White Paper

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Pay Me Later or Pay Me Now?

Tax deferral programs have served investors well in the past, but future shifts in the political environment and potential tax rate increases may cause this to change.

The title of this paper may have reminded you of an old car repair commercial featuring the punch line of “Pay Me Now or Pay Me Later,” accompanied by a grimy mechanic with a sinister grin on his face. The message warned that if you put off maintenance now, you risk paying more later on in bills and aggravation.

The common philosophy for paying income taxes has been the opposite. “Pay me later” has been the best strategy for the past few years, especially during the most recent period (see Table 1) when tax rates have declined to modern-day lows.

Table 1
Top Federal Income Tax Rates on Regular Income and Capital Gains since 1916

Year	Top Rate on Regular Income	Top Rate Applies to Married Taxable Income Over:	Top Rate on Capital Gains	Notes on Capital Gains Treatment
1916	15%	$ 2,000,000	15%	Capital gains taxed the same as regular income
1917	67%	2,000,000	67%	"
1918	77%	1,000,000	77%	"
1919-21	73%	1,000,000	73%	"
1922	58%	200,000	12.5%	Max rate of 12.5%
1923	43.5%	200,000	12.5%	"
1924	46%	500,000	12.5%	"
1925-28	25%	100,000	12.5%	"
1929	24%	100,000	12.5%	"
1930-31	25%	100,000	12.5%	"
1932-33	63%	1,000,000	12.5%	"
1934-35	63%	1,000,000	31.5%	Sliding exclusion of 70%>10 yrs; 0%<1 yr.
1936-37	78%	2,000,000	39%	"
1938-40	78%	2,000,000	30%	Excl. 50%>2yrs; 67% 18-24mo; 0%<18mo; 30%Max
1941	80%	2,000,000	30%	Excl. 50%>2yrs; 67% 18-24mo; 0%<18mo; 30%Max
1942-43	88%	200,000	25%	Exclusion 50% > 6 months; 25% maximum
1944-45	94%	200,000	25%	Exclusion 50% > 6 months; 25% maximum
1946-47	86.5%	200,000	25%	Exclusion 50% > 6 months; 25% maximum
1948-49	82.1%	200,000	25%	Exclusion 50% > 6 months; 25% maximum
1950	84.4%	200,000	25%	Exclusion 50% > 6 months; 25% maximum
1951-64	91%	200,000	25%	Exclusion 50% > 6 months; 25% maximum
1965-67	70%	200,000	25%	Exclusion 50% > 6 months; 25% maximum
1968	75.3%	200,000	26.9%	Vietnam War 10% surtax for part of year
1969	77%	200,000	27.5%	Vietnam War 10% surtax
1970	73.5%	200,000	32.3%	Transition on CG, Vietnam War 5% surtax; minim
1972-75	70%/50%	200,000	36.5%	50% exclusion, minimum tax effects
1976-77	70%/50%	203,200	39.9%	50% exclusion, minimum tax effects
1978	70%/50%	203,200	39%	50% exclusion, minimum tax effects; late year reduction
1979-80	70%/50%	215,400	28%	60% exclusion
1981	70%/50%	215,400	23.7%	50% or 60% exclusion, etc., transaition
1982-86	50%	215,400	20%	60% exclusion
1987	38.5%	192,930	28%	28% maximum rate
1988-90	28%/33%	* see below	28%/33%	Realized gains taxed same as other income
1991-92**	31% (31.9%)	84,300	28% (28.9%)	28% (28.9%) maximum rate
1993-96**	39.6% (40.8%)	255,100	28% (29.2%)	28% (29.2%) maximum rate
1997-2000**	39.6% (40.8%)	280,300	20% (21.2%)	20% (21.2% maximum rate)
2001**	39.1% (40.3%)	297,350	20% (21.2%)	"
2002**	38.6% (39.8%)	307,050	20% (21.2%)	"
2003-05**	35% (36.1%)	319,100	15% (16.1%)	Capital gains rate also applies to dividends
2006-07**	35% (35.7%)	338,525	15% (15.7%)	"
2008**	35% (35.4%)	351,250	15% (15.4%)	"
2009**	35% (35.4%)	360,050	20% (20.4%)	Dividends return to regular tax rates
2010	35%	369,050	20%	Note: All Bush tax cuts expire after 2010
2011 on	39.6% (40.8%)	378,250	20% (21.2%)	20% (21.2% maximum rate)
*1988-90 detail	28%	31,050	28%	
	33%	75,050	33%	
	28%	155,780	28%	

**Rates in parentheses include an additional tax on Adjusted Gross Income (phased out starting in 2006; repealed in 2010).
Notes: The definition of taxable income varied very substantially over the years. Taxable income is much less than actual income. Starting points for the top rate (indexed) are averages when multiple years are shown after 1987. Further Note: 1970-81 rates reflect a lower top rate on earned income (second figure listed). **CITIZENS FOR TAX JUSTICE, MAY 2004**

The current 15 percent Long-Term Capital gains rate has not been this low since 1933! In addition, most people do not recognize that this rate is due to “expire” in 2008 (see Table 2 below) unless Congress acts to extend this favorable rate or make it permanent. With no action by Congress, this rate will automatically go back to 20 percent. The current Top Tax rate on Ordinary Income of 35 percent is also scheduled to expire and revert to 39.6 percent.

Table 2
Current Rates vs. Sunset

Maximum Federal Rate On:	2003 Prior Tax Rate	Current Rate	Sunset Date
Stock Dividends	38.6%	15%	12/31/2008
Long-Term Capital Gains	20%	15%	12/31/2008
Short-Term Capital Gains	38.6%	35%	12/31/2008
Ordinary Income	39.6%	35%	12/31/2010

Many economists also believe that low tax rates are unlikely to continue in the current political climate. With government deficits creeping up due to Homeland Security, the war in Iraq, and domestic spending, the conditions that favored lower taxes have changed. Presidential candidate Senator John Kerry has gone on the record as favoring higher taxes to fund these costs. Of course, this will depend on whether or not there is a President Kerry and whether he sweeps enough Congressional candidates into office with him to change the overall political will on tax policy. However, such a scenario would make it very difficult to extend current tax rates.

So far you may have the impression that we feel tax rates are going up. Of course, we don't know this with absolute certainty, but we think it is reasonable to believe that taxes are unlikely to go down, and it's time to strongly consider which techniques would best serve our goals in the event that tax rates go up. We need to re-examine our long-held belief that taxes should always be deferred.

Table 3

Pre-Tax Annual Investment	Accumulated Investment	After-Tax Investment	After-Tax Accumulation
$50,000.00	$54,000.00	$32,500.00	$34,710.00
$50,000.00	$112,320.00	$32,500.00	$71,780.28
$50,000.00	$175,305.60	$32,500.00	$111,371.34
$50,000.00	$243,330.05	$32,500.00	$153,654.59
$50,000.00	$316,796.45	$32,500.00	$198,813.10
$50,000.00	$396,140.17	$32,500.00	$247,042.39
After-Tax Accumulation	$237,684.10		$247,042.39

Assumptions: 35% Ordinary Income Tax Until 2008 then 39.6%
15% Long-Term Capital Gains Rate Until 2008 then 20%

If we enter an era of higher tax rates, tax deferral programs such as 401(k)s, IRAs and Executive Deferred Compensation Programs may not serve us as well as they have in the past. Table 3 shows the effect of a deferral against an investment program currently taxed at Long Term Capital Gains Rates. It's easy to see that the deferral program has the edge in total dollars accumulated, however, the liquidation at the higher tax rate gives the “spendable capital edge” to the non-deferral program. Clearly, even in this scenario if there is a company subsidy or match, the program should be used. While a rate of return of eight percent is used in this example, it's best to consider each individual case to see if non-deferral investment opportunities deliver better return opportunities, giving the non-deferral programs even more “oomph.”

What about the assets with large unrealized capital gains exposure? It is always painful to consider selling an asset and paying taxes. We hate giving up an investment that has been good to us in the past, and we NEVER enjoy paying taxes. To make a decision like this, a comparison of investment opportunities is in order. The hurdle rate for a competing investment is much lower in the current tax environment. In Table 4, the grid shows the amount of increase in the Long Term Capital Gains Rate necessary to create rates of return where it would be advantageous to pay taxes now. Of course, if the expected rate of return is higher in a competing asset, then there is little reason to defer at these rates for tax reasons alone. This is particularly true if the asset in question is the “tail wagging the dog” in your portfolio, preventing you from being adequately diversified.

Table 4
The Liquidation Tax Hurdle

Years	2%	4%	8%	10%	12%
1	0.3%	0.5%	1.0%	1.3%	1.5%
2	0.5%	1.0%	2.1%	2.6%	3.1%
3	0.8%	1.6%	3.2%	4.0%	4.9%
4	1.0%	2.1%	4.4%	5.5%	6.7%
5	1.3%	2.7%	5.6%	7.1%	8.7%
10	2.7%	5.7%	12.6%	16.4%	20.4%

The window of opportunity for changing deferral options may be open for many taxpayers. It may be difficult to teach ourselves new tricks when it comes to doing tax planning. It is often said that old habits die a long slow death. However, if you believe that taxes will not be lower for you or that tax rates are likely to go up, then it is wise to consider your tax options now rather than to possibly look back later with regrets. Pay me now may be the best alternative based on today's tax and political climate. Let us know if we can help.

If you would like to learn more about the financial services provided by Robert J. Klosterman and White Oaks Wealth Advisors, Inc., call us at 800-596-3579, or visit [www.whiteoakswealth.com.](http://www.whiteoakswealth.com)

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