Fact or Fiction

by Doron Maresky

I will be in a lower income tax bracket when I retire

Setting the stage

Sitting with a new prospect some months ago, I was going through the data he had provided when filling out the financial questionnaire I had given him. In the process, I was asking questions on every entry: Why are you doing this? What led your decision at the time? Is this still relevant or important to you? etc. We'd then have a discussion around each item, me taking notes all the time. For the most part, he would readily look at other options as he was not completely satisfied with performance of various steps taken in the past. That is, after all, why he was prepared to meet with me when I first called him.

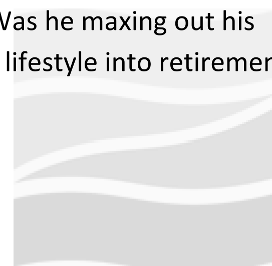
When we got to questions on his qualified plans, his whole demeanor changed. While he was disappointed in recent market performance, he was very confident it would bounce back soon. He also now replied very confidently, as if he knew exactly what he was doing and why. At the age of 47 he and his wife currently had a little over $850k in their 401(k) plans and were planning to work and contribute as much as they could to their qualified plans for another 14 years until they'd retire at 60. By then they believed they'd have more than enough to retire comfortably. Yes, before the market tanked in 2007-8 there was over $1.1M in their qualified plans… but he wasn't too concerned.

When asked what had led to his decision of contributing the maximum, he explained how a number of years ago he was contributing half heartedly to his qualified plan, preferring to play the market. One idle Saturday night, flipping channels on the TV, he happened upon what could be described as a "financial entertainer" giving free financial advice to callers by phone. It sounded interesting so he watched and became a regular. Over and over again he would hear this entertainer tell people to save as much as they can in their qualified plans. After hearing this repetitively for a few weeks he decided to seek his accountant's advice. The accountant concurred fully, explaining that not only does contributing to a 401(k) create annual tax savings, providing more spendable cash, but also that tax deferral is a great strategy as he'd probably be in a lower tax bracket when he retires. As a result, he and his wife have been saving as much as they can in their qualified plans ever since.

Regarding the tax saving that is (or is not) created, we'll look at that another time. As for being in a lower tax bracket when they retire, it was clear that we needed to look at this in depth.

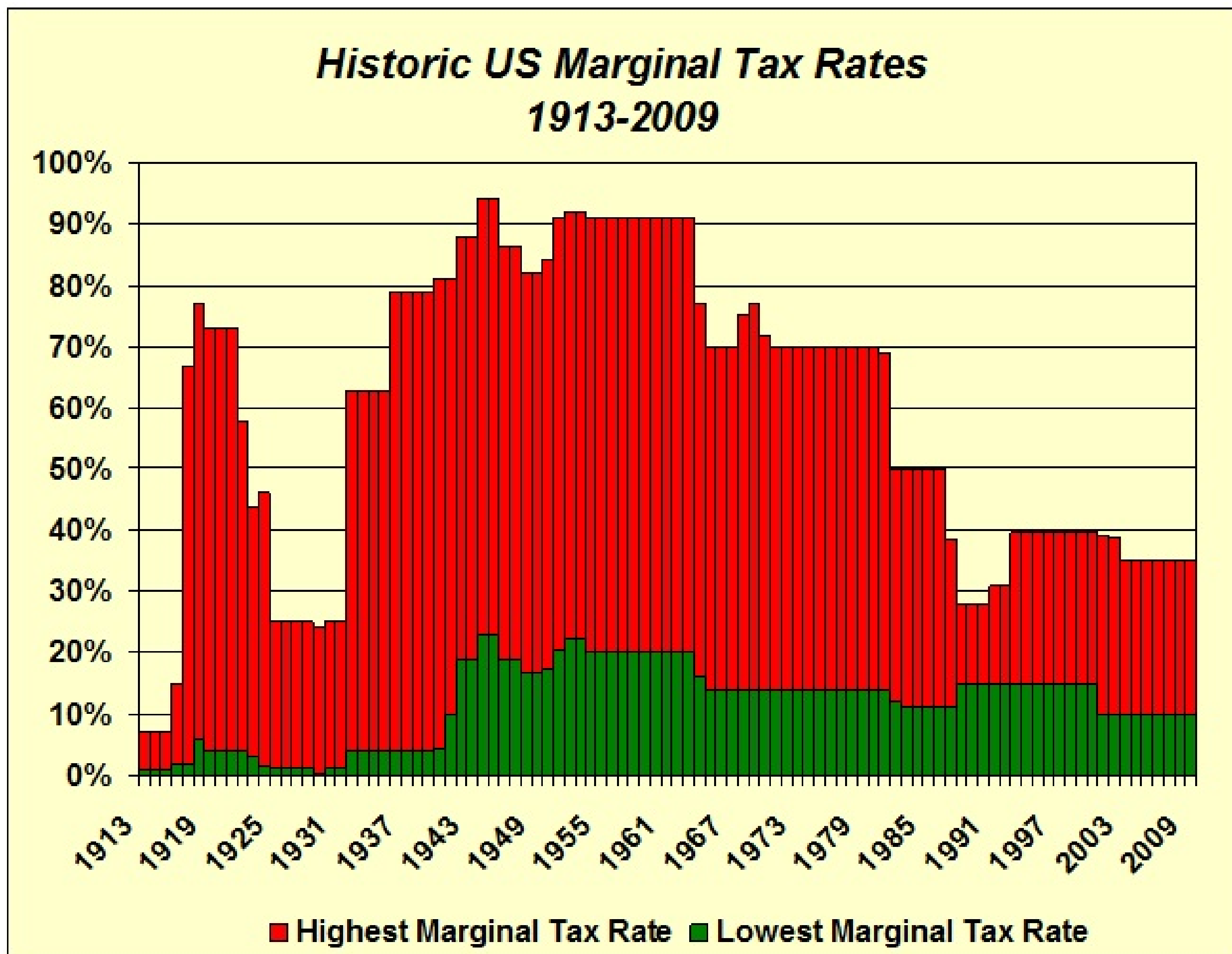
Understanding the myth

First, what did the accountant mean when he said my client would probably be in a lower tax bracket at retirement? We both agreed that this implied he'd be paying fewer taxes. What then would have to happen for that to come about? Only now my client realized that it meant either the government would reduce taxes (which he thought was unlikely) or he'd simply have less money for living expenses. In other words, he'd be paying less income tax or be in a lower tax bracket simply because he'd have reduced his lifestyle! Now, while this might be the very sad reality for many, was this really an acceptable financial plan for my client? Was he maxing out his 401(k) with the goal of reducing his lifestyle or did he really want to maintain his current lifestyle into retirement? Of course, the latter was the correct goal.



A brief discussion of income taxation clarified that he understood that the total sum on his statement was not all his to keep. The realization that he had a partner called Uncle Sam who owned a large part of that account was something he'd never really taken into consideration. When we discussed that as the account grew, Uncle Sam's part would grow proportionately, that made sense but when he understood that Uncle Sam had the power to change that proportion, his eyes opened wide.

So, all we needed now was to determine whether his basis for making maximum contributions to his qualified plan was still solid. To that end, we analyzed the "Historic US Marginal Tax Rates" graph below, in an attempt to understand what and how events over the last century had affected tax rates. While we cannot emphasize enough that there is no guarantee that events that influenced taxation in the past will continue to do the same in the present and in the future, it is important for our clients to know what the past behavior was.



Source: U.S. Treasury Department – Internal Revenue Service 2010

Income tax and the cost of wars

The chart shows what income tax for the American wealthy has looked like over the past century. This question that this raises is "What major local and global historical events have impacted these tax rates?"

What then were the events that brought about the implementation in 1913 of a Federal income tax bracket of 7.5%? In his inaugural address in March 1913, President Woodrow Wilson took advantage of the newly passed

16th Amendment to the Constitution (2/3/1913) and called for a reduction of tariffs and an introduction of tax on income. While many previous attempts had been made to introduce income tax it had, till the implementation of the 16th Amendment, been struck down as unconstitutional. Till this point in time, taxes were collected predominantly as a tax on products and trade.

The long term costs and financial repercussions of the Spanish-American war of 1898-1899 and the Treaty of Paris served to heavily burden the national purse and strengthen the case for a new Federal tax on income. Resulting in temporary US colonial authority over Cuba, and indefinite authority over Guam, Puerto Rico and the Philippines (with large military bases and personnel, including Guantanamo Bay, Andersen Air Force Base, Clark Air Base and Subic Bay Naval Base), the Spanish-American war is seen as a prominent cause of Woodrow Wilson's introduction of Federal income tax to the US public.

The success of this new tax in offsetting the high costs of the war itself and the costs of maintaining a military presence in the new colonies was tremendous. It was so tremendous in fact that 6 years later, in 1919, after the end of World War I, it justified increasing the tax bracket for the wealthy to more than 70%. Realize that US involvement in that war was relatively limited in scope and time and that was probably one of the main reasons that this tax hike to 70% only lasted a short period.

Booming economies, depressions and more wars

Followed by the economic boom of the roaring 20s, the highest tax bracket quickly came back down, all the way to around 25%. 25%!!! Taxes came DOWN to more than three times as much as Woodrow Wilsons original 7.5%... and there they remained till the economy crashed and the New York Stock Exchange came tumbling down at the end of October 1929. The ensuing decade of depression, with high unemployment, companies going out of business and rising inflation left multitudes of Americans turning to the government for financial aid. Income tax for the wealthy skyrocketed by the end of the 1930s to even higher than after WWI, to almost 80%.

With the outbreak of World War II in 1939 and German U-boats patrolling commercial and civilian shipping lanes in the North Atlantic, the US had to step up its readiness along its eastern seaboard. With the entry of the Japanese into the war on the side of the Nazis and escalation in the Pacific arena, the US found itself stretched thin to up its readiness at its numerous Pacific bases. With the Japanese attack on Pearl Harbor on December 7th 1941, the US was now an active, combating force in this war. As we saw in the wake of WWI, the increase in the income tax bracket for the wealthy was not long in arriving. Creeping up from its already elevated perch of almost 80%, by the end of the war the highest had passed the 90% mark! The tax, which only 30 years before was seen as unconstitutional, was now at over 90% on the last dollar for the wealthy!

War and peace between east and west

The Great Depression and WWII were only the beginning. WWII was followed closely by the onset of the Cold War and the emergence of numerous regional wars by proxy as tentacles of the Cold War. The first major regional war was the war in Korea in 1950. While the armistice ending the war was signed in 1953, the US presence continued well after and the Federal income tax bracket for the wealthy remained around the 90% mark for over a decade. With the yoke of the Cold War still weighing down heavily on the recovering world and US economy, hot spots were bubbling all over the globe (Cuba, South East Asia, Central Europe and Middle East) and it wasn't long before some of these hot spots erupted in full-blown war.

While the US was able to refrain from sending active forces to some of these regional wars, we still sent our ships and soldiers to the areas as a precaution and provided extensive, expensive support, arms, ammunition and supplies (Central Europe, Middle East). In South East Asia on the other hand, we were dragged into a quagmire

that exacted a very high price from us in order to disentangle ourselves. This high price was not just in human lives and political pride but also the financial cost of the war itself and the long term financial repercussions of the loss of human lives and loss of political face in the eyes of our allies all over the world. It was these factors that helped sustain our tax burden and the top bracket around 70% all the way into the early 1980s.

With the 1980s came “glasnost”, “perestroika”, “Reaganomics” and an apparent booming of economies everywhere. The Cold War was drawing to an end and the need for prominent, ongoing military presence (US and Soviet) was diminishing. With the returning of forces home and the dismantling and downsizing of military installations, there was less financial burden to fund our distant bases. The immense technological advances of the 1980s also marked the beginning of the where more could be accomplished faster and cheaper. The result was a new era of economic blossoming and the top tax bracket for our wealthy clients dropped to 28%. This was the first time in over 50 years that this once unconstitutional income tax lay below the 30% line.

The optimism of the 1980s was relatively short lived. Following almost a decade of rapid transitioning from stagnant and slow economies to fast growing economies coupled with new technology and automation of stock markets and trading, the world financial markets took a hit on October 19th 1987. Since known as Black Monday, a wave spread westward from the stock markets in Hong Kong (-45%) and the east resulting in the second highest single day drop of the Dow Jones Industrial Average – a drop of 22.6% in one day! Another major drop in the DJIA occurred a mere 2 years later, on October 13th 1989, triggering the collapse of the junk bond market. The ensuing period of mini-recession of the end of the 1980s naturally had its effect on the US economy. Coupled with the First Gulf war in 1991 and the war in Chechnya 2 years later, and the effect these wars had on the US threat perception, and having seen how tax levels have responded to wars and recession, the elevation of this tax bracket to the 40% level can be seen as consequential.

Current wars, depressions and other expenses in historical context

Looking back at the last 20 years, we can see that taxes have been relatively low and stable, compared to the 55 years of 50%-90% from the Great Depression till the mid 1980s. So, with the understanding that events that led the government to change taxes in the past will not necessarily lead to the same actions in the present and future, let’s take the present and look at it in historic perspective.

We are currently, in 2010, funding three expensive wars simultaneously: Iraq, Afghanistan and the Home Front War on Terrorism. The increasing likelihood of additional fronts with Iran or North Korea is already impacting military and diplomatic spending. Furthermore, the government is currently challenged by a multi-trillion dollar depression, with unheard of sums of money going to bail out failing companies and industries, double digit unemployment and rising inflation – impacted further by an accelerated rate of money printing.

On top of that we have approximately 70 million individuals born in the years immediately after WWII leaving the work force during the next 5 years. These are 70 million individuals who spent much of their working years and financial accumulation period during times of high income tax. Many of these individuals have insufficient funds save for retirement, possibly due to the higher tax rates through which they were trying to save. To make up for the money they have not saved, it is feasible to expect these 70 million baby boomers to rely quite heavily on the benefits of Social Security income and Medicare. In other words, the system will be losing 70 million current contributors to the tax pool and will in turn have those same 70 million relying on the existing government programs to supplement their retirement.

Moreover, there are an estimated 23 million other individuals anxiously waiting for the final approval of a bill that will provide them with free healthcare, and I use the word “free” very loosely. While this bill strives to provide healthcare to these 23 million individuals at little or no cost to them, there will obviously be a significant

additional tax burden for the country's working, taxpaying population? For clarification, in a country of 350 million, the 23 million waiting for free health plus approximately 70 million baby boomers and their dependents is between a third and a quarter of the US population!

Finally, let's not forget the effects of both natural and man-made disasters, such as hurricanes and the many millions of barrels of crude oil spilled into the Gulf of Mexico between April and July this year (2010), nor the millions of gallons of chemicals poured into the gulf to try and break up the oil. What long term repercussions will such events have on the entire food chain in the Gulf? What about the livelihood of the thousands who relied on that food chain to make a living? Where will the funds to compensate for these lost jobs and increased food costs come from?

Looking to the future

So, with all that in mind, and while we cannot be sure that these events will lead the government to change taxes as they have in similar circumstances in the past, is it feasible to expect taxes to change? In what way? To what degree? When? For how long? These are the unknowns we want our clients to be aware of and to be contemplating when they adopt the various strategies that they hope provide for their financial futures.

If my client has the option of taking his annual contribution as income today and pay his 30% or 35% income tax on it, should he really be locking that money up in a box that will be inaccessible to him without penalty for another 12-13 years and then be subject to whatever taxes are at that point in time in order to use that money?

That is, of course, hoping that there's still enough money left in the account to use, depending on performance of the market between now and then. Look for future Living Balance Sheet® articles you can use to help you clients differentiate between the facts and fiction in their financial lives.

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