Turning Inflation Into Wealth Mini-Course

Reading Two:

Seizing Your Wealth To Cover Retirement Promises: How The Government May Do It

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Overview

The higher the rate of future inflation – the more of your current net worth belongs to the government. Many investors do not realize the powerful financial incentives the government will have to boost inflation rates in order to pay for extraordinarily expensive Boomer retirement promises. From the government's perspective, high inflation rates offer the ability to transform after-tax investor assets into pre-tax income, which can then be taken from individuals through the "**Inflation Tax**." With substantial inflation, running the gauntlet of taxes once or twice is not enough, and even your after-tax net worth can be repeatedly raided under government tax policy, by using the pretext of non-existent income – which was itself created by government fiscal policy.

In this reading, we will precisely demonstrate the way this deeply unfair wealth seizure strategy works, and the multiple levels of challenges it presents. We will review the particularly severe potential implications for conventional investors, and illustrate by example how the one-two combination of inflation and the inflation tax could mean that a DJIA of 75,000 by 2029 could translate into a 73% reduction in real investor net worth. We will briefly discuss investor solutions, some advantages of tangible assets, and close by introducing the concept of taking advantage of the government's inflation blindness to Reverse the Inflation Tax, so that instead of paying real taxes on illusory income, investors can pay illusory taxes on real income.

Impossible Promises

A well-publicized study by *USA Today* put the total of unfunded promises by federal, state and local governments at $59 trillion. That isn't total promises but the present value of the anticipated shortfall compared to the current tax structure. The overwhelming majority of this total is federal promises to future retirees in the form of Medicare and Social Security. On a per household basis this amounts to a shortfall of $530,000, and when we include other factors, as discussed in later readings and videos, the sum rises over $1 million per non-retired and above poverty line household.

A clearly impossible sum.

One of the themes of this series is that impossible promises must be broken, and that if we don't want to be personally financially devastated – then our starting point must be accepting that the impossible is the impossible (which stands in stark contrast to the usual financial planning approach of assuming that the stocks occupy a separate universe from Social Security and Medicare, so that paper wealth can endlessly compound without limit – and without any messy connections to the actual economy). So, how specifically, will the impossible become the possible?

One answer is that the system breaks down and collapses. The future could be multiple levels of government all reneging on their promises to retirees, as well as the major corporations. But, that is such a messy solution. Not just for average people, but worse – messy for the wealthiest and most politically powerful segments of our population. In fact, such a Doomsday scenario might jeopardize both their wealth and their power. It would also compound the problem through depressing the tax revenues, because everyone would be losing money, and you don't pay taxes on (nominal) losses.

There is an alternative means of closing the gap. A means that keeps the promises paid in form (if not in substance). A means that redistributes wealth from taxpayers to the government. A means that keeps the status quo intact. All you have to do is make it Doomsday for the value of the dollar – in the right way – and real costs (retiree benefits) will plummet, real tax collections will skyrocket, and the gap will close.

There are three intertwined methods that the government can use in closing the fiscal gap through the use of inflation. The first is "Theft By Index Management", where the official government rate of inflation rises at a different rate than the real rate, making inflation-indexed promises easier to keep each year (there will be an entire reading devoted to this later in the course). The higher the real rate of inflation, the faster this strategy delivers its benefits to the government. The second method is "Evaporate Paper Wealth Claims", where the government dilutes competing claims on future goods and services by retiree investors through making the real value of their assets plummet, even while their paper value soars higher than ever. This pumping up of the paper value of investments then opens the door for the third strategy, that of effectively taxing inflation, that we will devote the rest of this article to exploring.

Seizing Assets Through Inflation Taxes

The easiest way to illustrate the Inflation Tax is with examples. Let's assume that through hard work and deferred gratification, you built up $40,000 in savings, which wasn't easy after paying all the taxes on the income as you made it (we'll keep the initial assumptions low to avoid too many zeros). Through judicious investing, you turned that $40,000 into a $100,000 current investment portfolio. Which again wasn't helped by paying taxes on every dollar of gain, but you've made it, the $100,000 is yours after-tax, and the government has no tax claim on it.

So long as a dollar is worth a dollar, that is.

Chart I below illustrates how by changing the value of the dollar, part of your after-tax assets can be taken by the government.

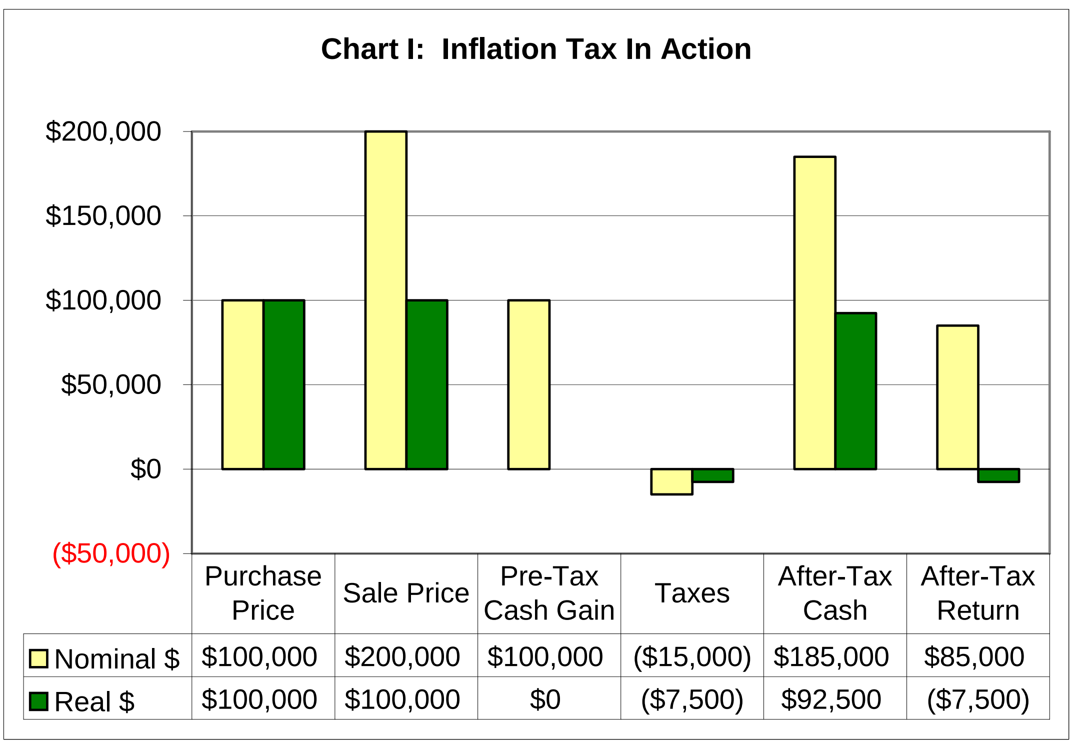
Chart I: The Inflation Tax In Action

Inflation: 100%
Tax Rate: 15%

	Nominal Dollars	Real Dollars (Inflation-Adjusted)
Purchase Price	**$100,000**	**$100,000**
Sale Price	**$200,000**	**$100,000**
Pre-Tax Cash Gain	$100,000	$0
Taxes	($15,000)	($7,500)
After-Tax Cash	$185,000	$92,500
After-Tax Return	$85,000	($7,500)
After-Tax Return (Percent)	85.0%	-7.5%

Ending Value Of The Property:

What The Government Sees:	**$200,000**
The Economic Reality:	**$100,000**



The left column represents nominal dollars. You buy almost any kind of asset for $100,000, and hold it long enough to be eligible for capital gains tax treatment. During that time, inflation destroys half the value of the dollar, meaning it now takes $2 to buy what $1 used to. Our key assumption is that your asset exactly keeps up with the surge of inflation – meaning it likely did better than most investments. So you get $200,000 when you sell it – even though in purchasing power or real dollar terms, the asset is unchanged in value (the right column, and the dark green blocks and bars are real dollars).

The government does not generally recognize inflation in its tax policy, it sees nominal dollars only (the pale yellow bars and boxes). What the government sees is that you just made $100,000, and it wants its share, in the form of $15,000 in capital gains taxes. Now, as long as we ignore inflation, that's not so bad. We still have $85,000 in "profits". Indeed, that 85% after-tax return on investment may look pretty sweet.

The problem is when we adjust our 85% after-tax return for the technicality of a dollar only buying what fifty cents used to. When we look at our real wealth in terms of the goods and services we can buy with the proceeds of selling our asset. When we go down the real dollar column on the right, and look with our dark green economic "eyes", then we see that we bought for $100,000, we sold for $100,000, and in terms of real wealth – our pre-tax gain is zero. But, we still have to pay taxes. When we discount those future taxes to bring them back to current dollars, at least it drops the real cost in half, down to $7,500. Unfortunately, once we pay those taxes – in purchasing power terms, we only have $92,500 left.

In other words, instead of making $85,000 – we lost $7,500 out of our $100,000 investment in real terms. When we adjust for inflation and look at what a dollar will buy – our sweet 85% return vanishes, and what we are left with is a 7.5% loss on our investment.

We just met the "Inflation Tax" – and it ran over us.

Let's review what just happened here. Through its reckless fiscal policies, the government created inflation that cut the value of our dollars in half. Meaning that everything that we owned in dollar terms, such as bank accounts and bonds, just had half the value taken away from us. However, we were smart enough not to put our $100,000 into a dollar denominated investment. We put it into another type of asset, an asset that kept up with inflation. We didn't actually make any real money, we just protected the purchasing power of our assets against the effects of unwise government policies.

So how does the government react? By stripping us of part of the wealth we did preserve, on the grounds of illusionary profits. With the illusion that created the pretext for seizing our assets having been created by the government in the first place.

Transforming After-Tax Assets To Pre-Tax Income

There is a very important principal that long-term investors of all kinds are wise to remember: **the higher the inflation rate – the**

greater the percentage of your assets that belongs to the government. This applies not just to taxes on your ongoing income, but to your after-tax assets as well.

In the first chart above, we looked at what happened with a 100% rate of inflation. The nominal value of our asset doubled – and we moved from having 100% of our $100,000 asset being after-tax, to having $100,000 in pre-tax income (50% of our asset), and $100,000 in an after-tax asset (50% of our asset). The government just transformed 50% of our assets from after-tax to pre-tax. Income that the government is then entitled to tax us upon whenever we trigger a tax effect by moving our investment to a different form, or trying to spend part of it. Income that doesn't economically exist in purchasing power terms, but was artificially generated through the government destroying the value of the currency.

What the chart below demonstrates is the government's powerful incentive to increase the inflation rate if it wants to maximize tax dollars. As shown, the higher the rate of inflation – the more of your assets becomes pre-tax income that is subject to taxation.

Chart II: Using Inflation to Transform After-Tax Assets To Pre-Tax Income

(Setting Up The Inflation Tax)

Value Of Your After-Tax Asset Portfolio Today: $3,000,000

Inflation	Nominal Portfolio Value (1)	Real Portfolio Value (1)	Pre-Tax Income (Nominal)	After-Tax Assets Transformed To Pre-Tax Income
10%	3,300,000	3,000,000	300,000	9%
25%	3,750,000	3,000,000	750,000	20%
50%	4,500,000	3,000,000	1,500,000	33%
100%	6,000,000	3,000,000	3,000,000	50%
250%	10,500,000	3,000,000	7,500,000	71%
500%	18,000,000	3,000,000	15,000,000	83%
1000%	33,000,000	3,000,000	30,000,000	91%

(1) For all inflation rates, it is assumed that value of the portfolio exactly keeps up with the inflation rate, so there is no real gain or loss in pre-tax purchasing power.

With the example $3 million portfolio, a 10% rate of inflation raises the nominal value of our portfolio to $3,300,000, meaning we have incurred $300,000 in pre-tax income – even though the real value of our investments haven't budged. This means that 9% of our real $3 million in after-tax assets just became taxable income. The percentage of assets transformed steadily increases with the rate of inflation, until we reach the bottom row where we see that inflation of 1000% will have the effect of transforming 91% of our assets from after-tax to pre-tax, as we are now subject to taxation on a full $30 million in illusory income.

Compounding The Problem – Repeated Raids

There is a particularly unfortunate aspect to the inflation tax – it isn't a one-time tax. For instance, let's say we own an asset for five years, during which time inflation turns 50% of our asset from after-tax assets to pre-tax income. We then sell the asset, pay the taxes, buy another asset – and start over again. Because further future inflation will again create another level of pre-tax income that will be taxed again. This principle is illustrated in the chart below:

Chart III

Repeated Raids On Your After-Tax Assets

Average Portfolio Turnover Period: 5 Years

Real Inflation Rate:	14.0%
Asset Appreciation Rate:	14.0%

Years	Real Compound Inflation	Asset Compound Appreciation	Beginning Tax Basis	Gross Sale Proceeds	Nominal Profits
5	92.5%	92.5%	$1,000,000	$1,925,415	$925,415
10	270.7%	270.7%	$1,740,332	$3,350,860	$1,610,528
15	613.8%	613.8%	$2,948,228	$5,676,561	$2,728,333
20	1274.3%	1274.3%	$4,858,061	$9,353,782	$4,495,721
					$9,759,997

Years	Capital Gains Tax Rate	Taxes	Ending After-Tax Position	Ending Value (2007 $)	Change In Net Worth (2007 $)
5	20%	$185,083	$1,740,332	$903,874	($96,126)
10	25%	$402,632	$2,948,228	$795,266	($204,734)
15	30%	$818,500	$4,858,061	$680,597	($319,403)
20	35%	$1,573,502	$7,780,279	$566,107	($433,893)
		$2,979,717			

To show how the chart works, let's say you start out with $1 million, inflation averages an annual 14% over the next 20 years, and through excellent asset choices you are able to do what most investors are not and earn 14% annually, so that you keep up with inflation – on a pre-tax basis, anyway. You try your best to follow a long-term investment strategy that minimizes tax consequences, but the world is in financial turmoil, and you do need to turn your portfolio over into new investments an average of once every five years.

For the first five year period, inflation and matching investment success on your part have raised the value of your portfolio to $1.9 million. The economic value is still $1 million, but inflation has created $900 thousand in nominal income, meaning 47% of your portfolio has been converted from after-tax assets to pre-tax income. You pay a little shy of $200 thousand in capital gains taxes at a rate of 20% (tax rates are assumed to rise by 5% every five years as the Boomers increasingly reach retirement age and everyone pays more), and you are left with $1.7 million in after-tax assets. When adjusted for inflation, you have about $900,000 of your original $1 million in purchasing power remaining, and this means the inflation tax has claimed about 10% of your assets.

Then it starts again. Forty-one percent of your after-tax assets are converted to pre-tax income, you pay a little higher tax rate, and lose a little more than another 10% of your after-tax real net worth. Repeat, and repeat again – and after 4 rounds and 20 years, you have ending assets of $7.8 million, but they are only worth $570 thousand in purchasing power, and you have lost 43% of the real value of your starting $1 million in assets to repeated rounds of the Inflation Tax.

Keep in mind as well that these assumptions are relatively benign in some ways, for a five year turnover is very slow by many standards, and for simplicity and conservatism we've kept all your income qualifying for capital gains tax treatment. The sting of the inflation tax is much worse when applied on an annual basis and at short term tax rates.

Conventional Investments May Fare Much Worse

The worst pain from the inflation tax may be reserved for conventional investors. Let's illustrate by using the chart below, and making a few simple assumptions. Let' s assume that the stock market rises by 9% a year, and that a $1 million investment has increased to $1.5 million in the next five years (call it the DJIA reaching 20,000). That 50% profit looks great at first glance. Except the problem is that average annual real inflation levels rose at a 14% annual rate instead of a 9% annual rate, for total compounded inflation of 90%. So the real value of the Dow in purchasing power terms has in fact dropped to 10,500, even while the paper value soared. The stock investor has fared significantly worse than a tangible asset investor who has succeeded in staying even in pre-tax, real dollar terms.

(As you can see from the DJIA reference above, most of this article was written before 2008 – however, it is even more timely today as the Federal Reserve creates money without limit to benefit the financial industry.)

Chart IV

Conventional Investments:

Repeated Raids On Your After-Tax Assets

Average Portfolio Turnover Period: 5 Years

Real Inflation Rate:	14.0%
Asset Appreciation Rate:	9.0%

Years	Real Compound Inflation	Asset Compound Appreciation	Beginning Tax Basis	Gross Sale Proceeds	Nominal Profits
5	92.5%	53.9%	$1,000,000	$1,538,624	$538,624
10	270.7%	136.7%	$1,430,899	$2,201,616	$770,717
15	613.8%	264.2%	$2,008,937	$3,090,998	$1,082,061
20	1274.3%	460.4%	$2,766,380	$4,256,418	$1,490,038
					$3,881,440

Years	Capital Gains Tax Rate	Taxes	Ending After-Tax Position	Ending Value (2007 $)	Change In Net Worth (2007 $)
5	20%	$107,725	$1,430,899	$743,164	($256,836)
10	25%	$192,679	$2,008,937	$541,898	($458,102)
15	30%	$324,618	$2,766,380	$387,560	($612,440)
20	35%	$521,513	$3,734,904	$271,758	($728,242)
		$1,146,536			

Ending Dow Jones Industrial Average:	75,000
Ending Change In Investor Real Net Worth	-73%

Now, let's assume that the $1 million in assets had been purchased with after-tax dollars, so the government had no right to the assets. However, the government does have rights to the $538 thousand increase in the nominal value of the assets, even though the real value was falling in purchasing power terms. Again assuming that capital gains tax rates rise as Boomer retirement finance problems soar upwards, the investor would pay $107,000 in taxes. That leaves

$1.4 million – but the $1.4 million is only worth $743 thousand in 2007 dollars. So the combination of government fiscal policy destroying the value of the dollar, and government tax policy taxing non-existent profits created by the destruction of the dollar, have taken 26% of the investor's portfolio.

Then it happens again, and again, and again. Until at the end of 20 years, the Dow now stands at 75,000 (with triumphant newspaper headlines every step of the way) – and the investor has lost 73% of the value of their assets on an inflation-adjusted and tax-adjusted basis.

Note that in some ways our assumptions are quite conservative. For instance, change the trading frequency to once every few months and the tax treatment to short term rates, and losing only 73% of your investment may begin to sound quite attractive. Also, we did leave dividends out of the discussion, which are the stock market's historical method of keeping up with inflation. Which is appropriate, as the compounded historical dividend rates of 1X to 2X long-term bond yields that created most of the historical stock market's long-term profits and resiliency… are long gone.

Solutions: Shelter & Speed

While a detailed discussion is beyond the scope of this article, tax-deferred accounts such as IRAs, Roth IRAs, and Keoghs do have some powerful advantages in dealing with the Inflation Tax. Technical rules and limitations aside, it may be worth considering the bigger picture as well. When your assets are in these accounts, your wealth is totally “inside” the government tax system, where the terms of the withdrawal can only occur on the terms the government specifies and with the taxes the government says – <u>at the time you are actually withdrawing the money</u>.

We have the rules as they are set up now. We also have the government’s former chief accountant, Comptroller General David Walker, trying to tell everyone who will listen that a financial “tsunami” is on the way, and the government cannot possibly pay for its retirement promises to Boomers. So, the rules – they will have to change. The retirement accounts will be a very attractive target for rule changing, simply because there is so much wealth there (if you need wealth, then wealth is where you go.) The exact form of the changes is of course currently unknown, but to complacently make long-term investment plans based on today’s rules – when we know there will be overwhelming pressures to change the rules down the road – may turn out to be a bit too trusting of politicians.

(This is particularly true with Roth IRAs, which are intended to address the inflation tax issue but offer no tax benefits at the time of contribution. So you put your assets in regulated accounts, where you can’t get to the money, with the rewards contingent upon future politicians keeping today’s politician’s promises, during what we know will be a time of great stress on government revenues. Kind of like that initial promise when the income tax was introduced that the tax rate would never exceed 1% or effect the middle class?)

Another strategy is to try to out-run inflation, by making such good investments that you leave technicalities like inflation and tax treatments in your dust. Always worth a try, but if you are investing in dollar-denominated investments, you might want to be sure you've got your running shoes on and laced up tight. As covered in the next reading ("Turning 10% Inflation Into A 27% Benefit"), with a 40% tax bracket and ordinary income treatment, you would have to earn 17% per year on your investments just to stay even with 10% inflation and the inflation tax.

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