

## Research Roundup

By Kerry Pechter      Thu, Mar 25, 2021

*Here's new research on tax avoidance among the very rich, the logic that millionaires use when buying equities, considerations for plan sponsors when estimating income from 401(k) balances, and a worst-case scenario for future tax rates.*



As the Biden administration begins its hunt for revenue to offset the trillions of dollars it hopes to spend on infrastructure renewal and green energy projects, we bring you recent research about taxes. One article describes how the very wealthiest Americans minimize or evade their taxes. The other article, by the Congressional Budget Office (CBO), describes how a big spending program might affect taxpayers and the economy.

You'll also find an article by MIT's Adam Solomon and James Poterba (the current president of the National Bureau of Economic Research) on estimating the "money's worth" of an income annuity. This article is must-reading for retirement plan sponsors who are now required by the Labor Department to tell plan participants how much income their current savings might buy. The answer: It depends.

Finally, financial advisors should benefit from a paper about the ways that millionaires decide how much of their portfolios to allocate to equities. The findings are based on a survey by UBS, GuideWell (a health insurance holding company) and two economists. Millionaires apparently disregard academic dogma. Links to the four articles can be found below.

### **The Rich Cheat on Their Taxes**

Americans with the biggest incomes naturally have the biggest tax bills, and new research finds that they go to great lengths to hide part of their income from the IRS, either in offshore accounts or by underreporting income from private businesses they own, according to new research.

"We estimate that 36% of federal income taxes unpaid are owed by the top 1% and that collecting all unpaid federal income tax from this group would increase federal revenues by about \$175 billion annually," write economic researchers from the Research, Applied Analytics and Statistics office of the Internal Revenue Service and from three universities.

Their paper, "[\*\*Tax Evasion at the Top of the Income Distribution: Theory and Evidence\*\*](#)," reports on efforts by what they describe as an underfunded IRS to go beyond conventional random audits, which they say fail to detect the sophisticated tax evasion techniques of Americans at the apex of the income spectrum.

"Random audits do not capture most tax evasion through offshore accounts and pass-through businesses, both of which are quantitatively important at the top," the paper said. "We provide a theoretical explanation for this phenomenon, and we construct new estimates of the size and distribution of tax noncompliance in the United States."

According to the paper, forms of evasion include "the abuse of syndicated conservation easements, micro-captive insurance schemes, private inurement in tax-exempt organizations, and the use of offshore trusts to evade tax. Many of these strategies involve pass-through businesses or other entities controlled by the taxpayer."

Wealthy Americans have more than \$1 trillion outside the US, leading the researchers to estimate that "\$15 billion in taxes was evaded from offshore accounts, with \$10.5 billion of this total attributed to the top 0.1%, and \$6.4 billion attributed to the top 0.01%."

### **How Millionaires Set their Equity Allocations**

A survey of 2,484 US individuals with at least \$1 million of investable assets shows that the most important factors determining the share of equities in their portfolios are "professional advice, time until retirement, personal experiences, rare disaster risk, and health risk."

How well do their financial beliefs and decisions follow "leading academic theories"? Not a whole lot, according to a new paper, "[\*\*Millionaires Speak: What Drives Their Personal Investment Decisions?\*\*](#)" by a team from the Yale School of Management, GuideWell, the health insurance holding company, UBS and the University of Toronto law school.

Only 15% of the survey respondents said that the fundamental consideration affecting equity allocation in most modern asset pricing theories—return covariance with the marginal utility of money—was very or extremely important to them. Only 9% of respondents said that "return covariance with the marginal utility of consumption" was very or extremely important.

"On average, respondents hold 53% of their portfolio in equities," the paper said. Only 6% hold no stocks (vs. 48% of the total 2016 Survey of Consumer Finance US study population). Of the stocks they own, 83% are domestic US. Only 10% of the millionaires invest in hedge

funds, venture capital, or private equity. Those who do allocate 13% of their portfolio to these vehicles.

“Rich investors collectively believe that high-profitability stocks offer high risk-adjusted returns. Indeed, it is not that such stocks have risk that is elevated, but not sufficiently elevated to offset their higher expected returns: our respondents tend to believe that these stocks have lower risk while offering higher expected returns,” the paper said.

“Conversely, they believe that high-momentum and high-investment-expenditure stocks offer low risk-adjusted returns, featuring lower expected returns and higher risk. Value stocks are thought to have both low expected returns and lower risk.

“Nearly half of our respondents have invested in an active investment strategy through a fund or professional manager, and the most common reasons for doing so are professional advice and the expectation that they will earn higher average returns from active investing. Past fund manager performance is seen as a strong evidence of stock-picking skill.”

### **The Present Value of an Annuity is a Moving Target**

Because the Department of Labor (DOL) now requires defined contribution plan sponsors to provide participants with annual estimates of the annuity income stream that their plan balance could purchase, two MIT economists have looked into the “money’s worth” of US individual retail annuities during 2020.

The money’s worth of an annuity is its expected present discounted value of future payments (EDPV) divided by the annuity’s purchase price. The economists used discount rates drawn from the corporate BBB yield curve. They used future mortality rates that combine a Society of Actuaries individual annuitant mortality table with projections of future mortality improvements from the Social Security Administration.

Their paper, [“Discount Rates, Mortality Projections, and Money’s Worth Calculations for US Individual Annuities,”](#) James Poterba and Adam Solomon demonstrates that the costs and potential benefits of the kind of retail annuities available to retiring plan participants are (and will always be) moving targets, affected by factors such as interest rates, the health of the annuity purchaser, and the design of the individual annuity contract (i.e., period certain, joint-and-survivor).

The papers shows that coming up with those estimates may be difficult for plan sponsors, considering the numerous variables involved. The low interest rate environment has also

been driving down the payout rates of income annuities for years. “Our central estimates... suggest money’s worth values for annuities offered to 65-year-old men and women of about 92 cents per premium dollars,” the authors write.

The government’s push to promote annuities unfortunately happens to coincide with a trough in the payouts of retail annuities, which results from an ongoing decline in bond yields. As the paper shows:

The average annual payout on a \$100,000 SPIA [single premium immediate annuity] for a 65-year-old man was \$5,748 in June 2020, [and between June 2020 and January 2021 dropped 3.3%, from \$5,748 to \$5,556. There was a similar drop, from \$5,424 to \$5,244, for 65-year-old women].

Payouts were \$6,456 in June 2015, \$7,344 in June 2010, and \$7,740 in June 2005. The yield on a 10-year Treasury bond, which averaged 0.73% in June 2020, was 2.36% in June 2015, 3.20% in June 2010, and 4.00% in June 2005.

Deferred annuities (and their tax-deferred equivalents, called Qualified Longevity Annuity Contracts), which characteristically produce income starting at age 80 or 85, offer less value than immediate annuities, the paper showed, partly because of adverse selection.

“The lower EPDV for the deferred annuities may reflect insurers’ reluctance to offer long-duration policies with substantial risk of medical progress or other unexpected developments before payouts begin. It is also consistent with more pronounced selection in the market for deferred annuities, with only the healthiest individuals at age 65 choosing to purchase deferred annuities,” the authors explained. That’s unfortunate, because deferred annuities have long been envisioned by academics as the thriftiest way for retirees to mitigate the financial consequences of living to extreme old age.

The authors also note that employers who follow DOL instructions and use the 10-year Treasury rate to calculate annuity payouts would understate the payouts.

“The regulations outline a procedure for calculating the potential annuity payout assuming that future benefits are discounted at the 10-year Treasury yield,” they wrote. “Our findings suggest that the use of the Treasury yield in this calculation may understate the income stream that will be available to future retirees.”

## **The Effects of Biden's Spending Plan on Future Taxes: CBO**

In their timely article, "[The Economic Effects of Financing a Large and Permanent Increase in Government Spending](#)," analysts at the CBO examine the fiscal challenge the US government will face if it tries to finance—without raising the federal deficit—an increase in annual federal spending by 5% or 10% of Gross Domestic Product (GDP) for 10 years.

The analysts, Jaeger Nelson and Kerk Phillips, rule out the possibilities of financing the increase with budget cuts or deficit spending. Instead, they focus on the tax implications and consider the impact of three types of taxes:

- A uniform tax on labor income only. That tax is like the Medicare hospital insurance payroll tax, which has no maximum taxable income.
- A flat (single rate) tax on all sources of income, including both labor and capital income.
- A progressive tax on labor income, similar to the current income tax, and a flat tax on capital income.

They conclude that:

To maintain deficit neutrality, tax rates for all three tax policies must rise over time to offset behavioral responses that result in smaller tax bases. After 10 years, the level of GDP by 2030 is between 3% and 10% lower than it would be without the increase in expenditures and revenues.

Younger households would experience greater loss in lifetime consumption and hours worked than older households, they write. A progressive income tax causes the largest fall in lifetime consumption and hours worked for higher-income households and smallest for lower-income ones. It also generates the largest decline in total output and the smallest decline in consumption among the bottom two-thirds of the income distribution.

But this isn't the whole story, the authors concede. "The analysis does not consider any effects of the expanded government spending... Well-targeted government spending on physical capital, education and training, and research and development increase the productivity of private businesses. Productivity increases brought on by well-targeted government spending boosts GDP, private investment, and, ultimately, the amount households can consume," they write.

The paper makes assumptions that are not universally held, such as:

“Taxes on labor income reduce after-tax wages, so they reduce the return on each additional hour worked. That reduced incentive to work is then partially offset because people have lower expected future income, which creates an incentive to work more to make up for their lost after-tax income. On average, the former effect is greater than the latter in CBO’s assessment; therefore, higher labor taxes tend to reduce hours worked in the economy. Higher taxes on capital income, such as dividends and capital gains, lower the average after-tax rate of return on private wealth holdings (or the return on investment), which reduces the incentive to save and invest and leads to reductions in saving, investment, and the capital stock.”

Those assumptions are based on the following belief, which behavioral economists, among others have questioned as dated and unfaithful to the real world:

“Households in the model used in this paper have perfect information about the path of future policy and the distribution of their potential earnings over their lifetime; moreover, households’ behavior is perfectly rational and consistent with their preferences about private consumption and hours worked.”

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