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Resolute Connections

In this month's newsletter our first article, *Tax Simplification That Really Is,* reviews one of the few tax simplifications to come out of Washington in decades – the 'Kiddie Tax', which hits many of our clients' children, has actually been streamlined, to a degree. *Defaults Down the Road for All* discusses the coming storm that is brewing; municipal finances in many states are a mess which may be a concern for many holding municipal bonds in their portfolios.

Crypto-Crash shows how fleeting the next big investment idea may really be, how does a -70% decline in Bitcoin sound? Finally *Deficit Funding* touches on an interesting development – Social Security is now tapping its trust fund as it is sending out more money than is coming in the door: when that trust fund runs out in 2034 it is insolvent. But not to worry those hard working souls we send to Washington will surely fix the problem, right?

If you have any questions about anything we have covered in the articles below, or a specific situation please feel free to give us a call, or visit our website, www.ResoluteFinancial.com.

Tax Simplification That Really Is

One of the biggest misnomers coming out of Washington is the idea of "tax simplification," where Congress purportedly makes it easier for all of us to fill out our tax returns by adding several thousand pages of new rules, rates and lists of things we can and cannot deduct under new lists of circumstances. The most recent version, with a complicated deduction for individuals participating in S corporations,

partnerships, LLCs and sole proprietorships; new rules governing the deduction of alimony payments; what new payments can be made, tax-free, out of 529 plans; and restrictions on state and local tax deductions for federal tax purposes is an excellent example of more complexity, not less.

But one actual reduction in complexity came with reform to the so-called "Kiddie Tax." Under the old law (get ready for some real complexity) a dependent child under the age of 18, or under 19 who provides less than 50% of his/her support, or a full-time student under the age of 24 would divide his/her income into two buckets: earned and unearned (investment) income. If parents claimed the child as a dependent on their return, the child's standard deduction would be the greater of $1,050 or the child's earned income plus $350 up to the standard deduction amount of the parents. If the unearned income was more than $2,100, the investment income—but not the earned income—would be taxed at the tax rate of the highest-income parent. Got that?

Under the new 2017 tax act, each child's tax is calculated using the trust tax rates rather than the parents' tax rates. Unlike individuals, trust have just four brackets for ordinary income: 10% (up to $2,550), 24% ($2,551-$9,150), 35% ($9,151-$12,500) and 37%, with the top rate applied to all income over $12,500. For long-term capital gains, different rates apply

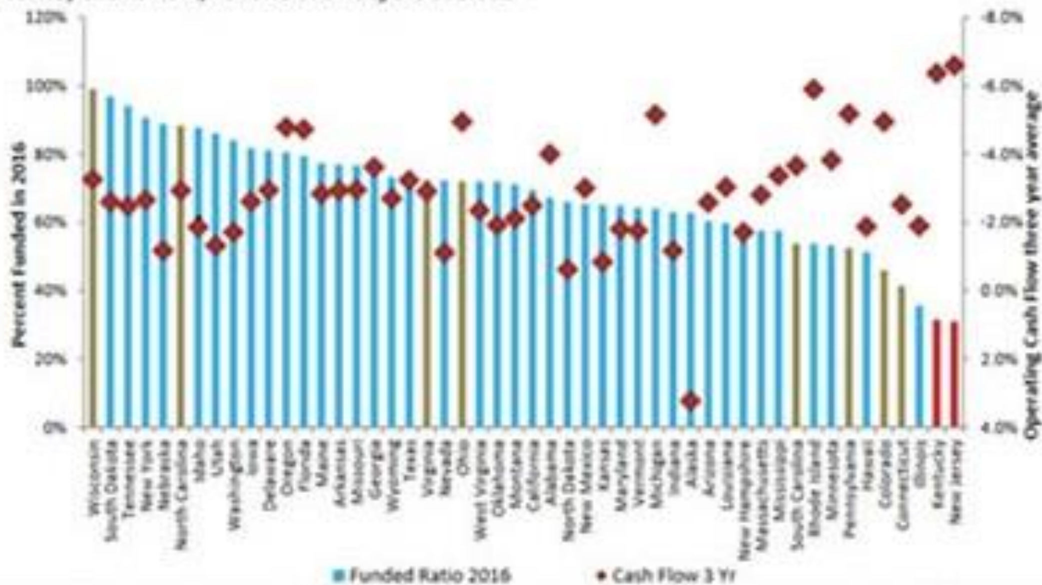
Of course, that means that children get to the highest tax rate with far less income than, for example, married individuals (where the top rate kicks in above $600,000 in taxable income) or heads of household ($500,000). But at least the calculation is simpler—certainly a rarity in our history of tax "simplification."

Defaults Down the Road

When it comes to municipal finances, we may have entered the calm before the storm. You can go to the MuniNet Guide, which describes itself as the "hub for state, local and municipal research," and find detailed historical statistics on the bankruptcies of small municipal utilities and special purpose districts, cities, towns, villages and counties.

What can we learn? First of all, that such filings are relatively rare. Since 1937, there have been just 680 so-called Chapter 9 municipal bankruptcy filings, including 311 since 1980. The default rate on workers' pension plans and bond obligations has dropped in recent years; there have been just 3 so far in 2018, 6 last year, 6 in 2016 and 3 in 2015. The report notes some of the most famous defaults, including Detroit, MI ($18.5 billion in 2013), San Bernardino, CA ($492 million in 2012) and, of course, Orange County, CA ($1.97 billion in 1994). Since 1980, Nebraska leads all states with 65 local Chapter 9 filings, followed by California (49) and Texas (40).

That's the calm, but where's the storm? A deeper analysis, provided by researchers at Harvard, shows that U.S. states, which are not permitted to go bankrupt, have developed an alarming tendency to over-promise pension returns to their workers, and may have to put their hands in their residents' pockets in order to make good on their debt and pension obligations. As you can see from the chart, the so-called "funded ratio"—basically the amount of money on hand compared with the overall obligations—ranges from pretty good (Wisconsin, South Dakota, Tennessee and New York) to pretty awful, as in: the 30s (New Jersey, Kentucky and Illinois).



Source: Harvard Kennedy School

Many municipalities and local governments, which compete with their states for bureaucratic workers, are even deeper in the red, and are still projecting high rates of return on their escrow accounts, beyond what any reasonable advisor would expect. According to a report by the Center for Retirement Research at Boston College, state and local public pension plans are still assuming that their pension reserve portfolios will earn, on average, 7.5% a year, down a little bit from 8% in 2001. Some are projecting 8.5% yearly returns—at a time when most financial planners would caution that you would be lucky to average more than 5% going forward the next ten years.

Underfunded pensions that are projecting that the markets will deliver more than they probably will is a recipe for disaster. A state and local municipal default storm is surely on the horizon, which means there could be a storm of Chapter 9 defaults making headlines over the next couple of years.

Crypto Crash

Chances are, if you remember the dot-com crash, it is not fondly. The Nasdaq Composite Index fell a total of 78% peak-to-trough, as companies like Pets.com cratered into oblivion.

Today's cryptocurrency investors are experiencing similar pain, and there's no clear end in sight. Bitcoin is down 55% this year, and the decline is now over 70% from top to, well, today. The total value of all tokens has fallen from $830 billion to around $236 billion. Meanwhile, the damage has spread to other tokens. A website called Dead Coins lists 800 other cryptocurrencies that are worth either zero or close to zero.

At its height, Bitcoin was clearly a bubble. Now it's hard to tell what the future holds. Regulators around the world have stepped up their scrutiny of cryptocurrencies, concerned that they have become a breeding ground for illicit transactions involving drugs and weaponry, along with money laundering, market manipulation and fraud. But bulls point out that the Nasdaq stocks eventually recovered dramatically from

their dismal lows—and say that at these prices, or the potentially lower prices to come, these coins manufactured out of thin air might be a bargain.

Deficit Funding

Many were alarmed when, on June 5, the good people who run Medicare and Social Security released a report that said that the Medicare program will become insolvent in 2026 and Social Security will face a similar fate in 2034. The Medicare projection is three years earlier than the previous report, while the Social Security projection is unchanged from previous estimates.

These problems are not new, of course. People are living far longer than anticipated when Social Security was created in 1935; in fact, the average life expectancy for a person who managed to reach age 30 at that time was age 68 for men and 70 for women. Today it's 79 for men and 82 for women. Meanwhile, Medicare has been hit with higher-than-inflation medical expenses—along with, of course, those longer lifespans.

Alarmists point out that the Social Security and Medicare Trust Fund reserves are "invested" in government securities, which is essentially the government writing itself an IOU—currently to the tune of $2.8 trillion, which is the total "asset reserves" in our largest social programs. Individuals are advised not to run their own finances this way, accumulating deficits but meticulously keeping slips of paper around which represent a promise to pay back every single nickel and dime eventually. But in fact, today nearly all of the money paid out to Social Security recipients, and on behalf of Medicare enrollees, are simply transfers of money paid into the program by workers. The money comes in in the form of FICA payments and taxes on Social Security benefits, and goes back out the door to beneficiaries.

So where's this alleged deficit? The report makes economic projections about the next 75 years, including the future fertility rate (children per woman), mortality, the annual percentage change in worker productivity, average annual wage increases, inflation, unemployment and the interest rate earned by those IOUs the government is writing to itself. One graph in the report illustrates the projected outcomes of three different sets of assumptions for all these (basically unknowable) variables, and two

of them are, shall we say, not optimal, while the third projects not just solvency, but actual prosperity for the combined trust funds going forward well past the year 2090.

Even if the worst case comes to pass, and the programs goes "bust," they won't actually stop paying benefits. There will still be workers who pay FICA taxes, and even if there is no trust fund, these collected payroll taxes can be transferred, as they are now, to Social Security and Medicare recipients. The Social Security trustees report how much of the projected payments would be covered by workers going out to 2090 under the three future scenarios. The worst case scenario says that there will be roughly an 18% shortfall in 2040, rising to roughly 22% by 2090. Basically, that means that Social Security recipients, worst case scenario, would have to get by on 82% of the benefits they were expecting in 2040, and 78% if they manage to live all the way out to 2090.

And, of course, that's if nothing is done to shore up the program between now and then. One of the simplest options on the table is to raise the age people can collect full retirement benefits as the average lifespan goes up, basically "indexing" retirement benefits to changes in longevity. Congress could marginally raise FICA taxes or impose more taxes on Social Security income.

The best advice here is not to panic about the fate of our country's social programs. There is no question we need to address their solvency, and with gridlock in Washington, that seems like a bit of a long shot. But even if Congress can't agree on tweaks and fixes, the world won't come to an end. Social Security and Medicare recipients will have to tighten their belts a bit—and maybe start voting for candidates who offer real solutions to the budget issues in Washington.

Source:
Bob Veres Inside Edition Newsletter

For more information on these topics or for a free consultation, contact Resolute Financial, LLC at (978) 463-8771 ext. 1003.

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