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VIEWS FROM CAMELBACK MOUNTAIN

The National Sales Tax is Coming

High corporate taxes in the United States have attracted a great deal of attention in 2014 as American companies worked tirelessly to shift profits outside of the United States to countries where taxes are much lower. These strategies range from complex transfer pricing arrangements to the outright exit from the United States through so called inversions, where American companies purchase foreign businesses and then relocate to the jurisdiction of the company that they just acquired.

Individual tax rates in the U.S. are also high and have been increased substantially as the Bush tax cuts expired and the Obama tax increases have taken hold. Most wealthy people in the U.S. pay high tax rates. Individuals find it much more difficult to escape or reduce U.S. taxes than many American companies. We do not know of many effective mechanisms to significantly reduce U.S. tax rates.

The government found out with corporate taxes that the higher the rates, the greater the incentive for people to attempt to avoid taxes. Unfortunately, this also stifles investment and other activities which nurture economic growth for the country. The highest marginal rate for individuals is now 39.6% at the federal level, but for many wealthy people, there is an additional 3.8% tax levied on what the IRS calls "unearned income," such as dividends, interest, and capital gains. For irrevocable trusts, the 39.6% bracket starts when income exceeds a mere $12,150 per year. While there are several states without any state income tax, like Alaska, Washington, Nevada, Texas, Florida and others, many states impose state income tax at the 4-6% rate, and some states, like California and Hawaii, have state income tax rates of 10% or more. Some cities, such as New York, levy their own city tax on residents' income. With combined rates in excess of 50% in certain locations, taxes become a real deterrent for wealthy people. We believe that as the tax rates go higher and higher, governments actually collect less money overall as tax payers relocate, retire, or attempt to take other actions in order to deal with high tax rates.

Over the past 50 years, governments (federal, state and local) here in the United States have decided, for better or worse, that it is society's obligation to take care of its citizens and other residents if they cannot or will not take care of themselves. We do not disagree with American society's generous and compassionate approach. We would, however, point out that this compassion is not free and it is claiming an ever climbing proportion of U.S. GDP. The benefits include Welfare, Medicaid, Medicare, Social Security, food stamps, disability payments, generous retirement benefits for government workers, college and graduate school education, and now the enormous cost of free or heavily subsidized health insurance. These are all good things, but not without high costs to the government and therefore taxpayers.

As governments have provided these benefits, the costs of operating governments at all levels have skyrocketed. This has led to large and persistent federal government deficits and enormous stress on state and local governments as well. We are starting to see major bankruptcies such as the city of Detroit, and severe stress that is being felt at numerous municipalities and states such as Chicago and Illinois.

Longer term, governments at all levels will need to acquire more resources in order to fund these programs. If we are right that higher and higher tax rates do not produce greater tax receipts in the long term, we think the likely outcome is that the Federal Government will likely initiate a federal sales tax, in addition to the existing income tax. The rate could start off at a relatively low level of 3-4% and gradually rise as more revenue is needed. Sales taxes are regressive in that everyone pays them and therefore the tax turns out to be a much greater burden in percentage terms for low income individuals. These effects could be offset, at least in part, through tax credits or other adjustments.

Whether we are right about a national sales tax or whether the government attempts to raise revenue through higher tax rates or instituting other fees, it is clear to us that the portion of GDP claimed by the government is likely to keep growing.

We are often asked for general advice about what our clients should leave as an inheritance for their children and grandchildren. Over time, our advice has evolved for clients to leave more rather than less for their families. We continue to believe that our children will inherit a more uncertain world and what may have seemed like excess assets a few years ago, may be more necessary to assure their wellbeing as well as that of future generations to come. The observations made above influence our thinking. Fortunately, one area of tax law has become much more generous to taxpayers over the past 10-15 years. Estate taxes have been reduced dramatically so that in most cases a husband and wife with a basic estate plan can leave children and grandchildren over $10 million in inheritance without incurring estate taxes. With a republican house and senate over the next two years, it is difficult to believe that estate taxes will be made more onerous. In 2016, we could well have a different democratic president and a democratic senate, which could lead to significant changes to estate tax laws. Historically, estate plans made before the laws changed have been grandfathered. We encourage all of our clients to review their estate plans over the next two years.

After several years of great returns for the U.S. stock market, we expect a more modest, but still positive total return from stocks in 2015. An expectation of 5-10% total return seems reasonable. We anticipate losses for bond investors due to our expectation of higher interest rates. The losses are likely to be more severe for longer and poorer quality bonds.

All of us here at L. Roy Papp & Associates, LLP wish you and your family, a healthy, happy and prosperous new year.

Best regards,

Harry Papp

Harry Papp
Managing Partner
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