

It's Tax Day—In July?!

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Normally, a tax commentary in July is either way late or waaaaay too early—but not in 2020, which has already been a year for the record books and the ages (and we are only a little past the halfway point. Yikes.). And while most news headlines have been negative this year, there was a little glimmer of relief from the U.S. Treasury Department in March when, in response to the COVID-19 pandemic, they pushed the deadline to file taxes back three months.

So, whether you've already filed your taxes, or you plan to celebrate Bastille Day* (July 14) with your accountant, we're celebrating Tax Day this year by outlining the impact of taxes on investing and examining the evolution of tax policy over time. Discussing taxes isn't the most exciting topic,** but it's certainly an important one.***

If the asterisks didn't give it away, we folks at Cetera Investment Management are not tax experts. It's best to discuss tax matters with your financial professional and accountant. But as taxes do impact investing, we'll look at them from that perspective.

Taxes and Investing

While everyone's tax situation is unique, taxes do play an important role in nearly every investment strategy—and understanding how can be an important step in making the most of your investments. There are two basic types of investment accounts: **taxable and tax-deferred**. In a **taxable investment account**, tax policy can have a large impact on your total return and investment decision-making, as there is a federal tax for dividend and interest payments as well as a capital gains tax when an investment is sold. Since 2003, the tax rate on dividends has been 15% for most individuals. For capital gains, the tax rate varies by income and the length of time the position was held before it was sold. If the position was held for less than one year, the tax rate is the same as your marginal ordinary income tax rate. If the position was held for longer than one year, the capital gains tax rate is either 0%, 15%, or 20% depending on your federal income tax bracket.



*This is not necessarily a bad idea, as the French did support us in our fight for independence (merci!), which was also centered on taxes.

**Unless maybe you are an accountant, in which case, please accept our apologies for our honesty—and our appreciation for what you do for the rest of us!

***To the accountants we offended, we hope that made up for it a bit.

In a **tax-deferred account**, taxes are not assessed on dividends, interest, or capital gains. Taxes are paid when money is *withdrawn* from these types of accounts, with exceptions including assets in a Roth IRA account (which has its own exceptions, including early withdrawal penalties.) Your financial professional can give you guidance on the best investment approach for your tax situation, helping you manage taxes to maximize your investments' after-tax returns.

The summary outlined above focuses on federal taxes, but as we live in the United States, we have to factor in state tax policy as well, and that can vary quite a bit. While the majority of states have a state-level income tax, there are exceptions. Seven do not have any state-level income tax, two states only tax dividend and interest income, and the other 41 levy state taxes on all income sources: that includes capital gains, dividends, and interest income from investments. California has the highest marginal tax rate in the country—sometimes called the “sun tax”—with a 13.3% rate for income over \$1 million for single filers (but don't expect a deduction for cloudy days). In a taxable account, the total return for an investment sold is net of both federal and state taxes, meaning they've already been subtracted from the total-return value.

Municipal Bonds

You may be happy to know there are ways to earn dividends without paying some of these taxes. Bonds issued by states, cities, and other municipalities are often exempt from federal taxation, and sometimes even state and local taxation. These exemptions were put in place to promote the private financing of state and local community projects for the greater good, such as airports, toll roads, hospitals, school districts, and the like. Municipal bonds are often advantageous for investors in high tax brackets.

Broadly speaking there are two types of municipal bonds: **general obligation bonds**



Taxes Assessed

Ben Franklin famously said taxes were a certainty, but for some states—and some people—it certainly depends. One thing is for sure: deficits and debt will likely keep them around for a while.

Sweet 16: The Sixteenth Amendment of the U.S. Constitution was ratified in 1913, granting the federal government the power to collect federal income taxes.¹

Unbalanced Budget: From 1962 to 2019, the federal government had an annual budget deficit 52 times and a surplus just five times.²

How Much Debt? The total amount of federal debt was \$23.2 trillion at the end of 2019, or roughly 107% of U.S. GDP.² That already-high number is expected to climb further in the years ahead. Most of Europe's developed economies are in a similar predicament, and Japan has a debt-to-GDP ratio of over 200%.

Always Pay Your Taxes: What landed Al Capone at Alcatraz? Not racketeering, smuggling, murder, or extortion—tax evasion!³

Legal Income Tax Shelters: Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming don't have a state income tax. New Hampshire and Tennessee don't tax wage income, but they do levy taxes on dividend and interest income from investments.

¹ National Constitution Center.
<https://constitutioncenter.org/interactive-constitution/amendment/amendment-xvi>

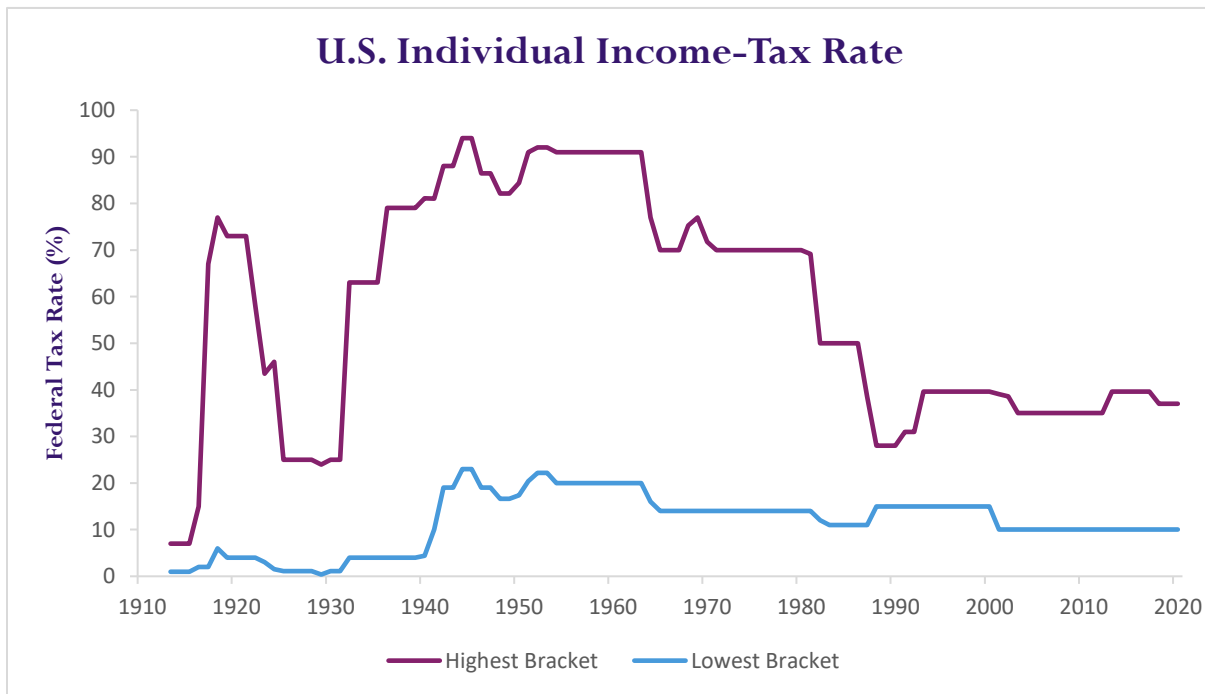
² Federal Reserve Bank of St. Louis

³ FBI. Famous Cases and Criminals: Al Capone.
<https://www.fbi.gov/history/famous-cases/al-capone>

and revenue bonds. **General obligation bonds** are backed by the full faith of the taxing authority or taxpayer money. Often considered the safer of the two bonds, this has changed recently with soaring pension deficits and waning political will to raise taxes or cut benefits. **Revenue bonds** are so called because they're tied to revenue streams, paying dividends based on revenues generated from cash flows from projects such as toll roads and airports. Revenue bonds are unique to the project for which the bond was issued to finance. As every municipality and project is different, there are unique risks and opportunities to each type of municipal bond, but with a little research, investing in them can offer tax-free income.

Mind the Gaps—They Tend to Change

Federal income tax rates have evolved over time, with the gap between their highest and lowest levels being quite wide. At the upper end, the top marginal tax rate was as high as 94% in 1945 and remained above 70% from 1936 through 1980. At its lowest, the top marginal tax rate from 1913 to 1915 was only 7%. In more recent history, the top marginal tax rate reached a low of 28% from 1988 to 1990, and has settled in a range between 35% and 39.6% since 1993. It's currently 37%.



Source: Cetera Investment Management, Federal Reserve Bank of St. Louis, U.S. Department of the Treasury.

The lowest marginal tax bracket reached a high of 23% in 1945 and a low of 0.375% in 1929. Since 1965, the lowest income-tax bracket has been as high as 15% and as low as 10%, which is the level it's at today. Going forward, tax policy is almost certain to continue its evolutionary path and change with the times, with tax rates likely trending higher if the federal debt-to-GDP ratio continues its current upward trajectory.

Conclusion

Even though baseball has been postponed, 2020 is still full of curveballs—one of them being talking about taxes on the Fourth of July at midsummer socially distant barbeques. And while the long, warm days of summer might not normally be when taxes are top of mind, those filing now may be breathing a sigh of relief they had an extra three months to do so.

Taxes are a key consideration when setting up a sound investing strategy, as the two go hand in hand. Since everyone's situation is unique, having an investment professional at your side to guide you through important investment and tax-related issues can help reduce the stress involved with these matters—and a little extra relaxation is what the summer is all about.

All of us at Cetera Investment Management wish you a wonderful Tax Day, a peaceful summer, and good health for you and your family.

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