Financial Alternatives
integrated wealth management

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Tax Reform—or Not?

You can be forgiven if you're skeptical that Congress will be able to completely overhaul our tax system after failing to overhaul our health care system, but professional advisors are studying the recently-released nine-page proposal closely nonetheless. We only have the bare outlines of what the initial plan might look like before it goes through the Congressional sausage grinder.

Executive Summary

- The recent tax proposal would significantly change income taxes, but there are many important provisions that have not been specified.
- The most noteworthy part of the proposal is a full repeal of the estate tax.
- Due to the makeup of Congress and the expected costs of the tax proposal, some sort of compromise will be required to push any changes through.
- The 10 year anniversary of a record S&P 500 high point is upon us, with several other crisis period anniversaries like the Lehman bankruptcy coming in succeeding months.
- Reflecting on your experience back then and looking at the recoveries of other financial crises can help prepare you for the next one.
- A key part of a good long-term investing experience is being able to stay with your investment philosophy, even during tough times.

Outline of the Proposal

The current seven tax brackets for individuals would be reduced to three — a 12%, rate for lower-income people (up from 10% currently), 25% in the middle and a top bracket of 35%. The proposal doesn't include the income cutoffs for the three brackets, but if they end up as suggested in President Trump's tax plan from the campaign, the 25% rate would start at $75,000 (for married couples), and joint filers would start paying 35% at $225,000 of income.

The alternative minimum tax, which was created in the late 1960's to ensure that upper-income taxpayers would not be able to finesse away their tax obligations altogether, would be eliminated under the proposal. But there is a mysterious notation that Congress might impose an additional rate for the highest-income taxpayers, to ensure that wealthier taxpayers don't contribute a lower share than they pay today.

The initial proposal would nearly double the standard deduction to $12,000 for individuals and $24,000 for married couples, and increase the child tax credit, now set at $1,000 per child under age 17.

At the same time, the new tax plan promises to eliminate many itemized deductions, with simply a promise to keep deductions for home mortgage interest and charitable contributions. The plan mentions tax benefits that would encourage work, higher education and retirement savings, but gives no details of what might change in these areas.

The most noteworthy part of the proposal is a full repeal of the estate tax and generation-skipping estate tax. Although these taxes only affect a small percentage of the population, an enormous amount of estate planning and calculations are involved for these families.

The plan would also limit the maximum tax rate for pass-through business entities like partnerships and LLCs to 25%, which might allow high-income business owners to take their gains through the entity rather than as income and avoid the highest personal brackets.

Finally, the tax plan would lower the maximum corporate tax rate from the current 35% to 20%. To encourage companies to repatriate profits held overseas, the proposal would introduce a 100% exemption for dividends from foreign subsidiaries in which the U.S. parent owns at least a 10% stake, and imposes a one-time "low" (not specified) tax rate on wealth already accumulated overseas.

Possible Implications

What are the implications of this bare-bones proposal? The most obvious, and most remarked-upon, is the drop that many high-income taxpayers would experience, from the current 39.6% top tax rate to 35%. That, plus the elimination of the estate tax, plus the lowering of the corporate tax (leading to higher dividends) has been described as a huge relief for upper-income investors, which could fuel the notion that the entire exercise is a big giveaway to large donors. But the mysterious "surcharge" on wealthier taxpayers might take away what the rest of the plan gives.

Many business owners with S corporations, LLCs or partnership entities would potentially receive a much greater windfall - if they could choose to pay taxes on their corporate earnings at 25% rather than nearly 40%.

A huge unknown is which deductions would be eliminated in return for the higher standard deduction. Would the plan eliminate the deduction for state and local taxes, which is especially valuable to people in high-tax states such as

California, New York, and New Jersey, and in general to higher-income taxpayers who pay state taxes at the highest rate?

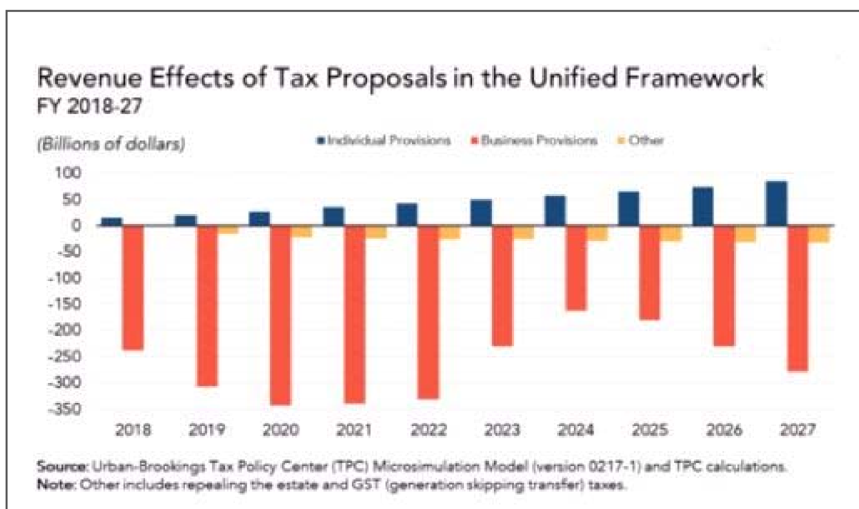
Currently, about one-third of the 145 million households filing a tax return — or roughly 48 million filers — claim this deduction. Among households with income of $100,000 or more, the average deduction for state and local taxes is around $12,300. Some economists have speculated that people earning between $100,000 and around $300,000 might wind up paying more in taxes under the proposal than they do now. Taxpayers with incomes above $730,000 would hypothetically see their after-tax income increase an average of 8.5 percent.

Economists are in the early stages of debating how much the plan might add to America's soaring $20 trillion national debt. One basic estimate by a Washington budget watchdog calculated that the tax cuts might add $5.8 trillion to the debt load over the next 10 years. According to the Committee for a Responsible Federal Budget analysis, Republican economists has identified about $3.6 trillion in offsetting revenues (mostly an assumption of increased economic growth), so by the most conservative calculation the tax plan would cost the federal deficit somewhere in the $2.2 trillion range over the next decade.

Others, notably the Brookings Tax Policy Center (see graph below) see the new proposals actually raising tax revenues for individuals (blue bars), while mostly reducing the revenues from corporations.

These cost estimates have huge political implications for whether a tax bill will ever be passed. Under a prior agreement, the Senate can pass tax cuts with a simple majority of 51 votes — avoiding a filibuster that might sink the effort — only if the bill adds no more than $1.5 trillion to the national debt during the next decade.

That likely means compromise. To get the impact on the national debt below $1.5 trillion, Congressional Republicans might decide on a smaller cut to the corporate rate, to something closer to 25-28%, while giving typical families a smaller 1-percentage point tax cut. Under that scenario, multinational corporations might be able to bring back $1 trillion or more in profit at unusually low tax rates, and most families might see a modest tax cut that will put a few hundred extra bucks in their pockets.



Alternatively, Congress could pass tax cuts of more than $1.5 trillion if the Republicans could flip enough Democratic Senators to get to 60 votes. The Democrats would almost certainly demand large tax cuts for lower and middle earners, potentially lower taxes on corporations and higher taxes on the wealthy.

Investing Lessons for the Next Crisis

It will soon be the 10-year anniversary of when, in early October 2007, the S&P 500 Index hit what was its highest point before losing more than half its value over the next year and a half during the global financial crisis.

Over the coming weeks and months, as other anniversaries of major crisis-related events pass (for example, 10 years since the bank run on Northern Rock or 10 years since the collapse of Lehman Brothers), there will likely be a steady stream of retrospectives on what happened as well as opinions on how the environment today may be similar or different from the period leading up to the crisis.

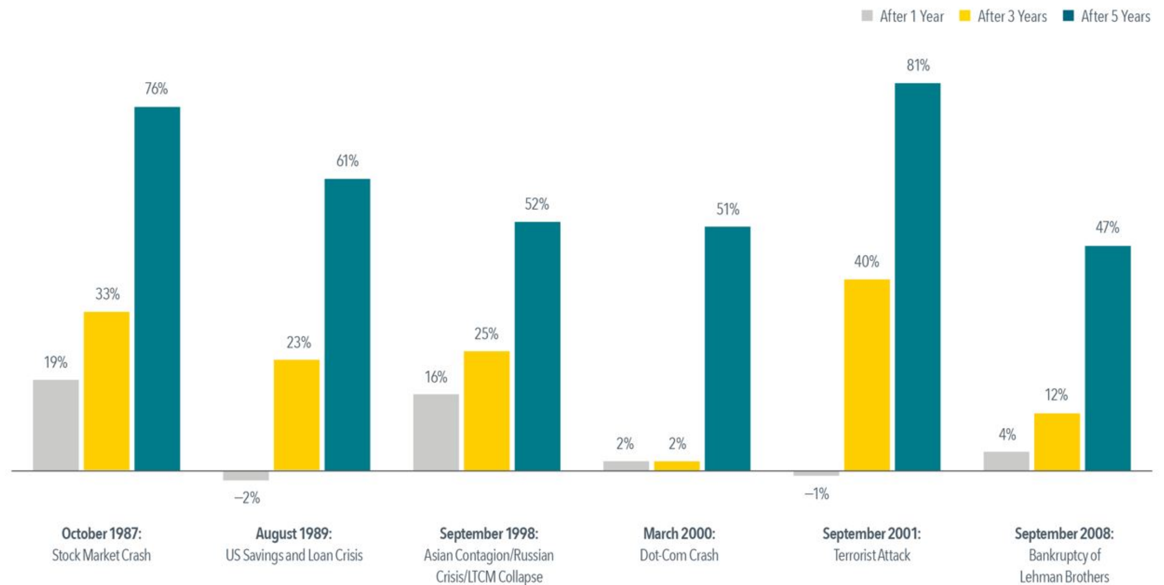
It is difficult to draw useful conclusions based on such observations; financial markets have a habit of behaving unpredictably in the short run. Still, there are important lessons that investors might be well-served to remember: Capital markets have rewarded investors over the long term, and having an investment approach you can stick with—especially during tough times—may better prepare you for the next crisis and its aftermath.

Remembering the Last Crisis

In 2008, the stock market dropped in value by almost half. Being a decade removed from the crisis may make it easier to take the past in stride. The eventual rebound and subsequent years of double-digit gains have also helped in this regard. While the events of the crisis were unfolding, however, a future of this sort looked anything but certain. Headlines such as "Worst Crisis Since '30s, With No End Yet in Sight," "Markets in Disarray as Lending Locks Up," and "For Stocks, Worst Single-Day Drop in Two Decades" were common front page news. Reading the news, opening up quarterly statements, or going online to check an account balance were, for many, stomach-churning experiences.

While being an investor today is by no means a worry-free experience, the feelings of panic and dread felt by many during the financial crisis were distinctly acute. Many investors

reacted emotionally to these developments. In the heat of the moment, some decided it was more than they could stomach, so they sold out of stocks. On the other hand, many who were able to stay the course and stick to their approach recovered from the crisis and benefited from the subsequent rebound in the markets.



Other Market Crises

It is important to remember that this crisis and the subsequent recovery in financial markets was not the first time in history that periods of substantial volatility have occurred. The graph on this page helps illustrate this point. It shows the performance of a balanced investment strategy following several crises, including the bankruptcy of Lehman Brothers in September of 2008, which took place in the middle of the financial crisis. Each event is labeled with the month and year that it occurred or peaked.

Although a globally diversified balanced investment strategy invested at the time of each event would have suffered losses immediately following most of these events, financial markets did recover, as can be seen by the three- and five-year cumulative returns shown in the exhibit. In advance of such periods of discomfort, having a long-term perspective, appropriate diversification, and an asset allocation that aligns with your risk tolerance and goals can help you remain disciplined enough to ride out the storm.

Summary

In the minds of some people, there is always a "crisis of the day" or potential major event looming that could mean the beginning of the next drop in markets. As we know, predicting future events correctly, whether they involve a market reaction or tax reform, is a difficult exercise. It is important to understand, however, that volatility and unpredictability is a part of investing and financial planning.

Investors must be willing to accept increased uncertainty to enjoy the benefit of higher potential returns. A key part of a good long-term investment experience is being able to stay with your investment philosophy, even during tough times. Additionally, a well thought out financial plan can help you be better prepared to face uncertain and ever-changing tax laws and financial circumstances.

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