

## A Voluntary Socialist

Financial planners recommend maximizing 401(k) contributions because it lowers taxable income and the account grows tax deferred until retirement. Yet I know of someone who has decided to disregard conventional wisdom and forgo funding his 401(k). He has decided to pass on this tax deferral benefit because he believes that America is falling down the slippery slope to socialism. He'd rather pay taxes today while tax rates are low than deferring taxes until retirement when he believes that his tax burden will be much higher. I disagree.

Do-it-yourself investors often allow their worst-case scenario vision of tomorrow to determine their actions today. While I'll admit that any worst-case scenario is possible (after all, anything can happen) I have to insist that since it's the *worst*-case scenario the odds that it will materialize are slim. The farther we gaze into the future the range of possible outcomes broadens and the less likely it becomes that any particular prediction will come to pass. We worry about the things we think we understand but our crystal ball is so clouded that we're often worried about the wrong thing. Prudent financial planning focuses on things as they are today, the *most likely* scenario for tomorrow and is flexible enough to accommodate changing circumstances. An airline pilot who acted upon the worst-case, rather than the most probable, scenario for today's flight would never leave home.

We have a graduated federal income tax system which can be confusing. The confusion comes from not understanding the difference between a taxpayer's average tax rate and marginal tax bracket. The average tax rate is easy to understand and calculate - divide the federal income tax by gross income. The marginal tax bracket is often misunderstood. Many people believe that if they are in the 25% marginal tax bracket that all of their income is taxed at 25%. But this is not the case. The marginal tax bracket is the tax rate to be paid on the *next* dollar of taxable income. We can look at a 2010 tax-rate chart to try and clarify this concept. A single taxpayer will pay a 10% tax on the first \$8,375 of taxable income, regardless of total taxable income. All taxable income between \$8,376 and \$34,000 is taxed at 15%, again regardless of total taxable income. The income between \$34,001 and \$82,400 is taxed at 25% and income between \$82,401 and \$171,850 is taxed at 28%. For married couples, the tax rates are the same but the income limits in each bracket are higher. For example, while the single filer reaches the 28% marginal tax bracket at \$82,401, a married couple reaches the 28% marginal tax bracket on taxable income above \$137,300.

Let's consider our fearful investor. He is single with an annual salary of \$125,000. If his itemized deductions and personal exemption total \$20,000 his taxable income will be \$105,000, placing him in the 28% marginal tax bracket. His federal income tax will be \$23,000. We can calculate his average tax rate by dividing his tax (\$23,000) by his gross income (\$125,000) and find it to be 18%. So for 2010 he will be in the 28% marginal tax bracket and have an average tax rate of 18%. But what if he takes my advice, forgets about creeping socialism and defers \$22,000 of his salary into his 401(k)? His taxable income would decline to \$83,000, his federal income tax would decline to \$17,000 and his average tax rate would decline to 14%. Not exactly an oppressive burden.

Our investor is going to pay an unnecessary \$6,000 in extra income taxes this year because he fears a socialist future for America. Were he not so worried, he would fully fund his 401(k) and his \$6,000 tax savings could grow tax deferred for as long as he desires. If he does this each year in the decade remaining before he retires and his 401(k) grows at an annual rate of 6% the account balance at retirement would increase by \$79,000. He is not just forfeiting \$6,000 every year by paying higher taxes; he is also forfeiting the compounded growth of those dollars. Sadly, this \$79,000 is the *minimum* amount that he will lose. The benefits of tax deferral will increase if income tax rates rise. For example, if tax rates double our investor would be in an insanely high 56% marginal tax bracket. I suppose that would qualify as socialism. However, with tax rates that high, the annual tax savings of a \$22,000 401(k) contribution would rise from \$6,000 to \$12,000. By not taking advantage of tax deferral, our worried investor is doing exactly the opposite of what he should be doing in a rising tax rate environment.

There is a second point to consider. One aspect of our tax code that is overlooked by those who believe that they will be in a higher marginal tax bracket in retirement is the inflation indexing of tax brackets (thank you, Ronald Reagan). For a single person today, the 25% marginal tax bracket tops out at \$82,400. If we assume 3% annual inflation for the next decade, the upper end of the 25% tax bracket will max out at \$110,700 for single filers and at \$184,500 for joint filers in 2020. The upper end of the 15% tax bracket for married couples will rise to \$91,000 by 2020. So unless you are fortunate enough to have a generous defined benefit pension plan or will have significant income during retirement, you're not likely to be in a higher marginal tax bracket during retirement than during your working years. If the so-called "Bush tax cuts" of 2001 and 2003 are allowed to expire as scheduled at the end of this year, the 25% marginal tax bracket will rise to 28% and the 28% tax bracket will rise to 31% - rates that were in place a decade ago. The 15% marginal tax bracket, which even the Obama administration has no plans to raise, will remain in place.

There's a third point that needs to be considered - one that I have not seen addressed by the financial media. 401(k) contributions produce a tax benefit at your marginal tax rate because your salary deferral comes off the top of taxable income. But in retirement, the tax on IRA and 401(k) plan withdrawals will be at your *average* tax rate not your marginal tax rate. Let me give an example. Let's consider a retired couple requiring \$8,000 per month in total income. They receive \$3,000 a month from Social Security and take the rest as distributions from a pretax retirement plan. With just the standard deduction and their personal exemptions they are in the 25% marginal tax bracket and will pay \$9,800 in federal income taxes this year. The tax on the Social Security portion of their earnings will be \$3,800 so the federal income tax on their \$60,000 distribution will be \$6,000 -- a 10% average tax. Obviously, these numbers will be different for each person's circumstances but the strategy is the same. Contributions to tax-deferred retirement plans generate tax savings at your *marginal* tax rate but withdrawals from these plans are taxed at your *average* tax rate.

For those individuals in low marginal tax brackets (15% or lower) a Roth IRA or a Roth 401(k) is a more appropriate selection than a traditional IRA or 401(k). The long-term tax-free growth offered by the Roth will be more beneficial than the current tax savings, especially for young workers who have many years for the Roth account to compound tax-free.

Considering what's been going on here in America the last few years, we can all appreciate the concerns our investor has about America's future. Many people consider a socialist future as inevitable. They believe that feeding off the public trough is a drug habit that our country can't kick. But can we agree that Americans have a proclivity to obsess over our worst-case scenarios? But these scenarios do not represent reality. A rising socialist trend may or may lie in our future. In the meantime we would do well to rid ourselves of the anti-historical belief that any current trends (politically or economically) will continue in a straight line to the horizon and beyond. In behavioral economics this error is called recency bias - the belief that what has occurred in the recent past is the new normal and represents the new permanent reality. We only have to look back a few years when conventional wisdom said that home prices could never go down to see the folly of such thinking.

Socialism has failed everywhere that it's been tried because eventually you run out of other people to tax. Today, Americans are rebelling against an economic strategy consisting of public debt, higher taxes and unending deficits. I find it encouraging that there's a taxpayers' revolt brewing and taxes haven't even gone up yet. The current collectivist regime in the White House and Congress were put in office by a panicked electorate during the worst economic crisis since the Great Depression. But as the panic has subsided, our attention has focused on what is being done rather than what had been promised. Never in our history have we placed more confidence in our political class than in ourselves. Never in our history have we asked government to redeem the citizenry; we ask government to protect the rights of the citizenry. We have never needed or wanted a political ruling class to determine the national agenda. We are a practical and sober nation of 300 million citizens who by our collective actions determine our national agenda. America has many problems but it is not a broken nation and it can be repaired. We enjoy such peaceful and prosperous lives that things have to get pretty far out of whack before we get angry enough to exercise our franchise and reverse the direction of our political and economic pendulums.

Believe it or not, the pendulum has been swinging back (unnoticed on this side of the border) in Canada. By the early 1990s, Canada was hobbled by out-of-control government spending, soaring debt and high taxes. It was the North American version of a Western European socialist democracy. Then things started to change. Quaint ideas such as less government spending, fewer government employees, a balanced budget and lower taxes started taking hold. By 1998 the federal government ran a budget surplus and began paying down its national debt. Provincial governments also focused on cutting spending, tax relief and reducing debt. The last three elections in

Canada have focused on taxes -- not whether they should be cut but rather what type of tax cuts should be implemented. In Canada the corporate tax rate is 18%, while in the USA it is 35%. Personal income taxes have declined. The bottom two personal income tax rates have been reduced and income thresholds for all tax brackets have been increased and indexed to inflation. The capital gains tax rate in Canada is now 14.5%. Our maximum capital gains tax rate is 15% but scheduled to rise to 20% at the end of this year. Canada's national sales tax was cut from 7% to 5%. The Canada Pension Plan (their version of Social Security) has been reformed and is now financially solvent and will be able to fund the needs of retiring baby boomers. If present trends continue, within two or three years Canada will have a smaller government as a share of its economy than we do here in the US. It is emerging more quickly from the global recession than almost any other industrialized country. If it was true that more government spending helps to grow an economy, the US economy should be outperforming the Canadian economy right now and Canada's economy should have outperformed ours back in the 1980s and 1990s - the exact opposite of what has happened. From 1982 through 2008 the Canadian unemployment rate was almost 3% higher than ours but since October of 2008, just about the time US government spending went off the charts, it has been less than ours. Besides playing hockey and drinking Molson beer, our northern neighbors have been changing the way they do business by freeing up their markets, lowering taxes and reducing the size of government.

So what can we say about our worried investor? He has allowed his fears to dictate his actions, is ignoring the effect inflation indexing has on tax brackets and confusing his marginal tax bracket with his average tax rate. He will pay 35% more in federal income taxes this year than Uncle Sam requires. That makes him, to my way of thinking, a voluntary socialist.

### The BP Disaster

No, I'm not talking about crude oil pouring uncontrollably into the Gulf of Mexico. The BP disaster that I'm referring to is the retirement plan allocation of BP's US employees. Along with the usual selection of mutual funds they have the option to invest their retirement savings into shares of BP stock. As of year-end 2009, more than 29% of all assets in the company's employee retirement plans were invested in BP stock. It's quite common for companies that offer their stock to employees to have a large portion of employee retirement assets invested in those shares. Coca-Cola employees have 51% of their retirement plan assets invested in Coca-Cola stock and Caterpillar employees have placed 44% of their retirement plan assets in company stock. Employees often have an emotional attachment to the stock of their employer, especially if the company appears to be doing well and has bright prospects for the future. That said, the unnatural affection of UAL that employees have for their company's stock remains one of the great unsolved mysteries of my adult life. But it's easy to see why BP employees were eager to invest in their company's shares. The company was profitable, the stock paid a 5½% dividend and it is a global supplier of petroleum products. What's not to like about the prospects of a company like that? Putting a large portion of your retirement savings in BP stock would seem to minimize the uncertainty and confusion of investing for retirement.

But putting too much money into your employer's stock violates one of grandma's best pieces of advice -- don't put all your eggs in one basket. From a financial planning standpoint it's not prudent to have your salary, health, life and disability insurance premiums, and retirement income all written on the same checking account. In fact, it's financially perilous. On April 30, when the oil rig exploded in the Gulf of Mexico, BP shares stood at \$59. They declined 50% in the next two months producing a \$1 billion loss in employee retirement accounts. To add insult to injury, the dividend was soon eliminated. No one can be sure if endless lawsuits and the cleanup bill will drive BP into bankruptcy court. If so, the company will eventually emerge from Chapter 11 reorganization but the value of BP shares in employee retirement plans will vaporize. Grandma knew what she was talking about.

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