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"…power is always dull, it is dangerous, it is brutal…"
—Ludwig Erhard, 1962

[A list] "of the molders of public opinion…would comprise several thousand persons. But…many of these leaders are themselves led, sometimes by persons whose names are known only to a few….A presidential candidate may be 'drafted' in response to 'overwhelming public demand,' but…his name may be decided upon by half a dozen men sitting around a table in a hotel room."
—Edward Bernays, Propaganda, 1928

Tax and Financial Strategies

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Wealth Creation Strategies

A Proliferation of Lies: Hidden Taxes and Phantom Tax Rates

I detest lying, especially when it serves as propaganda. Such lies are intended to manipulate opinions and are detrimental to sound public policy.

There are many types of lies including outright ones, half-truths, lying by omission (a continuing misrepresentation), false denials and changing the meaning of words, the degree of which has become Orwellian. While I do not include hyperbole or exaggeration a lie, I consider statements minimizing the cost of services and costs imposed due to government regulations among the most egregious lies. For example, the push for increased government control over health care in which the idea "your family health care premiums will drop $2,500" was a lie. I knew this because third parties would be paying more of patients' bills, and insurers were required to assess premiums based on a cost-plus (markup pricing) regime, which obviously incentivizes insurers to maximize costs to increase profits. In the eight years following, premiums for several self-employed clients more than tripled.

Among the numerous lies about taxation and tax law disseminated by the mainstream media is the idea the "wealthy" do not pay their "fair share" of taxes. The term "fair share" is never defined, the fact that the top 1% income earners pay 40% of all income tax and that more than 50% pay no tax is rarely (if ever) recognized, and few acknowledge that the "wealthy" may, in many years, have little or no income. The fact that some high-income earners are not "wealthy" is discounted; they may have a large one-time taxable gain on which a boatload of tax is paid. Some simply spend it all. Saying "wealthy" people don't pay taxes, or their "fair share" of taxes shows me, a decades-long tax pro, that person is either uninformed or envious. High income earners pay a ton of tax, especially in a system in which the more you make, generally, the higher the marginal tax rate and, consequentially, the larger the tax.

The Inflation Tax

However, one particularly destructive "tax" generally hits lower income earners and the less wealthy harder: **inflation**. Until the last issue of *Wealth Creation Strategies*, we have rarely mentioned inflation because it has been stable for nearly four decades. In the long run, however, inflation—a decrease in the value of money—is essentially a hidden tax and arguably the greatest and most destructive financial lie. The Federal Reserve (the "Fed") was purportedly created to protect the currency from changes in value; yet, since its inception in 1913 the value of $1 has collapsed to less than four cents. The Fed creates more dollars to accommodate government deficits, which chase the same aggregate amount of goods and services, serving to decrease the value of each dollar, increasing the dollar price of those goods and services. If inflation is 5%, the value of your cash decreases by an equal amount, offset by a fraction of a point for the minuscule interest earned, minus the tax on that tiny income. Inflation is partly caused by government spending more than it takes through overt taxation, borrowing the difference, forcing the Fed to create additional dollars via credit (that nearly $30 trillion in government debt—approximately $90,000 per capita, which does not include magnitudes-larger off-balance sheet items such as promises to pay future medical and retirement expenses via "Social Security" and Medicare). The rate of inflation has dramatically increased due to the unaffordable government handouts and payments for taking livelihoods by locking down businesses (see the 5th Amendment), along with a compliant Federal Reserve. The additional dollars first went to purchase and bid up the prices of financial assets, like stocks and real estate, and now goods and services. This ultimate hidden tax is particularly painful when wages do not keep up with inflation in everything else—which, for the last 18 months, they have not. While I believe a deflationary event is inevitable, we could continue to suffer price increases—the *result* of inflation—for a while.

Tax Law Deceptions

Another destructive hidden tax is created by **tax law that is unadjusted for inflation**. Some taxes are inflation-indexed, such as the regular income tax, comprising the advertised (nominal) tax rates on various "chunks" of income. Some deductions and credits are inflation indexed, such

as the standard deduction, the Earned Income Tax Credit, and allowable contributions to retirement plans and HSAs. However, many deductions, credits and exclusions are not inflation indexed. Phase-ins, which require income be added to the taxable base as other income increases, and phase-outs, where deductions and credits are phased out as income increases, are frequently not indexed. Due to inflation, taxes increase imperceptibly at first, but substantially over long time periods. For example, the extra tax imposed on a gain of $260,000 on the sale of a single filer's main home in 1999, using the non-inflation adjusted exclusion of $250,000 per person (established in 1997) would have been a couple thousand dollars. The additional tax on a profit that merely kept up with inflation could be nearly $64,000 today (see enclosed chart).

The yearly allowable net $3,000 capital loss deduction has been unchanged since 1976. The points at which Social Security income starts to become taxable have been unadjusted since the inception of phase-ins (the 50% phase-in, implemented in 1983, starts at—other income plus half of Social Security—$25,000 for single and $32,000 for joint filers; the 85% phase-in, created in 1993, starts at—other income plus 85% of Social Security—$34,000 for single and $44,000 for joint filers). The point at which most otherwise allowable rental real estate loss deductions begin to phase out ($100,000) and completely phase out ($150,000 of Modified Adjusted Gross Income) has been unadjusted since 1987. The American Opportunity Tax Credit (a tuition credit), has been unadjusted since inception in 2009. The Tax Cuts and Jobs Act, passed in late 2017, set a $750,000 mortgage limit on which main and second-home interest can be deducted; the $10,000 cap on state and local income and property tax deductions are also unadjusted, even as home prices skyrocket. The Net Investment Income Tax (NIIT, intended to help pay for medical coverage for lower- and now middle-income Americans and the undocumented) imposes a 3.8% additional tax on investment income once Modified Adjusted Gross Income exceeds $200,000 ($250,000 for joint filers—note that marriage penalty!); this has been unchanged for the nine years of its existence. Due to inflation, fewer taxpayers qualify for such deductions, exclusions and credits; the real tax savings decline each year and the tax increases accordingly. The failure to adjust these thresholds for inflation allows Congress to increase taxes every year without having to pass bills that overtly do so. This is devious.

Another widely touted myth, in this case a half-truth, is that **marrying saves taxes**. This has long been a peeve of mine; most people think they do right by getting married and will be rewarded with a lower tax bill. Sometimes that happens; oftentimes it does not, due to various marriage penalties, especially those that hit low-income earners. Low income refundable tax credits are reduced or eliminated by marrying, which could incentivize couples to reconsider getting married. *

Your Marginal Tax Rate May Not Be What You Think

Other than inflation, the most destructive lie is that **nominal (advertised) "marginal tax rates" can be relied on**. (The marginal tax rate is the % additional tax or % additional tax savings on a particular incremental "chunk" of income or deductions.) In making tax and financial decisions, most taxpayers believe these false rates, which often result in less-than-optimal and, even, poor decisions. When we show our clients the many hidden but very real tax rates that permeate the tax code and how they are affected, decisions often change. These hidden rates are often exorbitant, frequently increasing the real tax rate by 50-100% over the advertised one. The most common hidden rate results from the phase-in of Social Security income. While in the nominal 12% bracket, real tax rates are frequently 18% and 22.2% on "chunks" of income. Many single (and, recently, a few married) Social Security recipients pay 40.7% on the "chunk" of income for which the "advertised" rate is 22%. The phase-out of tuition credits subjects many taxpayers in the "advertised" 22% bracket to 34.5%, 47% and even 72% real marginal tax rates. Many low-income taxpayers who "think" they are in the 12% bracket are, for purposes of certain IRA and 401-k contributions, subjected to real marginal rates that often exceed 50% (and north of 100% in some select situations). Additional income is often taxed at 40% tax rates as the Earned Income Tax Credit phases out. Many middle-income taxpayers with rental property losses in "advertised" 22% and 24% brackets are subjected to real 31% and 36% marginal rates on large swaths of income.

Medicare Premium Surcharges (known as IRMAA, or Income-Related Monthly Adjusted Amount) have created stratospheric marginal tax rates since their inception in 2010. If income increases by $1 over various thresholds, Medicare premiums (an effective tax) can increase by as much as $1,000 per person—at each threshold. That is a 100,000% real marginal tax rate.

Repayments of federal medical premium subsidies create even higher stratospheric real marginal tax rates for some (in years other than 2020, when the repayment of the credit was retroactively suspended), exceeding one million percent for a couple of clients each year were it not for our strategic intervention.

Here's an example of how an understanding of real marginal tax rates can change behavior: working Social Security recipients relying on their "advertised" 12% rate normally forego retirement plan contributions. When we show their "real" (but hidden) bracket is 22.2% or 40.7%, they often make that contribution if otherwise eligible. Once they stop working, the withdrawal of those same funds may be taxed at 12% or even zero. They might save as much as $2,849 on a $7,000 contribution and pay tax as low as zero on the withdrawal. What a no-brainer! But most taxpayers have no idea how profitable such strategies can be.

The recent "stimulus" payments have increased such hidden brackets in thoroughly deranged fashion. As discussed in "The Season from Hell" in the previous issue of *Wealth Creation Strategies*, the tight phase-out range for the mid-2021 "stimulus" # 3 of as

much as $1,400 per person creates an add-on 28% ($1,400 / $5,000 phase-out) marginal tax rate for single taxpayers in the phase-out range (**Adjusted Gross Income, or AGI** of $75,000 to $80,000) and 14% *per taxpayer, spouse and dependent* ($1,400 / $10,000 phase-out) rate for **Married Filing Joint** (**MFJ**) taxpayers in the phase-out range, AGI $150,000 to $160,000. Joint filers with three dependents could be subjected to an additional (14% x 5 =) 70% *real* marginal tax rate, in addition to the advertised 22% income tax, 7.65% **FICA** (**Social Security and Medicare**) plus their state tax—more than 100% overall marginal rate on the "chunk" of income in the phase-out range. In other words, they could earn $10,000 and lose it all to tax and loss of "stimulus."

New Tax Laws for Families that May Require Planning

Three tax law changes that apply only to 2021 (unless extended) under the American Rescue Plan Act (**ARPA**) add to the difficulty in planning because of various hidden add-on marginal tax brackets. With only a few months left to adjust taxable gross income levels by increasing 401(k) contributions, how many will learn this, figure out what they can do *and* act timely? The first is an increase in the *Child Tax Credit* (**CTC**) from $2,000 to $3,600 for children up to and including age 5, and to $3,000 for children ages 6 through 17 (in other years, the $500 Other Dependent Credit kicks in at age 17). The CTC starts to phase out at $150,000 for joint filers, $112,500 for heads of household and $75,000 for single filers, decreasing by $50 for every $1,000 increase in income over the limits. This approximates an additional 5% hidden-but-very-real marginal tax rate. The credit decreases to $2,000 and flatlines for those with incomes under $400,000, where the credit again begins to decrease by $50 for every $1,000 increase of income.

ARPA also increased the *Child and Dependent Care Tax Credit* (**CDCTC**), the credit for costs paid to care for dependents under age 13 while the taxpayer(s) works. Generally capped for decades for most taxpayers at a 20% credit of amounts paid for dependent care up to $3,000 per dependent for up to two dependents, this credit has been "temporarily" increased to a maximum of 50% of amounts paid up to $8,000 per child for parents whose AGI is less than $125,000, phased down to 20% for those with incomes over $185,000 (after which it's stable until income hits $400,000, where the credit is newly phased out at a rate of one percent for every $2,000 increase or fraction thereof, hitting zero at $440,000). These limits and phase-outs are the same for all filing statuses. This creates a phantom, but very real, add-on (roughly) 4% marginal tax for those with one child (8% with two children) in the income phase-out zones. This subjects upper income taxpayers with dependent children qualifying for both the CTC and CDCTC to a phantom-but-real 45% federal income tax rate; add 3.8% Net Investment Income Tax, potentially 7.65% Social Security/ Medicare or 15.3% SE tax and as high as 9.3% California state income tax rate; zero to 8% in most other states.

Further complicating decisions, allowable Section 125 "Cafeteria" plan contributions, which decrease taxable wage income, were increased from $5,000 to $10,000 for 2021 only. While most parents normally get a larger tax benefit by contributing to such plans, this year a larger tax savings may result by *not* contributing and *instead* taking the 50% tax credit. This is obviously true if AGI is less than $125,000, as well as for many parents with incomes over $125,000, up to the point where the credit is less than their tax savings achieved by excluding the income. (Due to mismatches between allowable expenses for the credits and for this exclusion of income, it is even more of a mess than we can describe; email or call us if this applies.)

You can read more about the various lies on our website. Given my views on lying, it should not be surprising that one of the top headings by subject (item "B" in the index at https://www.dougthorburn.com/newsbysubject.html) is "Taxes, Stealth Taxes, Penalties and Other Lies."

Start planning for this now! The best way to avoid such exorbitant phantom, but very real marginal tax brackets, or to reduce taxes by other means, is to ***plan***. While this can often be done late-year or even the following year (for example) by making retirement account contributions and/or purchasing equipment for your business, starting late makes it more difficult. Say joint income is $180,000 before 401(k) contributions and you want to get AGI below $150,000 to fully capture the 3rd "stimulus" payment and child tax credit, and increase the dependent care credit. While you can do this by contributing $15,000 to each 401(k), you may not be able to reach that goal if you begin contributing in November. **Please plan early. We are here to help.**

If you did not qualify for the $1,400 per person 3rd "stimulus" payment based on 2019 or 2020 income, you can still qualify for it on your 2021 return if 2021 income is low enough. And there may be much more at stake. Take a joint filer with two kids in college that each qualify for $2,500 tuition credits. If the parents can decrease income from $180,000 to $150,000, they will save [(22% advertised marginal bracket x $30,000) + $5,000 tuition credits + $5,600 "stimulus" payments =] $17,200, or **57.3%** of the $30,000. Add 9.3% California tax savings of an additional $2,790, for a total potential savings of $19,990, or **66.6%. This is worth planning for, isn't it?** Take the same example but instead with younger children for whom you pay dependent care of $8,000 for each. By decreasing your income from $180,000 to $150,000 you save at the 22% advertised rate, 8% from the phase-in of the CDCTC, 5% from the phase-in of the additional CTC and $5,600 of "stimulus" payments (resulting from the $1,400 per person "stimulus" as income drops from $160,000 to $150,000). The total savings is $16,100, or **53.67%** of the reduction in income. Note the extraordinary change in marginal tax rates on the various "chunks" of income as income declines: from $180,000 to $160,000 the marginal rate of savings is (22% + 8% + 5% =) 35%; from $160,000 to $150,000, due to the phase-in of "stimulus" # 3, it is

[22% + 8% + 5% + (14% x 4 =) 56% =] 91%. Add California state rate of 9.3%, for an additional $2,790, and rake in a total tax savings of $18,890, or nearly **63%** of the income reduction, and **100.3%** of the "last" $10,000 in reduced income as AGI drops from $160,000 to $150,000. As a side note, decreasing income via a Cafeteria Plan helps reduce total income to $150,000 more easily and, at that level of income, may save even more tax dollars than the Child and Dependent Care Tax Credit. The lie of marginal tax rates can lead to complacency and a consequential failure to plan. While protecting oneself from the ravages of inflation is beyond the scope of this article, and there's not a whole lot we can do about the fact that many tax laws are not inflation-indexed (you can write your Congress-critter—good luck with that!), there are numerous changes you can make when you see through the lies of marginal tax rates and discover that your real rate is much higher than the advertised one. We hope this makes

* We can thank both sides of the aisle for the massive increase in single-parent homes which, among Black Americans, increased from 20% to 80% between 1964 and 2020. On the one side, the inception of LBJ's "War on Poverty" created massive incentives for an increase in single parent households; on the other, the Earned Income Tax Credit, which is much larger for single-parent workers than two-income households, was the brainchild of the great Milton Friedman, who intended that this replace all other welfare programs.

The Estate Tax Should be Abolished, Not Increased

The 2017 Tax Cuts and Jobs Act (TCJA) increased the gift and estate tax exclusion to a now inflation-adjusted $11.7 million per person ($23.4 million for most married couples), with a flat 40% estate tax on values exceeding that figure. This exclusion allows up to $11.7 million per person of lifetime gifts and assets—including businesses, farms, portfolios and real estate—to be passed to heirs tax-free, preserving resources in private hands.

The current administration is proposing a two-thirds *reduction* in the combined gift and estate tax exclusion, to $3.5 million per person, with a graduated tax rate of up to 65%. This will result in a huge *increase* in the number of taxable gifts and estates. This administration also proposes taxing unrecognized (unsold) capital gains exceeding $1 million on the final return of the decedent. An $11.7 million estate, currently tax free, would face a tax of at least $3.28 million and as much as $8 million for those with large, unrecognized capital gains, forcing the sale of estate assets—portfolios, IRAs, real estate and businesses—just to pay the tax. Below, we will see why the total tax on death may easily exceed 100% in *real* inflation-adjusted terms, decimating the capital upon which our high living standards depend.

This will increase profits of tax planning firms that this lifelong libertarian, who believes society is better off when you decide how your earnings are spent, invested and bequeathed, would much rather do without. The worst part is knowing the tax increases would go to government coffers to be largely squandered on politically driven rather than market (consumer) driven spending. As a few of us have learned from history, politically driven decisions are detrimental to wealth creation. There are several reasons why the implementation of these proposals will lead to *greatly* diminished overall societal wealth.

The Destruction of Wealth

First, despite occasional missteps, **you and your beneficiaries spend and invest your hard-earned funds more efficiently than any third-party bureaucrat working for a government ever has, can or will**. *The most efficient allocation of resources requires that property be allocated to its highest and best use.* Private owners have "skin in the game" while third party bureaucrats do not; you care a whole lot more how your money is spent or invested than anyone else. Additionally, an efficient and rational allocation of resources requires an interplay of supply and demand within a free market, where prices—which represent consumers' perceived values of stuff—are free to move. This is all-but absent in government systems. Because Consumer-Kings, by spending their earnings, force—incentivizing through the profit and loss mechanism as opposed to coercive force with threats of police-state violence—private owners to allocate resources to their highest and best uses, the more funds kept in private non-government hands the more efficient the allocation of resources. This increases the value of those resources, increasing overall wealth.*

Second, assets left to heirs that exceed the exemption amount **are largely double taxed, further destroying incentives to save, invest and create long-term wealth.** The decedent was taxed on wages, self-employment income, rental income, withdrawals from retirement accounts, interest and dividend income, and nearly every other type of income imaginable. These funds were used to buy the assets that comprise the estate. The decedent delayed gratification by not squandering and, instead, saving and investing—and tax was paid on income earned from investments. Most of the funds in an estate have already been taxed once; the estate tax subjects previously taxed earnings to yet another tax. If the proposed changes are implemented, fewer will defer gratification; more will opt, instead, to spend rather than invest which, by definition, reduces the capital upon which our living standards depend.

Extortion by Another Name

Third, the proposed estate tax will **subject more assets to both the overt estate tax and the most destructive covert tax, inflation**. Even without the estate tax, assets can be subjected to real tax rates exceeding 100%. For example, if you purchased an investment property for $250,000 in 1997 and sold today for $410,000, you would owe income tax on exclusively inflated gains, because $410,000 today was worth $250,000 in 1997. The same

you more likely to plan.

is true for such property purchased in 1980 for $120,000; these examples use the government's inflation calculations—which many believe are understated. You would pay tax on an inflationary ($410,000 – $250,000 =) $160,000 "profit" (or $410,000 – $120,000 = $290,000 for the 1980 purchase) which, at "normal" capital gains tax rates in CA would generally amount to, under *current* law, at least $38,000 ($75,000 on the larger "gain"). You invested $410,000 in current dollars 24 years ago and got back that same $410,000 and paid tax on $160,000 of illusory inflationary gains, leaving at most ($410,000 – $38,000 =) $372,000, or $227,000 in 1997 dollars—less than your $250,000 investment 24 years ago.

That said, under current law, heirs avoid tax on embedded gains on inherited property, because it is given a new cost basis: the fair market value on the date of the decedent's death. For example, if you inherit an investment property from your parent who purchased the property for $100,000 in 1970, valued at $600,000 on the date of death, your cost basis in the property is $600,000. Tax on what were largely inflationary gains is avoided. However, the current proposal would eliminate this "step-up" in basis, requiring the decedent to pay tax on the embedded gains on their final tax return. Hence, the *real* tax rate is greater than 100% and because inflation is so-often misunderstood or ignored, this extortion is hidden from nearly everyone.

Under the proposal, *all gains, over $1 million, including those due to inflation, would be taxed on death*, just as they are when sold before death. Say an $11.7 million estate consists of highly appreciated property purchased in 1980 for $1 million. The $800,000 portion allocated to the improvements has been fully depreciated, which leaves only undepreciated land, with a cost of $200,000, as the remaining basis. The federal income tax, using the current administration's proposed tax rate of 43.4% on long term capital gains exceeding $1 million, would be roughly $4.3 million (factoring in the current rate on long term gains on the amount up to $1 million). Currently, the estate tax is computed on the pre-income tax and pre-selling costs of assets held by the estate; if we assume that insanity continues, a $3.7 million estate tax is imposed. This leaves ($11.7 million – $4.3 million – $3.7 million =) $3.7 million for the heirs. Because $1 million in buying power in 1980 is the equivalent of $3.5 million today, the heirs get almost no return on investment from their parents' blood, sweat and tears from a lifetime of work and subsequent willingness to defer gratification, saving and investing their earnings.

And consider how incredibly difficult it will be to *reconstruct and prove the costs of improvements on inherited property*. As discussed in issue # 69 of *Wealth Creation Strategies*, tracking such upgrades and improvements to your own home is already a challenge; imagine trying to prove costs of an inherited property, especially if the decedent did not keep good records (assuming you can even find and interpret them!).

A **fourth** reason why overall wealth will be further diminished is the increased disincentive to save and invest and, instead, **an incentive to spend on frivolities**. Taxation of income and assets diminish capital formation because such taxation violates property rights. In countries where property rights are virtually totally unprotected and government takes or controls nearly everything produced, little if any long-term wealth is created. Cuba is an excellent example: nearly all capital there is 60 years old due to their 60 years of socialism (google "decaying Cuba images" for a view of ancient buildings and antique cars). Without new and continuous capital formation that is stifled under such repressive politico-economic regimes, aggregate living standards decline and ultimately collapse.

Why is efficiently allocated capital so crucial to the creation of societal wealth? Consider the difference between a big-rig driver and a worker carrying goods on her shoulders. The worker may have a higher I.Q., may be stronger, and may be better educated than the trucker, but the capital investment—the truck—makes the difference. The billions in deferred spending invested in factories that build those trucks, not to mention fleets of their output—the trucks—allow a big rig driver to *outproduce* and, therefore, *out-earn* a worker carrying goods by thousands of times. Savers and investors delay gratification by not spending their earnings on frivolities and instead invest, in the aggregate, billions in factories that build trucks and other tools of production. They reduce saving and investing when they keep less of their earnings. Capital dries up, innovations decrease, production dwindles and aggregate living standards stagnate or decline. Everyone except those with political pull lose.

Finally, the increased rates and decreased exclusion from the estate tax will incentivize the withdrawal of money from productive investments. This not only reduces capital and long-term wealth creation, but also reduces business formation, business expansion, business operations and job creation. It reduces the number of people willing to take risks in building the businesses that create goods and provide services, therefore decreasing societal wealth. While the proposed estate tax may not *directly* affect most of us, it *will* affect *everyone* adversely because it will *indirectly* reduce job creation, wages and the supply of goods and services.

I long wondered how Germany has done so well with its smothering welfare state. It turns out Germany imposes low taxes on the inheritance of family businesses. Taxes are paid by the individual heir, not the estate, with taxes ranging from 7% to 50% levied on the inherited assets based on the relationship of the decedent and types of assets; the closer to the bloodline of the decedent and the more business assets left to heirs, the lower the tax. As a result, a higher percentage of businesses in Germany are generationally family owned than in perhaps any other country. When publicly owned companies are required to compete with private family-owned firms, the former must remain lean and efficient to survive. This may be the reason for the preservation of the German work ethic and the creation of superior products by well-run companies that survive generations. It may largely explain the German economic miracle that contin-

ued long after its Austrian-school economist, Ludwig Erhard (the Minister of Economic Affairs under Chancellor Konrad Adenauer from 1949 to 1963), died. **

Their system is a classic case of every semi-free economy having a "freedom" outlet. In nearly every country (true also of the 50 states), innovation and wealth creation are smothered in some areas of the economy, while other areas are left freer.

These calculations do not include the effect of state income taxes and the estate and/or inheritance taxes imposed by 18 states (CT, DE, HI, IA, IL, KY, MA, MD, ME, MN, NE, NJ, NY, OR, PA, RI, VT, and WA) and the District of Columbia, most of which have lower exemptions. Their taxes can increase the overall maximum tax rate on an estate by as much as 30% for states that "piggyback" onto federal income tax rules.

As The Tax Foundation puts it, estate and inheritances taxes "disincentivize business investment and can drive high-net-worth individuals out-of-state. They also yield estate planning and tax avoidance strategies that are inefficient, not only for affected taxpayers, but for the economy at large."

If a decedent retains a big chunk of cash or funds a large enough life insurance policy to be able to pay for these proposed larger taxes on death, the assets were not put to their highest and best use—increasing their estates by building large productive enterprises. And while assets of an estate can be wasted and spent on frivolities by heirs, those who build large estates often teach their children to invest wisely; wealthy people who recognize that their children will not handle an inheritance properly can leave their estate to charity. Wealth is more efficiently allocated to non-governmental hands, regardless of ownership. You and your heirs are the best asset allocators and these extra taxes would take a huge bite out of the assets available to heirs. Everyone's living standards would be reduced by this overt disincentive for wealth creation, regardless of the purported political aims of such changes. The price of "equity" (equal outcomes) is a reduction in aggregate living standards.

* While this is true for all taxes, those that discourage the creation and maintenance of wealth are especially destructive. To maximize wealth creation, taxes should be minimal and based on nearly anything other than net worth or estate valuations and incomes. As for "value": the value of goods and services can only be rationally measured by the price willing consumers are willing to pay. There is no way to rationally value stuff you are forced to pay for (including medical and educational services). If force is involved, the value ascribed by the ultimate consumer is almost assuredly less than that ascribed by the producer.

** Erhard did more to denazify the German economy after WWII than anyone. Like every other socialist economy, the Nazis attempted planning from the top, complete with price controls, rationing, cronyism, cartels, misallocations of resources and government control and command of every important industry. As under Mussolini, Stalin, Castro, Mao and Kim, service to the state held the highest value. On a June Sunday in 1948, the late economist William H. Peterson, cited by Lawrence W. Reed in FEE.org's "Ludwig Erhard: Architect of a Miracle," wrote, "…without the knowledge or approval of the Allied military occupation authorities…Erhard unilaterally and bravely issued a decree wiping out rationing and wage-price controls and introducing a new hard currency, the Deutsche-mark. The decree was effective immediately. Said Erhard to the stunned German people: 'Now your only ration coupon is the mark.'" Erhard followed this up in the following months with a "blizzard of deregulatory orders." By cutting income taxes and deregulating the economy, the West German economy became "awash in capital and growth." Within two years, industrial output *tripled*. Personal initiative had been unleashed.

Other Proposed Tax Law Changes

The proposed tax law changes dealing with the estate tax exclusion, the new estate tax rate and a tax imposed on unrecognized gains at death are described above. Other potentially destructive proposals include:

Limiting profit deferral of tax-deferred exchanges to $500,000. Deferring tax on the profit in appreciated investment real estate via tax deferred exchanges has been part of tax law since 1921. We can safely predict that eliminating tax deferral will dramatically reduce sales, realized profits and, in the long run, government revenues. Arguably worse, fewer sales reduce liquidity, resulting in a less efficient allocation of resources because assets remain in the wrong hands.

Increasing the top rate on long-term capital gains and qualifying dividends from 20% to 39.6% for those with incomes over $1 million. This is in addition to the Net Investment Income Tax (NIIT) of 3.8% and state income tax (which can reach nearly 14% in California), which brings the potential tax on such gains up to 56.7%. Would you be inclined to sell a highly appreciated security, property, or business when you are subject to such an exorbitant tax rate? Because tax rates reduce sales volume and recognized profits, government revenue from capital gains has declined dramatically after every increase in the capital gains tax rate. The failure to adjust for inflation further disincentivizes saving and investing, reducing the capital formation on which our living standards depend. The U.S. capital gains tax would likely be the highest among all countries.

Increasing the highest advertised marginal tax rate from 37% to 39.6% on ordinary. If you want to decrease the supply of goods and services, tax the production of those goods and services. Increasing taxes serves to further reduce incentives to work, save, invest, and produce value for others. A married couple in which one spouse earns so much that the other spouse's income is taxed at the highest marginal rate results in a 51.9% combined federal rate (income plus net Self-Employment tax) on the additional earnings. Adding California income tax of as much as 13.3%, the marginal rate can increase to 65.2%. With tax rates this exorbitant, why work and produce value for others? Many second incomes in California are

already subject to 22% federal, 9.3% state, 1.2% SDI and 7.65% employee share of FICA, for a total rate of 40.15% (effectively 44.2% for the Self-Employed). In the long run, increasing real marginal rates disincentivizes spouses to work, reducing aggregate production, resulting in a lower supply of goods and services, which reduces government revenues (the Laffer Curve shows that tax revenues decline when tax rates exceed certain levels).

Increasing the corporate tax rate from 21% to 28%. Including the tax on dividends from after-tax income, the federal rate on corporate net income would reach more than 60% (73% in California), due to double taxation of the combined corporate and individual income tax on dividends and capital gains. The higher the tax rate, the lower the return on investment, disincentivizing saving and investing. When there is less capital available for investment due to taxation, expect lower capital ("trucks"), reduced wages, decreased productivity—fewer goods and services produced—and lower aggregate living standards. Again, this integrated rate would likely be the highest on the planet.

Requiring financial institutions to report annual account inflows and outflows to the IRS. The IRS will be given reports of all money going into and out of every financial account. While this may improve audit selection, such an intrusion into private affairs is unprecedented. To maximize tax revenues, financial privacy cannot exist—reason enough to seek the abolition of the tax on incomes (which disincentivizes production). We will likely have much more to say as this gets closer to realization.

Reducing thresholds at which credit card companies, PayPal and other such platforms are required to report payments to or sales by businesses and individuals. The current threshold for reporting payments and sales by such platforms would plummet from the current $20,000 to a mere $600. This includes reports for those not operating a business. How could this affect you? If you sell a few personal items using PayPal for $600 or more in any calendar year, you will receive a 1099-K reporting gross proceeds. This would require such personal and largely unprofitable sales to be reported on tax returns. While reporting private sales with no net income does not create tax (the losses on which are non-deductible), by default, compliance will increase costs.

Escaping Your State for Greater Freedom

In a recent interview with Tucker Carlson on "Tucker Carlson Today," British rapper Zuby points out that most national governments are much more centralized than ours. While he loves the U.K., there is no flexibility in location where he can move and gain more freedom. In mentioning that Americans who prefer greater freedom have 49 other states from which to choose, Zuby shows an appreciation for and understanding of "federalism" much more than most Americans—even if the differences between states have been seriously eroded over the last 110 years due to the encroachment on states' rights by the federal government.

The problem is, from a tax point of view, leaving a state may be easier said than done. While many states could give a rap about a resident leaving, several states do all they can to entrap their citizens. Let's take a look at one of those: California, if only because it is arguably the toughest from which to leave from a tax perspective, especially for high income residents.

California's high-income taxpayers pay by far the bulk of the state's onerous income tax. One percent, or about 180,000 taxpayers pay roughly half of all of the state's income tax (of the nearly 18 million California tax returns filed in 2020). The steps and rules to break free can be crazy—especially for high-income taxpayers and those with businesses in California.

If do not have a rental property or business with a California "nexus" (which is tax lingo for "connection"), follow a few simple rules and a clean break is relatively easy. If you own rental property and/or a business, it is much tougher. Let's take the easy case first.

How to cut ties for those with no California property or business

1) Move the whole family to the new state.
2) Change your auto registrations, drivers' licenses and insurances to your new address.
3) Change your voters' registrations to the new address.
4) Change your social, religious and professional affiliations to the new state.
5) Change your mailing address with everyone, especially the state and IRS! (Post office change of address forms do not accomplish this; forms should be filed directly with taxing authorities.)
6) Change any school attendance to the new location, or at least outside of California.
7) Spend as few days as possible in California for any visits to family, friends or vacations (California has specific rules that state if you spend over a certain number of days in California you will be deemed a California resident).

There are other ties to cut which, in the past, were important. However, the telecommunications revolution makes us think they can be overcome, even if they should not be ignored:

8) Bank locally if possible. Because of the challenges of changing banks and the ease of interstate banking, we think this can be easily overcome.
9) Getting a local telephone number used to matter. Because hardly anyone has a land line and when you move or change carriers you can keep your old number, we think this has become irrelevant.
10) Professional services can matter. Where you can change providers, do so. But you clearly want to keep your tax pro (!!!) and, frequently,

doctors. Since lawyers are state-licensed and state laws vary so much, you should switch to a local attorney; you can probably find a new dentist, GP, chiropractor, veterinarian and most other doctors near your new residence, along with a new hair dresser and colorist. However, we think the telecommunications revolution can overcome some of these issues.

How to cut ties for those with California properties or business

If you convert your home to a rental or own other rental property in the old state, you may face several challenges:

1) If you rent the home for too long after moving out (generally, three years), you will lose your $250,000 per person exclusion of gain. Therefore, you should consider selling when you move. And do you really want the headaches of an out-of-state rental property? If you keep it, immediately stop claiming the homeowner's tax exemption (that's the $7,000 exclusion of value on which property tax on one's main home is assessed). Do not use it as a second home; better to rent it out. If used as a second home, or even if it sits empty, California may argue you have not changed your "domicile" and that you "intend" to return. If the state wins its case, it will tax all your income regardless where you moved to.
2) Ideally, hire a property manager and, for California rentals (including your former home), have the manager withhold non-resident withholding tax. Whatever you pay for such extra services will, if there is any question whether you are still a California resident, help you overcome any presumption that your domicile is in California or other "former" state.
3) If you sell your home and pay the tax and do everything else right, you are home free. If you keep and rent it out, you will be required to file non-resident California returns. If you later exchange it, you will be required to report the deferred gain in the property(ies) exchanged until you die or eventually sell the upleg property (the new property/ies into which you exchanged) and pay the California tax on the California-deferred gain. Be aware: the deferred profits on such out-of-state exchanges must be reported every year until you sell or die. If you miss filing for a year, California will come after you immediately for the tax on the previously deferred profit.
4) If you have other California rental properties, you can probably keep them and file a non-resident return. If you sell them, you will pay a ton of tax, so consider a tax-deferred exchange and keep in mind the reporting rules noted in challenge # 3.

If you own a business with a California "nexus," you continue to file California income tax returns and pay California income tax on your net business income deemed earned from California sources. Your nexus may be a property location (a rental property or business location), or a certain level of earnings from California-based customers. The latter, created by a voter-passed 2012 Proposition, affects those whose California-based income exceeds certain thresholds:

1) Total California sourced income (a California resident receives the benefit of your company's services) exceeds 25% of your business gross income, or
2) If California sourced income is less than 25% of your business gross income, California sourced gross income exceeds roughly $600,000 per year (inflation-adjusted).

Even if these criteria are not met, your company has nexus if:

1) Your cost basis in your company's California real and other tangible property exceed the lesser of roughly $60,000 or 25% of the company's total cost basis in real and tangible personal property, or
2) Compensation to employees paid in California exceeds the lesser of roughly $60,000 or 25% of total compensation paid.

You can see that where you live is irrelevant. California requires that receipts be apportioned based on where your customers, property and employees are located. Say a computer support company provides support services through a call center located in Wyoming. The company's records indicate that 10% of its customers have billing addresses in California, while 25% of the calls originate in California. The company will be required to apportion income to California; it is required to file California returns and pay tax on that apportioned income—even if no one from the company ever steps foot in California!

A tax or other professional in Texas with 25% or more of his or her clients in California must file and pay California tax on the income paid by the clientele living in California, even if all business is done via email and telephone.

A pay-per-view telecast originating in Las Vegas with 20% of worldwide viewers in California must report 20% of its net income to California. Worse, the non-resident Mixed Martial Arts fighter who receives royalties resulting from pay-per-view revenues must file and pay California tax based on the proportion of the California audience, something over which he has zero control.

You might be thinking, "What an accounting nightmare!" You got it! You may wonder whether any of this cross-state boundary taxation violates the commerce clause of the U.S. Constitution. Courts have so far ruled it does not. We hope a future U.S. Congress puts a stop to this nonsense, as they did two and a half decades ago when they put the kibosh on states from taxing the retirement incomes of former residents who moved to other states.

Other states are seeing the tax revenues these special rules are beginning to bring to California. They are also seeing the penalties California is raking in for failure to file returns and pay long-overdue tax, because, until recently, hardly anyone understood the rules. You can expect many more states to get into the action by adding new "nexus" rules to their tax laws.

Potential Increased Tax Costs of Various Non-Inflation Adjusted Tax Laws

Tax Law	Year Set in Law	Max Deduction, Credit or Phase-Out Begins (and Ends if Applicable)	Current Value if Inflation-Indexed	Nominal (Advertised) Tax Rate in the Phase-Out Range	Real Marginal Tax Rate in the Phase-Out Range	Potential Increased Tax Cost
Net Capital Loss Deduction Allowed	1976	$3,000 ($1,500 for MFS)	$14,310	Various and no phase-out	N/A	$4,554
Soc. Sec. Phase-In @ 50%	1984	$32,000 MFJ; $25,000 Single	$83,520 MFJ; $65,250 Single	12%	18%	$960 *
Real Estate Passive Loss Allowance	1987	$100,000 – $150,000	$239,000 – $358,500	22% and 24%	31% and 36%	$6,000
Soc. Sec. Phase-In @ 85%	1994	$44,000 MFJ; $34,000 Single	$80,520 MFJ; $62,220 Single	22% MFJ; 12% Single	40.7% MFJ; 22.2% Single	$5,000 *
Main Home Exclusion	1997	$250,000 per person	$422,500 per person	Various and no phase-out	N/A	$63,825
Child and Dependent Care Tax Credit **	2001	$600 (higher for those with incomes under $43,000)	$902	N/A	N/A	$302 per child, 2 max = $604
AOTC (Tuition Credit) Phase-Outs	2009	MFJ: $160,000 – $180,000; all others: $80,000 – $90,000	MFJ: $203,200 – $228,600; all others: $101,600 – $114,300	22%	MFJ: 34.5% and 47%; all others: 47% and 72% ***	$2,500 per qualifying student
Net Investment Income Tax (NIIT)	2013	MFJ: $250,000; all others: $200,000	MFJ: $292,500; all others: $234,000	3.8% plus other taxes	3.8% plus other marginal rates	$1,615
Child Tax Credit **	2018	$2,000	$2,160	N/A	N/A	$160 per qualifying dependent
Other Dependent Credit	2018	$500	$540	N/A	N/A	$40 per qualifying dependent

* These are very rough estimates of the maximum possible additional tax cost from year 2000 through 2020. We have tax programs going back only to 2000 on which to run such estimates.

** The Law is different for 2021 only, which also has new phase-outs.

*** The lower figure with one qualifying child; the higher figure with two.

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