

## **QUARTERLY NOTE**

### **DECEMBER, 1997**

#### **BEYOND TAX MINIMIZATION: A CITIZEN'S VIEW OF THE TAX CODE**

As travelers to distant lands, most U.S. citizens could explain the fundamental features of our democratic way of life, including the importance of the separation of church and state, the balance in power between the state and federal levels of government, and between the judicial, legislative, and executive branches of the Federal government, in addition to the central nature of the freedom of speech and of assembly in our culture. But how many could explain the key features of our Internal Revenue Code and how this tax code reflects -and protects--our democratic way of life?

As odd as it may sound coming from a financial advisor in the midst of tax season, there are some aspects of our tax code that are as remarkable and wonderful as for example our freedom of speech, and so are worth treasuring:

1. Taxes in our country are approved by elected officials. There is no king with a power to tax.
2. Ours is an essentially voluntary system. Rather than outright confiscation, the government relies on an annual accounting from each citizen, who, assumed to be both willing and competent, operates for the most part on the honor system.
3. The tax code protects the separation of the federal and state governments by not allowing one level of government to interfere with the ability of another level to raise revenue. (This is why interest on municipal bonds issued by the state and local levels of government are not taxable at the Federal level, and why interest on Treasury securities is exempt from state tax.)
4. In the technical jargon of tax policy, ours is a "progressive" income tax: richer citizens pay more taxes than poorer citizens, both absolutely and as a percentage-of-income. While tax loopholes for the wealthy clearly exist, the loopholes are publicized because, as an exception to the rule, they are objectionable, not because loopholes are the dominant feature of taxation

for the wealthy. In fact, the applicable Federal income tax rate rises from 15% to 39.6% as taxable income rises, and taxpayers with the top 5% of income, pay over 50% of total income taxes. (IRS Statistics of Income Bulletin, Summer, 1997)

5. The tax code supports the separation of church and state by exempting churches and other religious groups from taxation.

We all --with reason--grumble about the tax code, its abusive complexity, its increasingly politicized nature, and in general the whole pain in the neck, and often mysterious aspect of it. Admittedly, just like our justice system, the tax code doesn't always work perfectly--but who would choose the alternative? Like freedom of speech and of assembly, the outcome in a few specific instances may not be what one would choose--but who would choose to throw the baby out with the bath water? In this sense, the tax code, despite its blemishes, does work. At bottom, the tax code is a fundamental reflection --and protection-- of our most basic values as a democratic society and, in this light, is worthy of both respect and our careful tending.

Of course, to say that the tax code has its favorable aspects, is not to say that figuring out the darn forms is either easy or pleasant, or that any of us can afford to ignore tax planning strategies. To facilitate this annual chore, please see the next page for a thumb nail sketch of Federal income taxes for individuals. With this bird's-eye view of the tax code in mind, your own taxes, as well as media reports on national tax policy, may make more sense.

## **INDIVIDUAL TAXES: A PRIMER**

( Line numbers refer to the 1996 IRS 1040 tax return, the main form for individual taxes.)

**GROSS INCOME:** To calculate the Federal taxes due each year, you first collect data on total income.

The IRS calls total income Gross Income, the sum of lines 7-21, and entered on line 22. Gross Income includes earned income, (e.g. salary income and/or income earned as an entrepreneur) and unearned income, (e.g. including interest and dividends from financial accounts, pension and alimony payments, taxable IRA withdrawals, and capital gains or losses that you realized by selling assets during the year or that were distributed to you, for example, by mutual funds during the year).

During January, you will receive, and should collect, several pieces of mail that document Gross Income including for example: Year-end statements from all investment accounts and bank accounts, 1099 Forms documenting non-salary income, and W-2 Forms from employers documenting salary data.

**ADJUSTED GROSS INCOME:** Next, the government allows several adjustments to Gross Income, including for example, deductible contributions to IRAs and deductible

alimony payments made during the year. Gross Income net of these adjustments is Adjusted Gross Income and entered on Line 31.

The Adjusted Gross Income (or AGI) has become important for tax planning purposes since the new tax law provides several new tax breaks to taxpayers with certain levels of AGI. Going forward, tax planning will increasingly focus on managing your AGI, e.g. by making or not making various financial transactions in particular tax years.

**TAXABLE INCOME:** To get to taxable income, certain exemptions and deductions are subtracted from AGI.

Exemptions are an IRS-determined amount awarded for each of a taxpayer's dependents and for such conditions as senior citizen status and blindness. Exemptions were worth \$2,650 in 1997 and rise each year with inflation.

Deductions are either standard (i.e. a set figure from an IRS table) or itemized (for taxpayers whose deductions exceed the table amount). Taxpayers with more deductions than the standard level (i.e. \$4,150 for single filers, and \$6,900 for joint filers) usually itemize deductions in order to minimize taxable income. Eligible deductions are allowed for several categories: Medical Expenses, Property & State Income Taxes, Interest Paid, (e.g. on most home-related debts), Charitable Contributions, and Miscellaneous Deductions. Miscellaneous Deductions include, among other items, investment advisory and tax preparation fees, unreimbursed employee expenses, and safe deposit box rentals.

**NOTE:** Medical and Miscellaneous Deductions are only deductible to the extent that they exceed certain levels of Adjusted Gross Income and so are not as valuable as other deductions. Also, Exemptions and Deductions are phased out as income rises and so are also not fully available to high income taxpayers.

To review and document exemptions and deductions, your accountant needs demographic data on your household and documentation of potential itemized deductions. Documentation usually includes canceled checks, acknowledgment letters from charities, and year-end statements from mortgage companies.

Taxable Income (or adjusted gross income net of these allowed exemptions and deductions) is entered on line 37. It is the applicable amount used to calculate the actual taxes due, either by referring to an IRS table or by applying the applicable tax rate. Taxable Income is a key figure for planning purposes since it determines which tax bracket you are in and therefore what financial planning strategies may be appropriate for you. Estimating taxable income for the subsequent year, is the first step in deciding how much to either withhold (or to pay through quarterly estimated payments) throughout the year.

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