April 2016 – Taxes and Politics

"Home life ceases to be full and beautiful as soon as it is founded on borrowing and debt." – Henrik Ibsen, Playwright often called the Future of Realism

Tax Proposals

Generally, we avoid talking about politics; however, since taxes and politics clearly intersect, your investments can be directly affected. Therefore, we are devoting this letter to the current tax proposals by the leading candidates. As 2016 passes, it looks like the two national parties are settling on two different visions.

We are focusing here on Hillary Clinton's and Donald Trump's proposals. In no way do we want to exclude Bernie Sanders, Ted Cruz, John Kasich or anyone else; however, we believe that no plan will ever be proposed without some modification, and there are two philosophes – a Democratic one and a Republican one. (As we discuss this below, we hope your eyes don't glaze over but this is important to all of us.)

Hillary Clinton's plan would significantly increase taxes on the "top one percent". However, in the end the increases are broader than just the "one percent" and would likely impact many in the middle class.

Donald Trump's tax plan would reduce income taxes on individuals and businesses, but the cost would likely significantly increase the federal deficit.

So, who are the "one percent"? Based on the most recent information available from the IRS, they are taxpayers who have incomes of $428,712 or more, and, before concluding that most will never be in that exclusive club, remember that this proposal would also include capital gains such as a sale of a business or appreciated stock held for a long time. Also, while the rhetoric is usually about the "one percent", most of the proposals actually impact the top five percent which would be those with incomes above $179,759.

<u>Clinton Tax Proposals</u>

- No changes to most tax rates. Top rate would remain 39.6% for most taxpayers;
- Impose 30% minimum tax on income above $1 million (also known as the "Buffett Rule");
- Impose 4% surcharge on incomes above $5 million (43.6% rate);
- Extend capital gains holding period to six years for taxpayers in the 39.6% bracket;
- Limit deductions for high-income tax payers; and
- Increase and expand the estate tax.

Clinton's proposals generally don't increase or reduce taxes for most taxpayers. High income individuals will be hit with substantial additional taxes. The danger, of course, is that in order to raise significant new revenue, more middle income individuals will need to be classified as high income individuals.

<u>Trump Tax Proposals</u>

- Lower individual tax rates with only 4 rates – 0%, 10%, 20%, and a top rate of 25 percent;
- Over 73 million households (for example – a married couple filing jointly with income under $50,000) would pay zero income tax;
- Dividends and capital gains would be taxed at a maximum rate of 20 percent;
- Estate tax would be eliminated;
- Alternative minimum tax would be eliminated; and
- Itemized deductions for the wealthy would be limited.

In addition, the Trump plan would tax “business income” at a flat rate of 15%. For example, income from a business would be taxed at this rate regardless of whether it was earned in a sole proprietorship, partnership, LLC, or a regular corporation. This provision would be a huge benefit to individuals who own a family business.

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Without any new tax plan the current projection by the Congressional Budget Office is that the Federal deficit will begin to increase this year and will grow another $600 billion to about $1.1 trillion a year ten years from now. Such deficits would increase the U.S. government debt higher to a total of $21 trillion in ten years.

In 2015, the interest cost on the Federal debt was approximately $400 billion. If the projections are accurate, and interest rates do not increase, the annual interest cost would be about 50% higher totaling about $600 billion per year; however, note that each 1% increase in average interest rates would add $200 billion to that number.

Clinton’s plan would increase tax revenue per the Tax Policy Center by about $1.1 trillion during this period yet in total it has less change than Trump’s plan. She claims she is going to lower taxes for others but many of these others pay no taxes now; and any such decrease would, of course, decrease tax revenue.

A major drawback (or benefit depending on your perspective) to Trump’s plan would be to reduce Federal revenue by $9.5 trillion over a ten year period. Unless the revenue can be raised elsewhere or Congress makes like sized cuts to Federal spending, the Federal deficit will continue to increase from the levels above which we believe already is barely manageable.

Neither plan fundamentally changes the Federal income tax system. The Clinton plan simply raises the tax rate on high income earners. The Trump plan simplifies and decreases the rate structure but the provision for taxing business income at a lower rate likely adds much complexity to the tax code. The end result is that Clinton’s plan would not require as much debt as Trump’s plan. Note that it is difficult to project the deficits as neither party have been very specific about spending plans.

Also note that our new President, regardless of the party, will not control the process. Most tax law is crafted in Congress and its tax writing committees by long-term staff. Other leaders, such as the House Speaker and the Ways and Means Chairman, will have great influence on any changes. Thus, Congress will have a significant say on taxes and spending.

Taxes are an important issue, not only because of the personal impact, but because of the overall impact on our nation’s economy. When viewed in this context, the tax policies of the two candidates help highlight the differences between the two parties.

The reason this all becomes very important to you and your investments is that any tax on your investments reduces your return, and the lower the return the longer it will take to reach your overall financial objectives.

As always we are grateful to you for your trust.