

Testimony of

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on

**How the Tax Code's Burdens on Individuals and Families Demonstrates the Need for
Comprehensive Tax Reform**

Before the

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Chairman Camp, Ranking Member Levin, and esteemed members of the House Ways and Means Committee, thank you for inviting me here today to speak with you on behalf of the Financial Planning Association¹ about the difficulties that American taxpayers face in navigating the current tax code and planning for their financial futures.

My name is Mark Johannessen. I am a CERTIFIED FINANCIAL PLANNER™ and a Managing Director at Harris SBSB, a McLean, Virginia firm which serves a wide range of individuals and families who seek objective advice and guidance in order to make smart financial decisions in four distinct areas: financial planning, portfolio management, tax compliance and fiduciary services. I served on the Financial Planning Association's Board of Directors for 6 years, served as its elected president in 2008, and I am honored to represent them here today.

Financial planners are dedicated to working with consumers on wisely managing their finances so that they can achieve success in their financial goals and navigate challenging financial situations at every stage in life. I am also committed to adhering to the Financial Planning Association's Standard of Care, which ensures that I act with due care and in utmost good faith for my clients, and always put their interests above my own. My experience as a financial planner has also provided me with a unique perspective on our tax code and how the current level of complexity and instability in that code affects taxpayers' financial decisions every day.

Overview

U.S. Supreme Court Justice, Oliver Wendell Holmes, Jr. once said, "Taxes are what we pay for a civilized society." But most Americans are probably more likely to agree with Albert Einstein who noted "the hardest thing in the world is to understand the income tax".

Much of the difficulty in understanding our tax system arises from the ever changing provisions of the code. In 1986, the goal of tax reform was to make the code more fair and simple. Since that time, there have been tens of thousands of changes and additions, each with its own set of rules, requirements, and phase outs. Let me repeat that: **Tens of Thousands** of changes and

¹ The Financial Planning Association is the largest organization in the United States representing financial planners and affiliated firms, with approximately 24,000 individual members. FPA members serve 3.5 million client households and directly manage more than \$1.8 trillion in assets. FPA is incorporated in Washington, D.C., where it maintains an advocacy office, with headquarters in Denver, Colorado.

additions to the tax code since 1986. The rates have been changed. New sections have been added and dropped.

Many provisions are now indexed for inflation. While indexing may protect taxpayers from higher taxes caused by inflation, it does result in annual changes to many tax provisions that require the taxpayer to stay up to date. It also creates a divergence from provisions that are static.

Congress has also added provisions that are designed to encourage certain behaviors. Many of these changes have the support of financial planners, such as the tax-preferred savings vehicles for medical, education, and retirement needs. Most financial planners believe the continuation of these particular savings programs is justified. Nonetheless, all tax incentives should be regularly reviewed by the Ways and Means Committee to ensure that they are effectively meeting Congress' policy goals.

Financial planners work with their clients in considering their long-term needs like education, retirement, estate, and risk management issues. By and large, taxpayers will have to meet these needs with after-tax money. So in creating a plan, it is impossible for financial planners to ignore the impact that taxes will have on clients' financial decisions.

Complexity Adds Confusion

As part of my training to become a financial planner, I was required to fulfill an education requirement and pass a 10-hour exam that covered all areas of financial planning, including tax, retirement and estate planning.² Even with my additional education and experience, I know that the tax code is so complex that only professionals completely dedicated to understanding its principals are able to complete a tax return for all but the simplest of filings. My firm employs an in-house Director of Tax and a Manager of Tax who work alongside a team of associates to prepare approximately 300 client returns. In addition, we outsource work to several firms, Certified Public Accountants (CPAs) or Enrolled Agents (EAs). It is not uncommon for financial planning firms to outsource **all** tax preparation work.

² Topic list for CFP® Certification Examinations:
<http://www.cfp.net/downloads/Financial%20Planning%20Topics%202006.pdf>

If the interplay of various tax provisions confuses trained professionals who specifically focus on understanding complex financial issues, imagine the plight of the average citizen who has only a basic knowledge of our tax code. According to IRS data, about 60 percent of Americans complete their own returns³. Many taxpayers choose to hire a tax preparation professional or purchase tax preparation software at an additional cost rather than worry about making errors or missing out on tax benefits by completing returns unaided.

It is a sad state of affairs when one of the basic duties of our nation's citizenry – to pay for their government – has grown so complex that many cannot complete it without professional assistance.

Too Much of the Tax Code is Temporary

Financial planning, by its very nature, requires dealing with uncertainty. We must consider changing family dynamics, life expectancy, health issues, and investment variability. Our training and the financial planning process provide us with specialized skills to deal with this uncertainty. However, it is not so easy for the average individual whose limited time is likely already fully devoted to their job, family and personal lives.

Part of producing a long-term financial plan for a client requires a consideration of what effect future taxes will have. While the tax code is always being updated and modified, today the most basic provisions are in a constant state of flux. The inability to predict – even in the medium term – the future rates on income, capital gains and dividends make planning more challenging and expensive for consumers. Plans become more complex to accommodate the multiple possibilities. Often they must be scrapped and redrafted as new laws are passed. This comes at additional frustration to the client and does not even address the issue of how an unadvised individual might make decisions in the current environment.

While the current structure may create plenty of busy work for the financial planner, it is energy that could be better spent working with clients on other aspects of their financial lives, such as

³ IRS Compliance Data Warehouse, Individual Returns Transaction File (Tax Year 2008); George Contos, John Guyton, Patrick Langetieg & Melissa Vigil, Individual Taxpayer Compliance Burden: The Role of Assisted Methods in Taxpayer Response to Increasing Complexity 7 (presented at IRS Research Conference, June 2010).

addressing poor saving behavior, credit counseling, and proper portfolio allocations. It is also time that cannot be spent helping new clients achieve their own financial security.

While taxes are the elephant in the room when it comes to maximizing investment returns, Planners counsel their clients to not allow tax considerations to drive their investment and financial decisions. All too often, though, consumers hold off on making important plans that they worry will be made obsolete, instead hoping that Congress will act first.

As you can see, consumers would benefit from comprehensive tax reform and a simplification of the tax code that provides permanency, stability, and predictability of tax laws.

Specific examples

Dealing Annually with AMT

If one income tax system isn't incomprehensible enough, most people forget that they also must contend with the Alternative Minimum Tax (AMT). Many of the deductions and credits that are allowed under the regular income tax are not allowed under the AMT. Consumers who have been carefully acting under the assumptions of the regular income tax regime can have their plans undone by the AMT.

To highlight the capriciousness of this system, consider a married couple who believed they might be subject to the AMT in 2010 and attempted to adjust their withholdings to match their expected liability. If they had based their decision on the law at the beginning of 2010, they would have overpaid their estimated taxes by over \$7,000⁴.

While the couple will receive a refund, that money has sat unproductive, rather than earning interest, being invested, or making its way into the economy. Had the couple failed to properly withhold, however, they would have run the risk of owing additional penalties and interest. This unfortunate outcome is another reason many taxpayers prefer to deal with taxes in the rearview mirror sometime around April 15. This backward-facing perspective erodes the value of credits

⁴ As based on the difference between the original AMT exemption for married couples in January 2010, of \$45,000, and what was signed into law on December 17, 2010, of \$72,450, assuming a 26% or 28% AMT tax rate.

and deductions meant to induce certain behaviors, as taxpayers wait for the tax preparer to tell them if they got a lucky break.

Investing Choices

Capital gains and dividend rates directly impact the choice of securities investments. If investors expect the rates on dividends and capital gains to remain equal for the foreseeable future, they would likely hold more dividend paying stocks, under the assumption that a dividend paid today is worth more than the promise of a future gain. Economic research has demonstrated that after these rates were equalized, companies did increase the amount of dividends that were paid out.

For seniors, the allocation between capital gain and dividend producing stocks can have significant impact on their after-tax level of spending. IRS Statistics of Income data show that seniors are more likely to have dividend and capital gain income than taxpayers in other age cohorts⁵.

Under current law, the top rates on dividends will nearly triple from 15 percent to 43.4 percent⁶ in January 2013. The long-term capital gains rate will also increase from 15 to 20 percent. This is already affecting investment decisions, as individuals shift their choices to maximize their after-tax profits. In some cases, investors will chose stocks that produce more of a capital gain or tax-free investment like municipal bonds.

Many investors are considering a “harvesting gains” strategy to minimize their exposure to a capital gains increase. Under this strategy, the taxpayer sells the security, taking the gain and paying the tax at today’s 15-percent rate. That same or similar security is repurchased, resetting the cost basis higher and reducing exposure to a future capital gains increase. While this strategy is rational and can save taxes, it isn’t free of cost.

⁵ <http://www.irs.gov/pub/irs-soi/08in15ag.xls>

⁶ In 2013, the dividend tax rate will revert to the individual’s marginal rate. A married taxpayer with AGI in excess of \$250,000 will owe and additional Medicare contribution tax of 3.8 percent.

Small Business

The increase in the dividend rate currently scheduled into law also provides a strong incentive to owners of closely-held C corporations to payout more of their profits as a dividend or bonus in anticipation of higher taxes. This loss of capital results in fewer dollars for the business to grow, pay salaries, or hire employees. The strategy is a rational means of reducing one's exposure to a dividend rate increase. However, the behavior is counterproductive to the business owner if tax rates remain the same. While the payout provides an initial increase in tax revenues, it is only temporary. In the longer term, it slows business and job growth and is ultimately counterproductive for the economy as a whole.

Choice of entity

When starting a new venture, entrepreneurs must decide whether to operate their business as a C corporation or as a pass-through entity, such as an S corporation, limited liability corporation, or partnership. There are non-tax reasons for choosing these options. Some limit liability and protect the owners' other assets from debtors. C corporations might be a better choice for startups that hope to be bought out by a public corporation.

Comments by U.S. Treasury Secretary Geithner have indicated that the treatment of pass-through entities may be modified in the future⁷. These comments have made many reconsider choosing a pass-through entity in light of this risk and unsettled business owners who are already using that business structure.

Roth IRA conversion planning.

The Tax Increase Prevention Act of 2005 (TIPRA) allowed taxpayers, starting in 2010, to convert their traditional Individual Retirement Account (IRA), 401(k) and 403(b) to an after-tax Roth account. For most investors, the fundamental question that determines whether to undertake the conversion is whether one will pay a higher or lower income tax rate when they retire. Many people can estimate their likely income bracket, but now they must also make a best guess about what the tax rate for that bracket will be.

⁷ <http://www.bloomberg.com/news/2011-02-25/geithner-says-tax-overhaul-must-address-businesses-filing-as-individuals.html>

In 2010, individuals faced an additional hurdle of deciding whether to elect to pay the entire tax on their 2010 tax return or to split it over their 2011 and 2012 returns. Because rates were scheduled to increase for many taxpayers in 2011, many decided to take the hit in 2010. Few people, however, have the cash to pay the taxes out of pocket. Those who paid the tax with part of the proceeds of the conversion permanently reduced the amount of principal that can grow tax free in their account and that they will have for retirement.

Charitable Contributions of Minimum Required Distributions

One of the provisions in “tax extender” legislation has been the provision to allow for the exclusions from income of up to \$100,000 of minimum required distributions that are transferred directly to a charity⁸. The provision had expired at the end of 2009. By the time the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 was signed into law on December 17, 2010, many of the required distributions had already been made. This negatively impacted both the individual’s planned charitable giving but also the charities themselves.

Estate planning

Under 2010 law, anyone with an estate of more than \$1,000,000 in 2011 would be potentially subject to the estate tax. Many individuals included a provision in the wills for a bypass trusts or similar entity to mitigate their estate taxes. Now, with the exemption at \$5 million, many have incurred the legal cost to draft a bypass trust they don’t think they need, given that the exemption is now portable. However, portability is only an option if BOTH members of the couple die in 2011 or 2012, unless of course, Congress makes the provision permanent.

A middle-income family that has steadily saved \$1.5 million over their lifetime may have had to redraft their will several times in the span of a couple years to keep up with changing laws, at a cost of several thousand dollars per each change. While the cost of having an improperly drafted will can come at a very high price, it is not surprising that many clients are taking a “wait and see” approach for Congress to work on legislation that is expected to be more permanent.

Closing

As a result of the complexity and lack of predictability in our tax code, I am increasingly seeing the tail wagging the dog when it comes to taxes and the financial decisions being made by my

⁸ IRC section 408(d)(8)

clients. Rather than plan ahead, the vast majority of taxpayers choose to deal with their taxes through the rearview mirror, sometime shortly before the April 15 deadline.

In its effort to appeal to constituent concerns, Congress has killed the code with its kindness, loading it up with thousands of special breaks and exemptions. While the goal to encourage certain behaviors is laudable, the sheer magnitude of these special breaks and exemptions has made the income tax system unmanageably complex.

This complexity has created a cruel burden on those who can least afford it. Those who are unable to afford the cost of a competent, professional tax preparer or tax preparation software are the most likely to miss out on the multitude of tax benefits that could be a lifesaver for them in these challenging economic times.

Americans would be better served by a tax code that is fair and simple.