX-DEFERRED INCOME

All else being equal, tax-free money is the best type of income. There are three main types of investments that produce tax-free income:

1. Municipal bonds
2. Roth IRAs
3. Life insurance held until death

While paying no tax on income is obviously better than the alternative, it comes at a cost, which may negate its benefits.

Municipal Bonds

Municipal bonds are debt obligations issued by a federal, state or local government. When you invest in a municipal bond, you are essentially loaning the governmental entity money in exchange for a set amount of interest to be paid over a predetermined period. At the end of the term, the full amount that you invested is returned to you.

Interest earned from an investment is usually subject to ordinary income tax rates, but under the current rules, interest paid on municipal bonds is generally tax-exempt if the bonds are used to fund governmental projects constructed for the public good.

The federal taxation of municipal bonds is complex. To add to the complexity, each state has its own laws governing municipal bonds. However, most states do not tax individuals on the interest arising from municipal bonds issued by that state.

For the sake of considering the costs and benefits of investing in municipal bonds, let's assume that such bonds are income tax-free on both a state and federal level.

First, the benefits have already been discussed — the income from such bonds is income tax-free. This means that a municipal bond has a higher after-tax yield than a corporate bond with the same interest rate.

For example, let's assume the going rate for a corporate bond is 8%. If a taxpayer is in the 25% tax bracket, the effective rate of growth on the bond is actually 6% (i.e., the 8% interest rate is decreased by 25%). As you can see, since the municipal bond is income tax-free, it can pay a lower interest rate and remain equally as effective as a taxable bond paying a higher rate.

What are the problems with municipal bonds? First, municipal bonds generally pay a lower interest rate than other investment options.

Second, tax-free income from municipal bonds can also affect your Social Security benefits. This is because such interest is added back to the equation for determining your modified adjusted gross income (MAGI) for Social Security. This could push your income levels high enough to expose your benefits to taxation.

As with any investment, you should compare the costs and benefits of investing in municipal bonds. While the interest earned from these bonds is generally tax-free, you should be aware of the possible consequences to your Social Security benefits and to the alternative minimum tax to which the bonds might subject you. Furthermore, you should be aware of the possible reduced interest rates on municipal bonds and the possible state taxes such bonds may incur.

Bond obligations are subject to the financial strength of the bond issuer and its ability to pay. Before investing, consult your financial professional to understand the risks involved with purchasing bonds.

Roth IRAs

Investing in a Roth IRA can be another powerful tool to avoid income taxes on its growth. To fully understand the costs and benefits of investing in a Roth IRA, you need to know how they differ from traditional IRAs.

Here's the main difference: When you earn income and contribute to a traditional IRA, you don't currently pay taxes on that income. However, when you withdraw money from the traditional IRA, you will incur income taxes on the full amount that you withdraw.

Conversely, when you earn income and contribute to a Roth IRA, you are still required to pay taxes on that income. On the other hand, when you take money out of the Roth IRA, you generally do not incur any income taxes on that amount, assuming the account has been open for at least 5 years and you are over age 59 ½.

Simply put, traditional IRAs grow tax-deferred while Roth IRAs grow tax-free. How does this affect your investment?

Here's an example: Floyd earns $50,000 in 2022 before taxes. As the year winds down, his employer decides to give Floyd a $5,000 bonus due to his exceptional work. Floyd decides he wants to save this money for retirement. Let's assume he narrows his choices down to either contributing to a traditional or Roth IRA.

If he makes a deductible contribution to a traditional IRA, the $5,000 bonus is essentially untaxed for now, so he can invest the full $5,000 into the IRA. Conversely, if he invests in a Roth IRA, the $5,000 bonus will currently be taxable income. Floyd is in the 22% tax bracket for 2022, so he will incur a $1,100 tax bill on his bonus. He's left with $3,900 to invest in the Roth.

Now let's assume that both IRAs invest in the same exact investments, which grow at about a 7.2% rate, roughly doubling every 10 years. In 20 years, the $5,000 invested in the traditional IRA grows to $20,000, but will be subject to tax when distributed (i.e., it's tax-deferred). Assuming Floyd remains in the 22% tax bracket, this $20,000 is subject to a $4,400 tax, resulting in a net $15,600 upon its distribution.

What about the Roth IRA? The $3,900 invested would grow to $15,600, and upon its distribution, Floyd would receive the full $15,600 income tax-free.

As you can see, there is no difference in these two options. However, if you expect your tax rates to be higher when you decide to withdraw your money from the IRA, Roths begin to look more appealing.

Why would your tax rates increase? The two primary reasons are:

1. You are earning more income in the year you withdraw the money, and are therefore subject to a higher income tax bracket; or

2. The federal government raises your tax rates.

For example, assume the same facts as the previous example. However, assume also that in 20 years, Congress has increased income tax rates so that now Floyd is in a 50% tax bracket. His Roth IRA would be unaffected because such distributions are not subject to federal income taxes. Thus, Floyd keeps all $15,600. If, instead, he had invested in a traditional IRA, he would be subject to a $10,000 tax — i.e., half of the entire distribution. After taxes, he would only retain $10,000 as opposed to the $15,600 from the Roth account.

There are two limitations with Roth IRAs. First, in 2022, you may only contribute $6,000 to your IRA, plus an additional $1,000 if you're age 50 or older. Second, once your income level reaches $129,000 if single, or $204,000 if filing jointly, the maximum amount you may contribute to a Roth IRA begins decreasing. If your adjusted gross income reaches $144,000 if single, or $214,000 if filing jointly, you cannot contribute to a Roth IRA for that year.[8]

Life Insurance

Finally, life insurance proceeds also provide an option to receive money tax-free. Life insurance comes in two main forms:

1. Term life insurance
2. Permanent life insurance

When most people hear about life insurance, the first thing they usually think of is term life insurance, where you enter into a contract that provides a certain death benefit that will go to your heirs upon your death. In exchange for this possible death benefit, you must pay predetermined monthly premiums for a predetermined term — usually 10 or 20 years. If you don't die within the term, you won't receive anything from the policy.

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[8] *IRS.gov. Nov. 5, 2021. "Amount of Roth IRA Contributions That You Can Make for 2022." https://www.irs.gov/retirement-plans/plan-participant-employee/amount-of-roth-ira-contributions-that-you-can-make-for-2022. Accessed April 26, 2022.*

On the other hand, as long as the premiums are paid, permanent life insurance will pay a death benefit. Because a death benefit will ultimately be paid, premiums under such policies are generally higher than term insurance contracts. However, as you make payments, the death benefit of the contract typically increases.

If the life insurance policy is a non-modified endowment contract (non-MEC), you are generally allowed to withdraw funds from the cash accumulation value tax-free up to the amount you have contributed into it. For example, if you have a policy with a cash value of $100,000 and have contributed $75,000 in premiums, you may take a distribution of up to $75,000 income tax-free. The next $25,000 will incur taxes at ordinary income tax rates. If the policy is a modified endowment contract (MEC), withdrawals and policy loans are fully taxable as income to the extent that there is a gain in the policy over the amount of net premiums paid. Taxable distributions are also subject to a 10% federal tax penalty if the owner is below age 59 ½.

On the other hand, if you die without taking any distributions, the beneficiaries of the policy will receive the death benefit income tax-free.

One downside to planning for retirement with a life insurance contract is that the tax advantages are generally not available until your death. However, if the policy is a non-MEC, you will be able to borrow from the cash value throughout your life without incurring income taxes as long as the insurance contract is still in force. If the policy lapses, the entire cash value of the policy — including the amount of the debt you've withdrawn — will be treated as a distribution. This would result in ordinary income to the extent the cash value exceeds your contributions.

Assuming the policy remains in force, at your death, the life insurance company retains the amount of the outstanding loan from your death benefits, and what remains is distributed to your named beneficiaries without incurring income taxes.[9]

Tax-Deferred Money

Tax-deferred money is basically earned income that is not subject to income taxes until a later date. Qualified retirement plans (e.g., 401(k), 457(b) and 403(b) accounts) and traditional IRAs are common examples of plans enabling tax-deferred treatment. Not only is the tax on the actual income deferred until a later date, but the growth on the income is deferred as well.

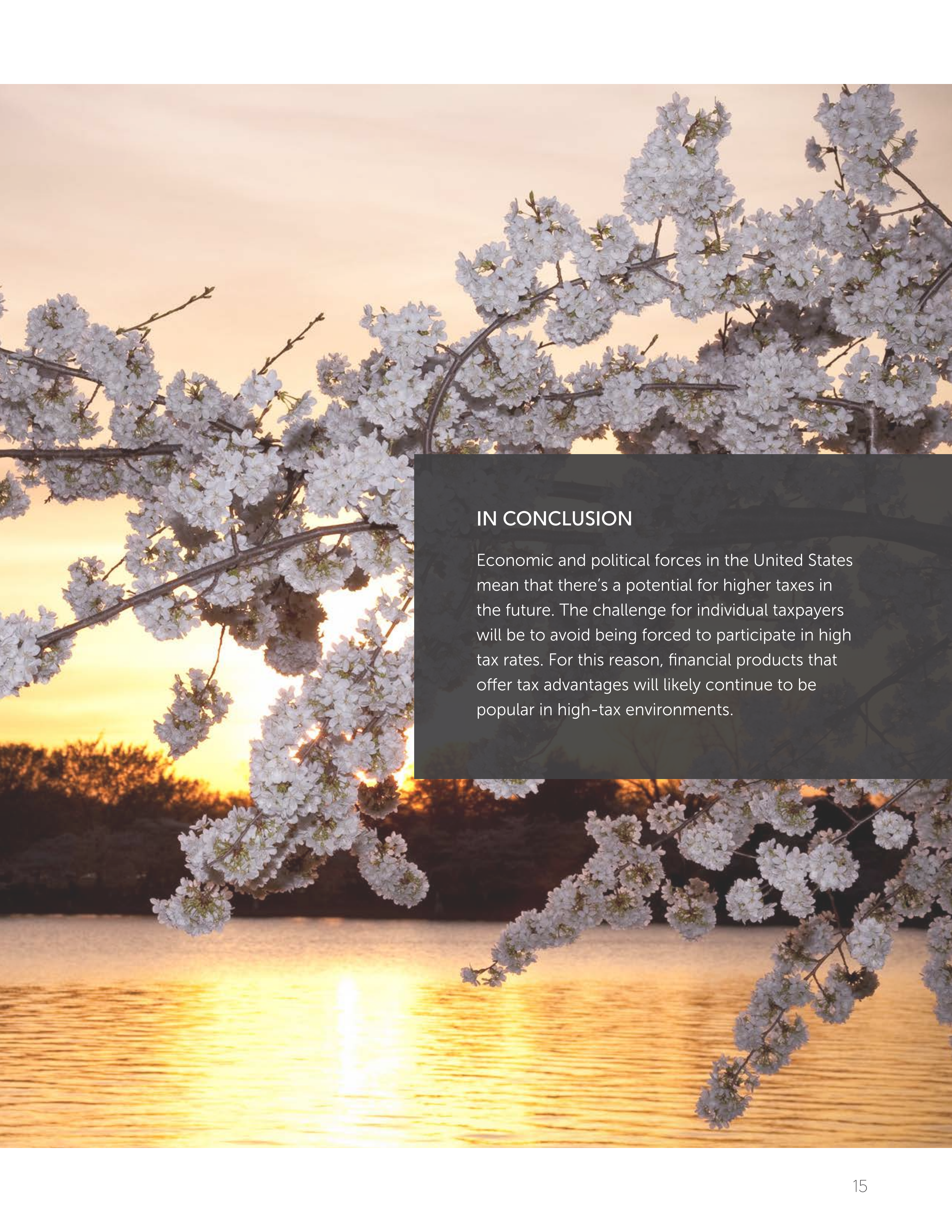
[9] Life insurance involves fees and charges, including surrender penalties for early withdrawals. You may need to qualify medically and potentially financially for coverage. Life insurance death benefits are generally tax-free to a properly named beneficiary.

Policy loans and withdrawals will reduce available cash values and death benefits, and may cause the policy to lapse or affect any guarantees against lapse. Additional premium payments may be required to keep the policy in force. In the event of a lapse, outstanding policy loans in excess of unrecovered cost basis will be subject to ordinary income tax. Tax laws are subject to change. You should consult a tax professional.

For example, assume Floyd's employer has a 401(k) plan set up for its workers, and that Floyd is in the 22% tax bracket. If Floyd contributes $1,000 of his income to the 401(k) plan this year, then that amount is not included in Floyd's gross income. He therefore is deferring paying $220 in taxes until a later date.

Floyd doesn't completely avoid paying taxes on his contributed money — he merely defers it until a later date. So how much is the deferral of income worth? Let's say he distributes the same $1,000 in 30 years. Assuming he's in the same income bracket, he will incur $220 in taxes 30 years from now. Using a present value calculator, we find that $220 in 30 years is worth only $66.40 today, discounted at a 4% interest rate. The difference, $153.60, is what it's worth to defer the tax on this income.

Keep in mind that all distributions from qualified retirement plans are subject to ordinary income taxes, and if taken before age 59 ½, an additional 10% federal tax penalty.



IN CONCLUSION

Economic and political forces in the United States mean that there's a potential for higher taxes in the future. The challenge for individual taxpayers will be to avoid being forced to participate in high tax rates. For this reason, financial products that offer tax advantages will likely continue to be popular in high-tax environments.

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