Accommodating the Tax Man

April 19, 2022

Yesterday was the day of reckoning for investors who benefitted from the ongoing bull market in stocks from 2019 through 2021and decided to realize their profits by selling appreciated stocks in 2021. Even though investors like to make money, they don't like to pay taxes on that capital gain. You probably wrote the check to the Feds filing either electronically or via check postmarked April 18, 2022. For our firm's private clients, we know the pain as we manage our own money the way we manage those client taxable accounts who have chosen to invest for long-term growth. So, we too had a record tax bill for last year. The experience leads us to believe that the Federal government is beginning to take back some of that stimulus money it doled out to the private sector during the past two years via programs such as the Payroll Protection Program. Our expectation is that the budget surplus for the second quarter ending April 30th will be a shocker as we expect those tax revenues to surge. The reason is that tax flows are increasing dramatically. "The federal budget ran a $193 billion deficit during March, **a 71% decline** from a year earlier, as the government took in more in tax and other revenue while spending edged lower despite higher interest costs on the public debt" according to an article in the Wall Street Journal!

Seldom, if ever, does the press follow what we call the tax "bouncing ball." Remember, that is the old technique of tracking music and lyrics when novices want to sing along. The ball moves from note to note and word to word as the beginners sings along. The same type of experience exists for a dollar of federal government spending. For example, let's say the government spends money on goods and services or just gives a dollar away. What happens? If we assume that the tax rate on that money is 20% and that transactions occur at that tax rate when the person who receives that money spends it, the receiver of the money has a tax to pay on that income, adjusted for costs or expenses associated with that sale. Then, it goes on to the next person or company and gets taxed again and, as the dollar continues to move through the system it becomes smaller and smaller as the government benefits from most transactions. Of course, the process only works if the entity receiving the dollar pays taxes. For taxpayers in the zero-tax bracket, the dollar doesn't shrink due to taxes. If the government were to impose a minimum tax on everybody, then the dollar would become an increasing amount of tax collections. On the other hand, if that dollar were to change hands only among those who are in the maximum income tax bracket, then the government would collect that dollar of taxes much more quickly.

The bottom line is that government deficit spending is not a total loss to the federal government's balance sheet as some or most of that spending comes back in the form of taxes. The faster the economy grows and prospers, the faster that spending turns into tax revenues. For those investors who realized large capital gains for 2021, they will be big contributors to those tax collections this year even though most of that payment will be at the favored capital gains tax rate.