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Something to Think About

OAKWORTH CAPITAL BANK

COMMON CENTS

A lot of folks have asked my opinion on the Administration's tax reform proposals. I think I have surprised them with my less than sophisticated response: anything is better than doing nothing. As the old saying goes, if you are standing still, you are falling behind.

In helping run a trust and wealth management department, our Byzantine tax code benefits me professionally. I couldn't argue otherwise and keep a straight face. Folks will go to some lengths to either postpone or try to avoid paying a hefty tax bill, and this often includes various trust accounts and other tax deferred vehicles. That shouldn't come as a shock, but as I tell everyone: "the IRS will eventually get its money, even if it has to wait a while."

I guess you can say I have seen how some of the sausage is made, and it detrimentally impacts the free flow of capital throughout our economy.

With that caveat out of the way, I did some math a little while ago regarding Federal tax receipts as a percent of Gross Domestic Product (GDP). I ran the numbers as far back as I could easily get the data, which was slightly before World War II. This was after the worst of the Great Depression, but before the boom in economic activity the war engendered.

Over all those years, regardless of the marginal tax rate structure, it seems Washington collects anywhere from 18-19% of our overall economic output. This percent goes down during periods of economic distress, but rights itself as the economy improves. Of course, tweaks in the code can lead to changes in Washington's portion, but we are ordinarily talking basis points as opposed to percentage points.

Basically, there is a strong correlation, almost perfect, between economic growth and absolute tax receipts. They go up together, and go down together. Duh. Therefore, Washington's focus should be on economic growth, as it collects more money when the economy is making more of the stuff. Again, duh.

But will the Administration's plans grow the economy? This question will engender all sorts of academic and theoretical debate. A lot of this discussion will be very brainy stuff, well beyond normal cocktail party conversation. I suppose that is why people are kind of surprised by my decidedly less than erudite response.

I will be blunt. The Obama Administration's last proposed budget estimated the accumulated deficit will increase roughly an additional $8 trillion over the next decade. This assumed a somewhat moderate real GDP growth rate. I won't bore you with all the details, but we can expect pretty sharp increases in nondiscretionary items, read transfer and so-called entitlements payments, and very little real growth in the rest of the budget, in aggregate.

That last part is stasis. That is not doing anything different, and it isn't real pretty. Further, the way we calculate GDP, it also pretty much means Washington won't add much to the equation over the next decade. Let me flesh that out a little.

The equation the Bureau of Economic Analysis (BEA) uses to calculate GDP is C + I + G +/- Net

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Exports. C stands for consumer expenditures; what we as individuals consumers spend. I represents what businesses and investors spend on real estate, technology, intellectual property, inventories, and the rest of the private sector's investment in our economic infrastructure. G is government expenditures, that which the government actually purchases. It does NOT include transfer payments (Social Security, various welfare programs, grants to states, any other so-called entitlement payments, etc.), government employee (at all levels) related expenditures, or servicing the national debt. Obviously, these things take up a huge chunk of current government outlays and will only go UP over the next decade.

Since the BEA calculates GDP (using this equation) adjusted for inflation, static 'real' growth in the discretionary portion of the Federal budget essentially means no 'real' growth in fiscal policy out of Washington.

That means the rest of the economy has to take up the slack, meaning businesses and individuals. As such, reforming and simplifying an inefficient, complicated, at times punitive tax code is a good start in getting more money moving around the economy more quickly. Hopefully, this will stimulate economic growth which will increase Washington's tax receipts. At least that is the thought process.

Is this all a gamble? Sure, but the status quo is a gamble too. So, in this regard, again, anything is better than doing nothing. I apologize if that isn't academic enough.

With that said, there are two elements of the Administration's tax proposals I would like to address: 1) the capital gains tax, and; 2) the inheritance tax.

First, the White House isn't proposing any real changes to the Federal capital gains tax structure other than to eliminate the 3.8% surcharge for those individuals above a certain income level. I find this disappointing, as I was hoping President Trump would make meaningful changes to this punitive tax.

I call it punitive because, in my opinion, this is a major impediment to the free flow of capital throughout the financial system. Period. Investors will hang on to potentially underperforming investments in order to NOT have to pay Washington 20-23.8% of the realized capital gain. Further, the individual states have their own capital gains tax rates, including Alabama's 5%. As such, investors in my state potentially pay up to 28.8% of their profit on an individual investment in tax. That is a significant amount, particularly when there is NO guarantee they can reinvest the proceeds of a sale into another investment which will generate at least that amount in a relatively short-period of time.

Let me give you an example. Assume Investor A has $1,000,000 in Stock X with a cost basis of $100,000. Analysts expect Stock X to return an annualized 7.5% over the next 10 years. Investor A is considering purchasing Stock Z, which analysts believe will have an 10% average annual return for the next decade. What does A do? I will save you the math, and tell you A holds onto Stock X.

If we assume A will pay 28.8% of their gain in tax, they will start their investment in Z with $740,800. In 10 years, at 10% annualized, this amount will be equal to roughly $1,921,444. Not bad. However, if A doesn't sell X and has an annualized 7.5% return over the same time frame, they will have $2,061,032. That is a no-brainer, and the government collects no tax.

Now, what if the capital gains tax rate were 0%? A sells X to buy Z, and would have $2,593,742. The government still doesn't collect anything, but societal wealth has increased by over $500,000. More? Okay, it the TOTAL capital gains tax were 10%, the various governments would collect $90,000, Investor A is 'break even' in their investment in Z by the end of year 4, and is about $300,000 ahead ox X at the end of 10 years.

This might seem an extreme example, but, again, I have been doing this quite a while and it really isn't. After all, it is just math.

In essence, the capital gains tax inhibits the free flow of capital to its highest and best use, which is a serious impediment to economic growth and potentially societal wealth. It is just inefficient, and I would imagine the government would actually collect more of this tax if it took the rate down to 10%....seriously. It is much easier to speculate one investment will outperform another by 10% than by 23.8%, obviously.

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As for the inheritance tax, again, I benefit professionally from a complicated tax code. However, having been in and around trust departments and trust investments for the better part of my career, I can tell you one thing: if the goal is to get money away from a concentrated group of people, let the younger generations have it free and clear. I mean no impediments. Period. Give it to them, and let them spend it as they see fit.

After all, a complicated estate plan will keep the younger generation from doing just that. It will ensure money is tied up in various vehicles that ultimately extend the dilution of an estate for at least an additional generation. Obviously, these things inhibit the free flow of capital throughout the financial system. Forget about the curious aspect of taxing someone after they are dead, it is inefficient.

Fortunately, for overall economic activity if not my job, the Trump Administration is proposing eliminating the inheritance tax. This makes great economic sense, particularly considering Washington isn't in the financial position to stimulate the GDP equation over the next decade. It needs to have as much money floating around the private sector as is possible, and not tied up in tax deference or avoidance legal structures.

Even so, I wouldn't bet much more than a plug nickel the Congress will eliminate the inheritance tax in its entirety without a major battle. This will likely lead to some form of compromise. If Vegas had a gambling line on the end result, I imagine the over/under line would open at a 20% or 25% tax on the amount over the current exclusion amount (which is adjusted for inflation for any event). Further, the Congress will likely make some form of meaningful adjustment for privately held family businesses and operating farms. The latter will be rife with curious accounting practices, to be sure. It all depends on what your definition of a farm is.

In the end, I am not a huge fan of the Administration's total tax reform package, but it is a step in the right direction.

There will be any number of people who cry it isn't fair, and claim it will lead to greater income and wealth inequality. They might even point out how income inequality was less years ago when the highest marginal tax rates were much higher than they are today. However, there is a little secret to those rates: no one paid them, either literally or figuratively. For instance, in 1960, the top marginal tax rate was 91% on incomes in excess of $400,000 (married and filing jointly). This applied to, get this, 0.002% of filers. In fact, you only needed to earn $25,000 to be in the Top 1% back in those days. The marginal tax rate at that amount was 43%, compared to the 39.6% today. Significant? I will let you decide.

Disclosure