Countdown to Tax Deadline and Potential Tax Reform

Dear Valued Clients & Friends:

"*Taxation without representation ain't so hot either*" Gerald Barzan, humorist.

Taxes on our mind

Most Americans have recently completed or are in the process of completing the annual chore of submitting their individual income tax returns to the appropriate government entities. No matter your current economic situation, many people find this a complicating and confusing process. By the time the returns are filed, exhaustion has most likely set in. It does not matter whether you are just collecting the information or actually preparing the returns, this can be a tiring experience.

Just when you think you have had enough tax thoughts for the year, we are flooded with news that the federal government is looking to push through major tax reform. Congress has recently stated they are moving into tax reform after the health care reform was defeated. Not taking a side on what is good or bad, we thought it would be helpful to explain what to expect in the months ahead. Hopefully, this will make the news easier to understand.

History of Tax Reform

The last major overhaul of the income tax was the Tax Reform Act of 1986. The purpose was to simplify the tax rules while also reducing deductions and rates. The process took 11 months from the bill being introduced in the House until President Reagan signed it into law. The lesson here is major reform takes time. Maybe this time is different, but we would be apprehensive to think it will be radically different today.

Recently tax laws have been modified in patchwork fashion. Add this rule, modify this rule, and delete this rule. The end result is a tax code that has become much more complex and lengthy since the 1986 Act was passed over 30 years ago. Time is ripe for a return to simplification. However, the situation has been complex for some time and continues to trend towards more complication. Again, we would be apprehensive to think simplification is guaranteed.

Reconciliation Process

If major overhaul does not happen, the obvious next question is then what? The reconciliation process has become that answer recently. Reconciliation is a process that allows the Senate to pass legislation with only 51 votes, rather than the 60 votes normally needed to clear procedural hurdles. This process was also used by Democrats in 2010 in passing the Patient Protection and Affordable Care Act and by Republicans in 2001 and 2003 to pass the Bush-era tax cuts. The Republicans currently control 52 Senate seats. In today's divided government, this method appears once again to be the preferred strategy.

The reconciliation process can be defined by its mandatory requirement that the bill not increase the government's deficit beyond the 10-year window from when the bill is signed into law. The media and government officials call this deficit neutrality. However, before the 10 year window is up, the bill could approve deficit increases. This is how the 2001 and 2003 tax acts were passed. The Senate was not able to garner the 60 votes to make the legislation permanent, so they had to pass the bill under the reconciliation process. To avoid running afoul of the deficit neutrality rule, Congress had to have some provisions expire after 10 year period. You probably remember the confusion in 2010 surrounding expiring tax provisions. This was the cause for the confusion. Will the current legislators be willing to try their hand at that experience again? Only time will tell.

I think a simplified illustration will help understand this reconciliation process. Suppose a family of five is preparing a family budget for the years 2017-2026. The family budget normally requires approval from four family members. The family cannot come to a compromise that will please at least four family members. Thus, the three members in agreement decide to use this special reconciliation process. The caveat being that this special reconciliation process can only be used if the budget for the years after 2027 does not create a deficit (i.e. expenses greater than income). Expenses can be larger than income during the years 2017-2026, but those provisions causing the deficit would have to expire at the end of 2026. Assuming the three members can agree on this, their ideas can pass through as law in their family budget plan.

Now, imagine all the assumptions that we make in creating our own financial plans ten years down the road. Multiply that complexity by a large number and you have the government situation! Getting fifty-one Senators from across the US to go along with a plan instead of three family members also brings its own challenges.

What to do?

Tax reform is a difficult process. Many public policy initiatives are scattered throughout the tax laws. Reducing tax rates is the easy part. The hard part is everything else. The reduced rates will eventually have to be offset with cuts in spending or closing perceived tax loopholes in order to be deficit neutral. Thus, some taxpayer groups will be unhappy. Compromise will have to occur on some level if change is to be made.

Much like our investment strategy, your individual action with regards to possible tax reform should come back to your goals and individual situation. Understanding your current goal and financial situation is an imperative first step before even thinking about possible tax reform effects.

With knowledge of your current situation in hand, diversification in tax strategies is a good place to start with an unknown future. Diversification in type of accounts (tax-deferred, taxable, or tax-exempt) begins to set-up taxpayers for flexibility in the future regardless of the outcome. Being knowledgeable on your goals, having a grasp on your current financial situation, having flexibility in type of tax accounts, and keeping informed on changing tax reform begins to feel like a situation positioned for success.

As always, we appreciate your business and stand ready to discuss and review any changes or updates in your personal situation. If someone you know would benefit from this newsletter, please feel free to pass it along. We look forward to continuing to serve you in all of your investment and planning needs.

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