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Brief Analysis

The Coming Tax Tsunami

by Pamela Villarreal and D. Sean Shurtleff

Over the next 25 years American taxpayers will face a fiscal tsunami. The first of the baby boomers will be eligible for early retirement beginning next year, and will be eligible for Medicare in 2011. The last of the Baby Boom generation, born in 1964, will reach normal retirement age (67 years) in 2031. Most baby boomers are approaching their peak earning years when they have the greatest capacity to save for retirement. Many failed to save when they were younger and need to catch up. Unfortunately, expected tax increases will make it increasingly difficult for each succeeding age cohort to save for retirement. Following are some of the tax hikes coming down the pike.

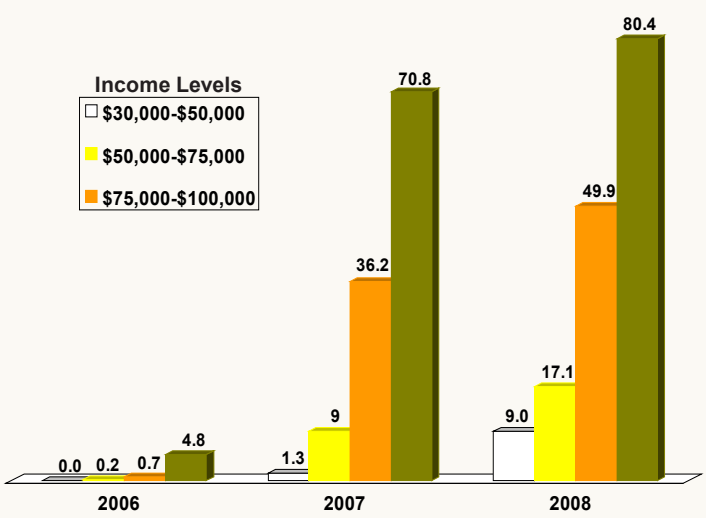
2007: The Exploding AMT. The idea behind the Alternative Minimum Tax (AMT) was to tax wealthy households who had so many deductions they paid no income tax. The AMT excludes a basic amount of income and imposes AMT rates on income above that amount. Taxpayers must pay what is owed under the standard tax code or under the AMT — whichever is higher. But the income threshold for the AMT was not adjusted for inflation for many years. As a result, the number of people required to pay the AMT grew steadily. The 2001 Bush tax cut bill included an AMT inflation adjustment:

- From 2000 to 2005, the AMT income threshold for single filers rose 26 percent, from $33,750 to $42,500.
- The income exclusion for joint filers rose 39 percent, from $45,000 to $62,550.

But these higher income exemptions expire this year. As a result, almost 19 million additional taxpayers earning less than $100,000 will be subject to the AMT [see the figure], and each will pay on average nearly $3,000 more in taxes on income earned in 2007. Income saved in tax-deferred accounts is excluded from taxable income for AMT calculations. But deposits to after-tax retirement accounts, such as Roth IRAs, are made from disposable income, and boomers with Roth accounts will have $3,000 less, on average, available to save due to their higher tax payments.

2008: Medicare, the Sleeping Giant. Over the past four years, the revenue generated by the 2.9 percent payroll tax for Medicare Part A (Hospital Insurance) has fallen short of outlays. In 2006, this annual deficit reached $10 billion. Moreover, over the next 10 years, Part A expenditures are expected to grow 85 percent to $385 billion, and the projected annual shortfall will grow to nearly $45 billion in 2016.

In addition, Medicare Part B, which covers office visits and physicians' fees, is financed by beneficiaries' premiums and general revenues. Premiums are adjusted periodically to cover about one-fourth of the Part B expenditures while general revenues (income taxes) finance the remaining three-fourths. Premiums are up to 73 percent higher for single seniors with taxable incomes greater than $80,000 and couples with incomes greater than $160,000. These income thresholds have been adjusted annually for inflation. However, President Bush's



Source: Leonard Burman, et al., "Options to Fix the AMT," Tax Policy Center, January 19, 2007.

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budget proposal for 2008 calls for eliminating these inflation adjustments. Thus, over the years, as inflation pushes more Medicare beneficiaries above the income thresholds, they will pay higher premiums.

Filling the projected shortfall in all parts of Medicare will require an income tax increase of 22.7 percent by 2030! Thus, younger baby boomers could face a much higher tax burden in their retirement years to pay for their own Medicare benefits.

2009 to 2011: The Disappearing Bush Tax Cuts. The 2001 and 2003 Bush income tax cuts lowered tax rates throughout the income range and reduced capital gains taxes. But if the provisions are not made permanent, these reduced rates will expire soon:

- In 2009, the tax bracket for the lowest income-earners will rise from 10 percent to 15 percent; the highest earners will face an increase from 35 percent to more than 39 percent.
- In 2011, the capital gains tax rate will increase from 15 percent to 20 percent for most taxpayers, and will increase from 5 percent to 10 percent for taxpayers in the 10 percent and 15 percent federal tax brackets.
- The tax rate for dividends will rise from 15 percent for most taxpayers to normal income tax rates, which can exceed 39 percent!

These tax changes will have a significant impact on retirees and workers approaching retirement. Tax hikes on capital gains and dividends will be especially burdensome on boomers. For instance, the Tax Foundation reports that in 2004:

- The 45-to-54-year-old age group, all of whom are boomers, claimed 22 percent of all dividend income and 22 percent of all capital gains, the highest percentage of dividends and capital gains for any age group.
- Like the cohorts before them, boomers are likely to receive substantial income from capital gains in retirement; in 2004, 30 percent of 65-to-74-year olds claimed capital gains, a higher percentage than any other age group.
- More than half (51 percent) of 65-to-74-year olds reported dividend income, also a higher percentage than any other age group.

In addition to tax increases, if current tax provisions expire, the limit on contributions individuals can make to an IRA will no longer rise by $500 a year and instead will remain at the current level of $4,500 per individual. This means baby boomers will face new limits on their ability to sock away extra savings for retirement and take advantage of catch-up contributions for those over age 50.

Democrats on the House Ways and Means committee have proposed an increase in the top income tax rate from 35 percent to 39.6 percent before 2010, and a gradual rise to 44 percent after that. The measure did not reach the House floor, but it clearly shows support for even more tax increases.

2017: The Incredible Shrinking Social Security Surplus. Currently, the payroll taxes of today's workers pay the Social Security benefits of today's retirees, with a "surplus" left over that is spent on other government programs. In 2017, however, Social Security expenditures are projected to exceed dedicated revenues. By 2020, the deficit will reach almost $68 billion, and will continue to increase thereafter. Closing this growing fiscal gap will require higher taxes or lower-than-projected benefits. According to the 2007 Trustees' Report, an immediate payroll tax increase of almost 16 percent would keep the program solvent through 2075 assuming the revenues are saved and invested. Alternatively, benefits could be immediately reduced 13 percent. Baby boomers, both working and retired, could face both.

Avoiding the Tsunami. Workers planning to retire in the next 25 years will have fewer opportunities to save and will face a higher tax burden to boot. What can be done to avert this impending disaster? The aim should be to maximize the opportunities for baby boomers to earn and save without tax penalties, while restraining spending growth on elderly entitlements. To do so, Congress should:

- Make the Bush tax cuts permanent — particularly the income, dividends and capital gains tax rates.
- Continue to raise the ceiling on retirement account contributions, and retain the higher "catch up" contribution allowed for 50-year old and older workers.
- To avoid payroll tax increases and slow the growth of Medicare spending, allow workers to contribute after-tax earnings to an account to "prepay" retirement health care expenditures.
- Similarly, allow younger baby boomers to prefund their Social Security benefits by saving some of their payroll taxes in personal retirement accounts, reducing their dependence on the pay-as-you go system.

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