JVL Associates, LLC
NEWSLETTER

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Income Taxes – Can They Be Reformed?

"Where is the politician who has not promised to fight to the death for lower taxes and who has not proceeded to vote for the very spending projects that make tax cuts impossible?"

Barry Goldwater

As the season turns to fall, Washington has turned to "tax reform". President Donald Trump and the Republican leadership have issued their framework for the upcoming debate on taxes. Before we look at this framework in more detail, let's refresh ourselves on who pays the taxes and to what extent.

As we have done in prior years, we will present data from the Federal Individual Income Tax returns received by the IRS. (1) The data presented is from the 2014 tax returns that were filed in 2015 which is the latest year the data is available.

Throughout this commentary, taxpayers are categorized based on their adjusted gross income (AGI).

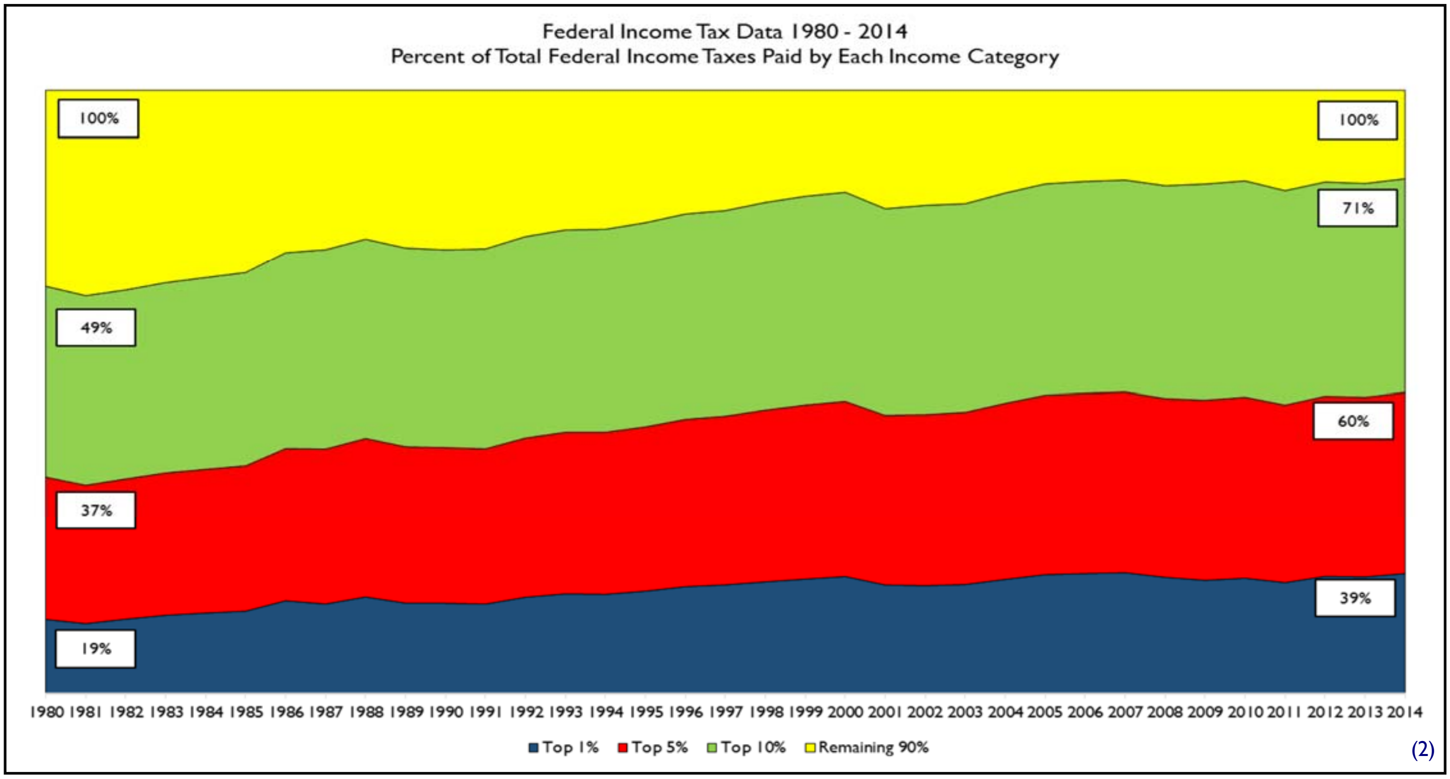
The chart below shows that the top 1% of taxpayers (AGI above $465,626) earned 21% of the income (as measured by Federal Adjusted Gross Income) and paid 39% of the total federal income taxes. Add in the next 4% and we see that the top 5% of taxpayers earned 36% of the income and paid 60% of the taxes. Combine that with the next 5% and we see that the top 10% of taxpayers earned 47% of the income and paid 71% of the taxes. Again, the top 10% of taxpayers earned 47% of the income and paid 71% of the taxes.

Summary of Federal Individual Income Tax Data, 2014

Source: Internal Revenue Service

Category Based on Federal AGI	AGI Brackets	Number of Tax Returns	(In Millions $) Total Federal AGI	Percent of Total Federal AGI By Category	Percent of Total Federal AGI Cumulative	(In Millions $) Federal Income Taxes Paid	Percent of Federal Income Taxes Paid By Category	Percent of Federal Income Taxes Paid Cumulative
Top 1%	$465,626 and up	1,395,620	$ 1,997,819	21%	21%	$ 542,640	39%	39%
Top 2% - 5%	$188,996 - $465,265	5,582,482	1,493,048	15%	36%	281,513	21%	60%
Top 6% - 10%	$133,445 - $188,995	6,978,101	1,092,549	11%	47%	149,971	11%	71%
Top 11% - 25%	$ 77,714 - $133,444	20,934,306	2,106,871	22%	69%	218,555	16%	87%
Top 26% - 50%	$ 38173 - $ 77,713	34,890,508	1,924,257	20%	89%	143,958	10%	97%
Bottom 50%	under $38,173	69,781,017	1,094,119	11%	100%	37,740	3%	100%
		139,562,034	$ 9,708,663	100%		$ 1,374,377	100%	
www.taxfoundation.org								

The next chart shows the percentage of the total federal income taxes paid by differing taxpayer income categories back to 1980. The chart helps visualize the shift in income tax payments towards the higher earning taxpayers. In 1980 the top 1% paid 19% of the total federal income taxes while in 2014 they paid 39%. The top 5% paid 37% in 1980 vs. 60% in 2014. And the top 10% earning taxpayers paid 49% of the federal income taxes in 1980 while paying 71% of the 2014 taxes.



Additionally, we see from this next chart that only the top 10% of taxpayers pay more than 10% of their federal adjusted gross income in federal income taxes while the remaining 90% of all tax filers pay 10% or less of their adjusted gross income in federal income taxes.

Summary of Federal Individual Income Tax Data, 2014

Source: Internal Revenue Service

Category Based on Federal AGI	*AGI Brackets*	*Number of Tax Returns*	*(In Millions $) Total Federal AGI*	*(In Millions $) Federal Income Taxes Paid*	*Federal Income Taxes Paid as a % of Federal AGI*
Top 1%	$465,626 and up	1,395,620	$ 1,997,819	$ 542,640	27%
Top 2% - 5%	$188,996 - $465,265	5,582,482	1,493,048	281,513	19%
Top 6% - 10%	$133,445 - $188,995	6,978,101	1,092,549	149,971	14%
Top 11% - 25%	$ 77,714 - $133,444	20,934,306	2,106,871	218,555	10%
Top 26% - 50%	$ 38173 - $ 77,713	34,890,508	1,924,257	143,958	7%
Bottom 50%	under $38,173	69,781,017	1,094,119	37,740	3%
		139,562,034	$ 9,708,663	$ 1,374,377	14%
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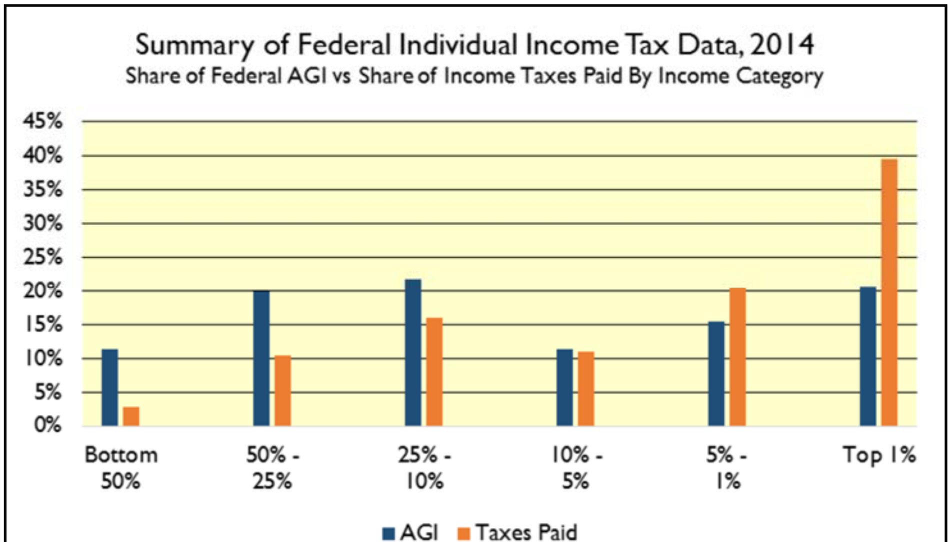
And finally, we see that the bottom 90% of taxpayers pay a substantially lower percentage of the total taxes than they earn of the total income, while the top 5% pay a substantially higher percentage of the total taxes compared to their percentage of the total income.

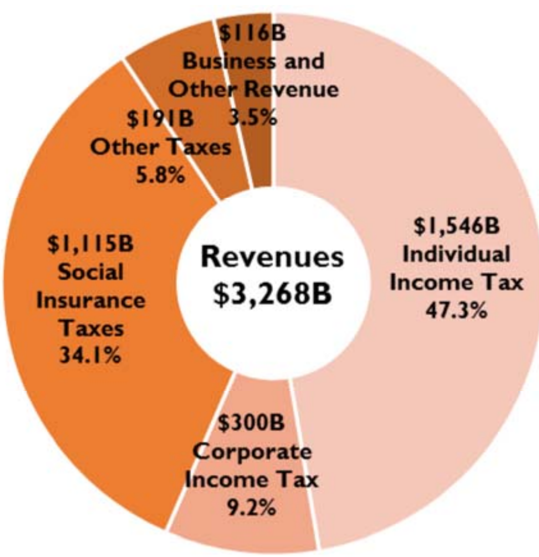


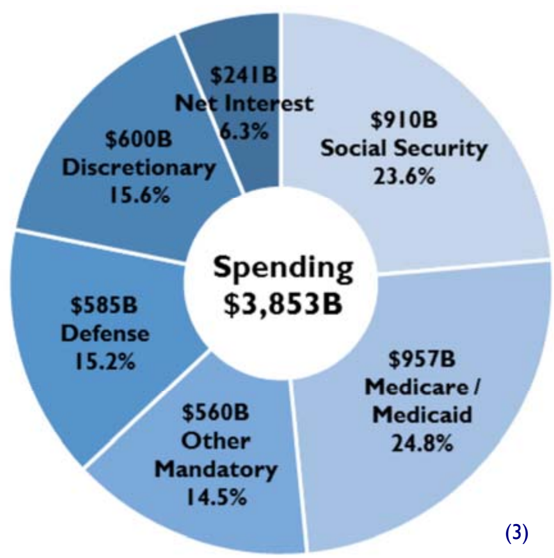
(2)

It is also important to point out that since 1980 the average tax rate paid has come down for all taxpayers. Who has benefited "the most" will be part of the debate. These facts will be twisted and turned by each of the respective parties to provide support for opposing sides of the tax reduction side of the debate.

- In 1980 the average tax rate (federal income taxes paid as a percent of federal adjusted gross income) was 26.85% for the top 5% and 6.10% for the bottom 50% of tax return filers.
- In 2014 the average tax rate was 23.61% for the top 5% and 3.45% for the bottom 50% of tax return filers.
- The decrease in average tax rate (raw %) from 1980 to 2014 is 3.24% for the top 5% and 2.65% for the bottom 50% of tax return filers.
- Another way of saying the same thing is that the decrease in the average tax rate (as a % of the 1980 rate) is 12% (3.24 / 26.85) for the top 5% and 43% (2.65 / 6.10) for the bottom 50% of tax return filers.

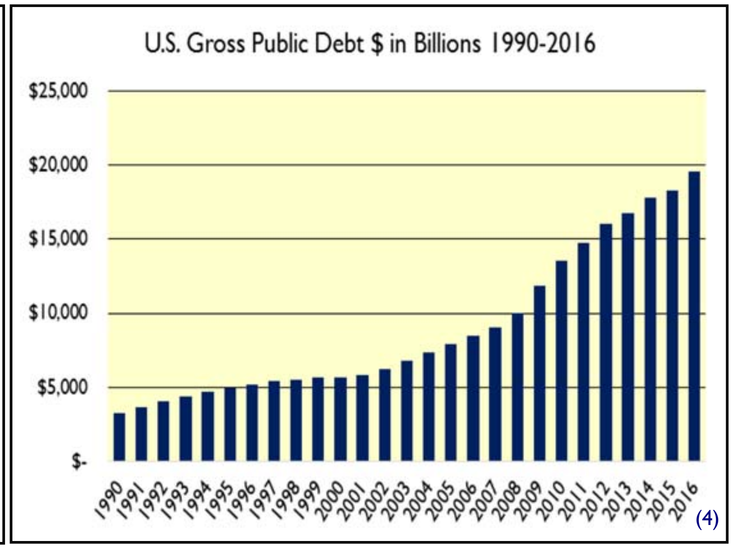
Any discussion of taxes should be accompanied by a consideration of the Federal budget and our National debt. The following pie-charts show the sources of the U.S. revenue and the categories of the U.S. expenditures for the 2016 fiscal year. (3) Individual income taxes make up 47% of the total Federal revenue. Looking at the expenditures we see that 63% of the total spending is made up of Social Security, Medicare, Medicaid and other mandatory programs, 6% is net interest on the National debt leaving only 31% "in play". Of that 31%, defense spending accounts for half and other discretionary expenses make up the remaining 15%.



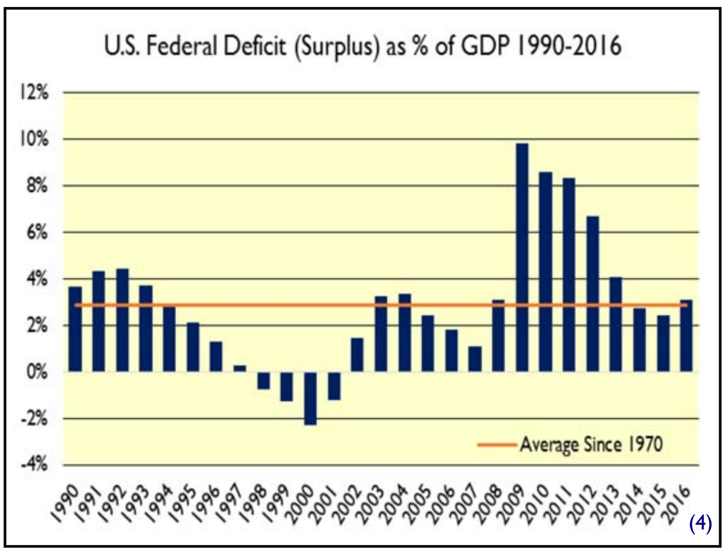


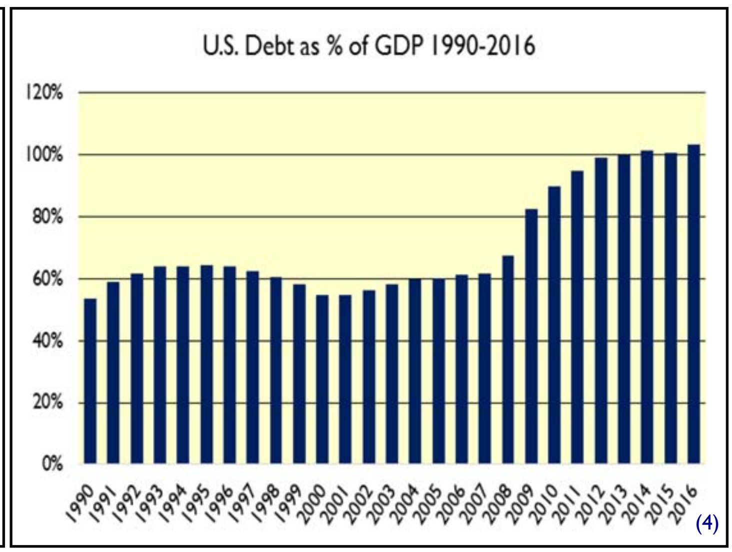
(3)

The next 2 charts show the annual deficits and the gross national debt in dollars. We are spending over $500 billion more each year than we collect which is adding to our $20 trillion debt.



The same data is shown as a percentage of the U.S. GDP to give perspective to the data in comparison to the size of the U.S. economy (as measured by the GDP).





And that transitions us to the current talk of tax reform. It is important to note that at the current time there is only a framework for discussion – there is not a tax bill written. The framework (5) lays out various items of reform but does not lay out the many details that will have to be a part of the final tax bill to actually implement the changes.

The four stated principles of the framework are:

1) Make the tax code simple, fair and easy to understand

2) Allow Americans to keep more of their hard-earned paychecks

3) Level the playing field for American businesses throughout the world

4) Bring back trillions of dollars that are currently kept offshore to reinvest in the U.S. economy

Items in the framework affecting individuals are as follows:

- Condensing the current seven tax brackets into three: 12%, 25% and 35%. A fourth bracket may apply to the highest income taxpayers to protect from shifting the tax burden from high income to middle income taxpayers. The framework does not provide guidance on the income limits in each bracket.
- Consolidating the standard deduction and the personal exemptions into one larger standard deduction of $12,000 for singles and $24,000 for married couples.
- Eliminating most itemized deductions while preserving the deduction for mortgage interest and charitable contributions.
- Increasing the child tax credit and providing a $500 tax credit for the care of a non-child dependent.
- Repealing the Alternative Minimum Tax (AMT).
- Repealing the estate tax and generation skipping transfer tax.

Items in the framework affecting businesses are as follows:

- Reducing the corporate tax rate to 20%.
- Taxing pass through business income at a maximum rate of 25%. This is the income earned by businesses that is not taxed at the corporate level but rather the income is passed through to the individual income tax returns of the owners. The tax writing committees are given latitude in determining how to implement this.
- Allowing for the immediate write-off (or expense) of the cost of new depreciable assets other than buildings for at least five years.
- Limiting the deduction of business interest.
- Changing the way businesses are taxed on income earned outside of the U.S.
- Implementing a lower one-time tax on accumulated offshore profits brought back into the U.S.

Tax reform has a long way to go before any bills are passed and the final legislation is signed by the President. This will not be easy and will not be bi-partisan. There are provisions in the framework that have a larger negative effect on taxpayers in certain states vs. other states thus pitting legislators of states against each other. I believe the business tax provisions have broader support than the individual tax provisions, but the current plan is to wrap it all in one tax reform bill.

While most people only think of taxes once a year, we think about them all year long. We will be following the tax reform progress all along the way. Taxes on differing investment options are an integral part of an overall investment strategy. We have no control over what comes out of Washington, but we can help clients understand the impact that tax rates have on their financial and investment strategies.

If you know of someone who could benefit from our services, please pass our name along. We would enjoy the opportunity to share our experiences with others.

All of our newsletters are archived on our website at www.jvlassociates.com

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References

[1] Tax Foundation's Fiscal Fact - "Summary of the Latest Federal Income Tax Data, 2016 Update", by Scott Greenberg, February, 2017

[2] Information obtained from the Tax Foundation website:
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[3] Budget of the U.S. Government - A New Foundation for American Greatness, Office of Management and Budget, Fiscal Year 2018

[4] Information obtained from U.S. Government Revenue website:
https://www.usgovernmentrevenue.com

[5] Unified Framework for Fixing Our Broken Tax Code, September, 2017

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