VIEW CAPITAL ADVISORS, LLC

Panorama

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Senator Warren's Wealth Tax

In this Issue:

Senator Elizabeth Warren (D-MA) is one of several Democratic presidential hopefuls for 2020. A key platform in her campaign is to address rising income inequality in the U.S. She has announced her plan to deal with income inequality by imposing a wealth tax on high-net-worth individuals.

Various media sources report that Senator Warren's proposal would assess a 2 percent annual wealth tax on individuals with more than $50 million in net worth, increasing to 3 percent on those with more than $1 billion in wealth. So for example, a family worth $60 million would owe the federal government $200,000 in wealth tax, in addition to income tax they may owe on their taxable income for the year.

Wealth taxes are not a new idea and date back many years. But they have been used less and less frequently. In 1990, 12 member countries of the Organization for Economic Co-Operation and Development (OECD) imposed a wealth tax. Today, only four do. Countries have dropped the taxes due to the challenges they pose. In particular, there is a significant question as to whether a wealth tax would even be constitutional under U.S. tax law.

The U.S. Constitution prohibits federal direct taxes that are not apportioned by population, except for the income tax which is specifically permitted by the Sixteenth Amendment. So the question is, what is and is not a direct tax? In one of the first U.S. Supreme Court cases to address the issue in 1796, the Court held that a capitation (flat rate on each person) would be a direct tax and thus unconstitutional if not apportioned. In the Pollock case of 1895, they came to a similar conclusion. Accordingly, the Sixteenth Amendment was adopted to allow income taxes to be constitutional.

Every other tax that has been challenged on these grounds has been upheld. Inheritance and estate taxes were upheld not as direct taxes on wealth, but as indirect taxes on the transfer of wealth. Corporate income taxes were upheld not as taxes on the value of shares or income, but as excise taxes on the privilege of doing business in the corporate form.

Those taxes in some way involve a transaction, while the Warren wealth tax does not. Based on these precedents, it is quite possible that Warren's proposal would be found unconstitutional. But it's not a forgone conclusion as the precedents go both ways, and it's not an area the Court has opined on for a long time.

Despite the potential unconstitutionality, there are other reasons why a wealth tax is a bad idea. First, these taxes are difficult to administer. The ultra-wealthy tend to have very hard-to-value assets. They own assets such as real estate holdings, trusts, yachts, fine art collections and private business ownership interests. It is difficult to value these assets on an ongoing basis and is highly judgmental. Imagine how difficult and expensive it would be both for wealthy taxpayers and the IRS to value these assets annually? The IRS would have to staff up with an army of appraisers and other experts resulting in prolonged periods of IRS audits and disputes over valuation.

Second, despite the claims of some wealthy individuals that they "don't pay enough" federal tax, the natural tendency for all taxpayers is to take all available legal steps to reduce or avoid exposure to any form of taxation. The U.S. is one of only two tax systems in the world that tax its citizens and residents on their worldwide income and assets. So, hiding assets outside the U.S. doesn't work for U.S. Persons, and will result in criminal penalties. And, there are significant costs to renouncing U.S. citizenship in an attempt to circumvent worldwide U.S. taxation. We have seen first-hand what happens in other countries such as France that does not have a worldwide tax system. Wealthy citizens and tax residents simply pack up and leave the country, and take their wealth with them.

Finally, a wealth tax would result in double taxation. Citizens owe income tax on their earnings for the year. Any net increase in wealth on income not spent and appreciation in value during the year would also be included in the wealth tax base. Worse, the same wealth gets taxed year after year. At least in the income tax venue, earnings are generally only taxed once, which creates tax basis to avoid future double taxation on previously taxed assets. Wealthy individuals may also question the propriety of continuing to work for compensation due to the tax burden. This will reduce productivity and make everyone poorer as a result.

Perspective

Strength

Roth IRA Conversion

The Roth IRA was established by the Taxpayer Relief Act of 1997 as an alternative retirement savings plan. Money contributed to Roth accounts does not result in a tax deduction, unlike contributions to tax-deferred accounts. Both Roth and tax-deferred accounts benefit from tax-free growth. But Roth dollars, unlike tax-deferred dollars, will not be taxed when withdrawn by the account owner. Like regular tax-deferred retirement accounts, there are limitations on how much can be contributed by an individual taxpayer, if any, to a Roth IRA during a tax year.

If you're approaching retirement, you may have accumulated a sizeable balance in traditional IRAs or qualified retirement plans. This article discusses the opportunity you have to convert those assets into a Roth account as a more effective way to fund it.

A Roth account's main benefit is tax-free distributions. If you're over the age of 59½ and your Roth account has been open for at least five years, all of the money you take out of it is tax-free. In addition, Roth IRAs don't have required minimum distributions (RMDs) for the original owner, whereas traditional IRAs are subject to RMDs to the account owner after you reach age 70½. So converting a traditional IRA to a Roth IRA reduces RMDs and the risk that they will increase your retirement income tax rate.

Increasing Roth assets can also improve your tax diversification—the mix of account types with different tax characteristics. Basically, that means you have more flexibility when deciding how to fund your retirement lifestyle from sources that may be non taxable. Roth assets are also a hedge against higher statutory tax rates in the future. Following the individual tax cuts passed in late 2017, one might believe that tax rates are unlikely to be any lower during your lifetime.

Sounds too good to be true? The catch is that you pay ordinary income tax right away on the amount you convert from your traditional IRA. So the strategy generally doesn't make sense if you pay taxes on conversion at the same or a higher rate than when distributions are taken later. This could happen for people that have or anticipate lower taxable income in retirement. They may reduce spending, which means they don't need as much income. In addition, at least 15% of Social Security income is non-taxable depending on the retiree's income.

Retirement distributions for many represent a large portion of your annual income and optimize the tax brackets, resulting in a lower average tax rate. In contrast, the conversion adds to the income taxed primarily at your marginal, or highest rate.

There are also factors to consider specifically for the year of conversion. Higher taxable income that year could have one or more of these negative effects:

- A higher tax bracket;
- A higher portion of Social Security benefits subject to tax;
- Higher Medicare premiums; and
- Less eligibility for student financial aid.

Given these issues, when does it make sense to consider a Roth conversion? Consider these scenarios:

1. A low-income year for someone with irregular income. This could even be a year when you've been unemployed. Unfortunately, those years often coincide with cash-flow challenges, making extra tax payments impractical.
2. Alternatively, stagger a series of smaller conversions over several years to reduce the overall marginal rate tax cost.
3. Early in retirement before you face RMDs. The strategy is most valuable for affluent households when most or all of the following circumstances apply:
   - You expect to leave an estate.
   - You can comfortably afford the conversion taxes and fund your spending with cash or a taxable investment account.
   - Your traditional (pretax) accounts are likely to generate RMDs that you won't need for spending. And importantly, they will likely be taxed at a significantly higher rate than what you pay on the conversion.

Once done, a Roth conversion is irreversible. The previously available option to "recharacterize" (undo) a conversion was eliminated as part of the 2017 tax legislation. Evaluating Roth conversions should be coordinated with a broader retirement income strategy, including your Social Security claiming decision and the order you draw from different accounts. A Roth conversion strategy is worth investigating early in retirement, before RMDs begin. That will give you enough time to determine whether it can be an effective part of your overall retirement strategy.

Integrity

Innovation

How Do Capital Gains Affect My Tax Rate Brackets?

Under U.S. tax laws, there are several categories of taxable income that come with differences in taxability and tax rates. Understanding those differences as well as the order of taxation of these categories of income is critical to effective income tax planning for individuals.

The sale of capital assets in taxable accounts, such as stocks or mutual funds, generates a recognized gain or loss that must be reported in the year of sale. However, the timing of capital gains are to a large extent voluntary. Certainly the investor's needs weigh heavily in the timing decision. But still, one can choose to sell a mutual fund in this year or next, or not at all.

Our system of taxation is predicated on a progressive rate bracket concept. As your income increases, you are progressively taxed at higher marginal tax rate brackets as you exceed designated taxable income break points. So this begs the question – if a taxpayer chooses to sell a capital asset this year at a significant gain, will that gain potentially push the taxpayer up into a higher marginal tax rate bracket?

Long-term capital gains and qualified dividends have lower tax rates than other forms of income such as wages, retirement plan distributions and taxable interest. These items are categorized as "ordinary income." So if a taxpayer has $150,000 of wage income in a tax year, and decides to recognize a $150,000 long-term capital gain in the same year, will the taxpayer's ordinary income be taxed at the marginal rate bracket for $150,000 or $300,000?

The answer – marginal tax rate brackets apply first to ordinary income. So a married taxpayer with $150,000 of ordinary income in 2019 will be in the 22% marginal rate bracket on that income. There are 3 long-term capital gain and qualified dividend tax rates in 2019. For married taxpayers, the rate is 0% on taxable income up to $78,750, then 15% up to $488,850 and 20% above that. So in this case, the $150,000 long-term capital gain would be taxed at 15%, separately from the ordinary income. The tax forms work to ensure that the components of the calculations are done correctly and result in a single combined tax due for that taxpayer.

Let's take another example to illustrate the relevance to income tax planning. Assume a married individual has no ordinary income from wages this year. Instead, he realizes some long-term capital gains from mutual fund sales to fund his living expenses for the year. He also wants to convert $100,000 from a traditional IRA into a Roth IRA. Since the $100,000 IRA conversion is ordinary income in the conversion year, and tax rates apply to ordinary income before capital gains, he will be able to manage his tax bill down to the 10% and 12% tax rates. $100,000 of ordinary income less $24,400 of standard deduction puts these taxpayers in the maximum 12% ordinary marginal income tax rate bracket!

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View Capital Advisors, LLC was founded in 2004 by its principals with the mission of providing sophisticated investment asset management and financial and estate planning to our U.S. and Non-U.S. clients.

We seek to bring wealth planning best practices and a wide range of non-proprietary solutions to our clients. We also conduct our own research and diligence on world markets and investment alternatives.

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