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*"Housing busts, unlike bear markets on Wall Street, often start almost imperceptibly and unfold slowly."*

—Jonathan R. Laing, "Barron's", June 20, 2005

# Wealth Creation Strategies

## Tax and Financial Strategies

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Issue #21, July - August 2005

## Froth in the Real Estate Market

*"Everybody has heard about the boom in [California] real estate...[They ask:] 'You think then that the present growth in Southern California will continue?' Most assuredly."*

*Salesman for a Southern California real estate firm quoted in The Los Angeles Times, November 1887*

*"The wild scenes of [rampant real estate speculation] twelve and fifteen and eighteen months ago are in no danger of being soon repeated."*

*The Los Angeles Times, November 1888 after the real estate bust.*

In the October 2004 newsletter I suggested it might be a good time to sell California real estate. The more I study the market, the stronger my opinion. Federal Reserve Chairman Alan Greenspan has emphasized for years that because housing is a local market it's almost impossible to have a national housing bubble. However, he recently said some regional house-price inflation was showing signs of being excessive and that, "at a minimum, there's a little froth in the market," adding, "it's hard not to see that there are a lot of local bubbles." California's a big one.

I mentioned I've learned that predicting where the peak of a speculative mania lies is treacherous and that any number of events could be seen as the catalyst for the pop. Given stable interest rates, one possibility is a tightening of lending standards. An ominous sign that this may be occurring is that the Federal Reserve and other bank regulators, admitting to a possible bubble in housing, recently issued guidelines requiring that home equity-line lenders look more closely at borrowers' ability to repay under various future market conditions. They are planning on issuing similar guidelines covering loans used to purchase homes.

Mass psychology, which drove the markets up, may have reached its euphoric peak. It is difficult to imagine a greater level of optimism regarding future expectations when interest-only loans, comprising a mere 2% of new home loans in 2002, accounted for 47.1% of all such loans in 2004 and 61% in the first two months of 2005. Along with Adjustable Rate Mortgages (ARMs) with which they are often combined, such non-traditional loans accounted for nearly two-thirds of mortgage originations in the latter half of 2004. The market share of ARMs, which comprised only 18% of new purchase loans in early 2003, now totals almost 50% of the national market and over 60% in California. ARMs, which can result in negative amortization (in which the loan balance owed continuously increases), rocketed from 6% of jumbo loans (non-FNMA-qualifying loans exceeding \$359,650) in the first quarter of 2004 to almost one-third of such loans by year-end. With lower initial monthly payments, ARMs and interest-only mortgages have allowed home buyers to qualify for larger loans, enabling the purchase of more expensive homes than with their fixed-interest rate traditional counterparts. This has

fueled demand, which has resulted in increasing prices, further fueling demand as the herding instinct takes hold.

The fact that the surge in non-traditional loans has occurred in the face of relatively flat interest rates increases the odds that borrowers are stretching to buy more home than they could otherwise afford. Many wouldn't even be buying. Some object that if creative-financing schemes hadn't been developed, housing would be unaffordable. However, this suggests that a basic law of economics no longer exists: if there are no takers at a given price, sellers are forced to reduce prices until buyers return. In other words, the "creative financing" intended to make housing more affordable has instead resulted in ever-increasing prices. The mythology is all-pervasive: while a journalist in a recent Los Angeles Times article wrote, "Zero downs...eliminate a formidable barrier to owning a house" and "without such a mortgage, buying the house would have been 'impossible,'" zero downs simply increased demand, which increased prices, which created a windfall for the seller. Houses will change hands with less creative financing, albeit at lower prices.

Consider an extreme case. What would happen to demand if zero down and zero payment for five-years financing became available? It would, of course, surge. What do you think prices would do? They would skyrocket until everyone who has ever wanted a home but couldn't afford one had bought, at which point we'd be out of buyers. While we've seen a lesser version of this, the principle is identical. The tightening of lending standards will simply hasten the inevitable.

There are a number of other observations that create concern in the conservative mind not only for real-estate values, but for the entire economy:

1. The median price of a California home was 15.4% higher than the nation's in 1968. By 1977, it was 45.2% higher and in 2004 143.5% higher, when the median price reached \$450,990 in California and \$185,200 in the United States as a whole (which means that not counting California, the ratio is even worse).
2. Real home prices adjusted for inflation fell by over one-third from 1894 to 1944. Home prices do not always increase even with rising populations. In Japan, with a population over three times that of California's on roughly the same land area, prices of homes in some areas fell almost 75% from 1990 to 2003.
3. Two-fifths of all American jobs created since 2001 have been in housing-related sectors, including construction, real-estate sales and lending.
4. A study by the International Monetary Fund found that output losses after house-price busts in wealthy nations have, on average, been twice as large as those after stockmarket crashes, usually leading to recession.
5. Full-page ads in major newspapers have been announcing a flood of no-money down real estate seminars ranging up to \$4,000 in price for a weekend. Such seminars are creating unrealistic expectations of easy money not dissimilar to that created by day-trading workshops popular at the top of the NASDAQ stock market bubble in 2000.
6. The percentage of homes purchased for investment nationwide has increased from 5.81% in 2000 to 8.65% by the end of 2004. The percentage of homes bought for investment now exceeds 16% in parts of California, Florida and most of Nevada.
7. With increasingly little or no documentation of a borrower's income, employment or assets, 25% of all buyers and 42% of first time buyers got in the door with no down payment on their house purchase last year.

My guess? We may experience a 20-50% collapse in prices in many areas by 2012.

## Turbotax vs. the Tax Professional

### When the right tax is the wrong decision

The slogan "Taxes made easy; taxes done right" was drilled into our consciousness early this year as Turbotax ads saturated the airwaves. However, a question I continuously ask during the planning and tax preparation process is, "are we making the right decision?" It's one that software, including the far more expensive program I use, does not answer.

First, we need to understand the choices and then ask which option is the best fit for the person's needs, plans, future income (estimated as best we can) and risk preferences. Part of the challenge stems from the fact that there are four taxes to consider: the regular income tax, the Alternative Minimum Tax (AMT), the Social Security or Self-Employment Tax and, most of the time, a state income tax. In addition, due to phase-outs and phase-ins of credits and deductions as income increases or

decreases, the marginal tax bracket—which determines the tax savings that may result from implementing one of many strategies involving the creation or elimination of numerous deductions and credits—is highly variable. The interrelationships and effect of differing types of income, deductions and taxes on the alternatives can be mind boggling.

#### Government math

#### 15% = 5% to nearly 50%

Consider those in the 15% federal tax bracket. Those with Social Security income are subject to a 22.5% and 27.8% rate. Taxpayers who qualify for the Earned Income Credit can be hit with a 25% rate. While the rate on dividends and long-term capital gains is a miniscule 5% for those in the 15% bracket, Social Security recipients may be shocked with a 12.5% and 17.8% tax

on such income. When we add in Social Security withholding tax or Self-Employment tax and state income tax, other tax brackets reach almost 50%. These "other" tax brackets determine the rate of savings for additional deductions such as mortgage interest, property tax, business deductions, rental property deductions, 401k's and IRAs.

Even with identical dollar amounts, the savings can vary greatly for each deduction. For example, the tax savings for a person in the supposed 15% bracket can be zero for an additional \$1,000 in mortgage interest and property tax if the standard deduction exceeds actual deductions. For the same person, the savings could be \$150 or \$331 for \$1,000 in business expenses, \$436 if Social Security income is a factor and zero to \$650 for a \$1,000 contribution to a 401k or traditional IRA. That \$1,000 in additional business expenses

for California residents with identical income of \$20,000 can save \$100, \$190, \$310 or \$375 depending on a number of factors, including mix and amount of income types (such as wages vs. self-employment) and filing status.

Do we deduct the cost of new business equipment in full or depreciate? Invest in a traditional or Roth IRA and if yes, how much in each? What will \$20,000 of mortgage interest and \$6,000 of property taxes every year really save in tax? The possibilities are endless, depending on filing status, total income, other deductions and whether you're starting above or below the standard deduction. This is the reason my response to the question, "What tax bracket am I in?" has for years been, "For what purpose are you asking?"

#### **Two examples of complexity: retirement savings for low income earners, and the state income tax vs. sales tax deduction decision**

The Low Income Savers Retirement Credit (LISRC) provides a classic case of muddled confusion, making tax decisions challenging. The savings from a \$2,000 Roth IRA for a single person or married couple qualifying for this credit can range from \$200 to about \$700 per person and up to \$1,000 for Heads of Household. It can be zero for a taxpayer already reaping the benefit of the credit from a \$2,000 401k contribution. The savings from a \$2,000 traditional IRA contribution for someone who qualifies for the LISRC ranges from \$400 to \$1300. Sometimes, a combination of Roth and traditional IRAs provide optimal overall tax savings, including the consideration of future tax costs of withdrawals from traditional IRAs. Investment concerns as well as annual fees for small IRAs need to be considered, adding to the complexity of the decision-making process.

Another example, albeit "temporary," is the choice of a deduction for state income tax or sales tax. You'd think it would be a cut and dry decision. Not so fast: by claiming the lower sales tax deduction rather than state income tax

and forfeiting, say, \$400 in '04 tax savings, a number of clients will likely shave \$600 to \$800 off their '05 tax. While a refund of tax for which a deduction is claimed is taxable, a refund of tax that was never deducted is non-taxable. This is particularly valuable for those who expect to be in a higher bracket in '05.

#### **More government math 25% = zero to 55%**

One would think that those in the nominal 25% federal and 9.3% California state income tax bracket would save 34.3% of mortgage interest, property tax, deductible IRAs or 401k's, or \$343 per additional \$1,000 of such deductions. However, this doesn't take into account the child tax credit, which can pop those who qualify into a 39.3% bracket for purposes of 401ks and deductible IRAs. Nor does it count the AMT, which can result in a 32.5% marginal federal rate in addition to the nominal 9.3% state rate (which is often 10.1% due to phase-outs of exemptions and deductions). However, while the savings from additional 401k contributions might total 42.6% (32.5 + 10.1), the savings that results from additional mortgage interest is only 34.3% and zero for additional property tax. While the question of how much to invest in one's 401k becomes a no-brainer at that level of savings, the decision to purchase a new home is not so clear-cut. What bracket am I really in? is a question that needs an answer for each type of deduction. A decision to sell the old home and buy a new one could hinge on the fact that any increase in property tax (which, in California, is determined by the initial cost plus value of permitted add-ons) may save not a whit of income tax. Remodeling may be a relatively more attractive option for many who are subject to the AMT.

For the self-employed, there are a host of additional taxes, deductions and credits to consider in deciding whether or not to deduct vs. capitalize the cost of new equipment. Not the least of these is the Self-Employment (SE) tax. While nominally 15.3%, the effective rate is

often really about 12% after taking into account a deduction for half the SE tax, but can be as low as 2% (Medicare tax only, with a deduction for half of it at both the federal and state level). Expected future income also plays a role in helping determine the best strategy, as does the ambiguity of the item in question. How easy will it be to prove that 80% of the miles racked up on the SUV are for business? What is the likelihood of an audit on that first-year depreciation of up to \$25,000 on which taxes are saved at a possible 55% rate (the real 12% SE tax plus the 42.6% rate above)? There is also the crucial decision of whether to remain a sole proprietor or incorporate, for which there are numerous tax as well as legal considerations.

#### **Why self-preparation may be dangerous to your psychological and financial health**

While many of you are capable of preparing your own tax returns, there are a variety of reasons you don't.

- ❖ For some, it's enough to pull together the information for preparation and by then, you're too disgusted with the system to want to complete the task.
- ❖ Others don't want to spend the time and aggravation learning yet another computer program, especially one for which the rules usually change every year.
- ❖ Some simply want a return signed by a professional, which many perceive as less likely to be subject to IRS scrutiny—and even though perfectly legal, you don't want the hassle and inconvenience of an inquiry.
- ❖ There is a lower likelihood of error, decreasing the odds of unnecessary and sometimes frightening correspondence.
- ❖ The situation and tax return is too complex to learn the law or take a chance that you adequately understand it.

The most important reason for many *should* be the fact that most situations require important decisions such as those enumerated above, which may be overlooked or answered sub-optimally in self-preparation. While options may

not even be apparent, important choices without obvious optimal solutions sometimes need to be considered yearly.

However, if there is only one such choice every five or ten years, the savings from making the right one can

greatly exceed many years worth of investments in your favorite tax professional.

## Income Averaging

### Making the Best of a Low Income Year

The fact that our tax system is “graduated,” with different “chunks” of income taxed at different rates, lends itself to unique and oft-overlooked long-term tax reduction strategies. These would exist even under what most consider a pure flat-tax regime, in which all income in excess of a large deductible amount, a zero bracket, is taxed at one rate. After all, with a large zero bracket, the optimal strategy would be to use up that zero rate, either by earning more or shifting income from other years. The fact that we have a system with various deductions on which offsetting income avoids tax, along with low brackets on additional income and even lower tax rates on certain types of income, only serves to complicate the calculations. However, muddling through the complexity can be worth thousands of dollars in long-term tax savings.

Increasing income in low-income years is particularly helpful for those with normally higher incomes or unrealized profits in capital assets (such as stocks or real estate), large retirement plans or deferred annuities. We may benefit by taking income now if we can pay tax at a zero, 10% or even 20% rate, knowing that the income could be taxed at a 35% rate five, ten or even twenty years later. We can capitalize expenses when allowable, invest in Roth IRAs rather than deductible retirement plans and withdraw funds from non-Roth retirement plans and deferred annuities even if the income isn't needed. Selling securities and other assets at a profit (easy solution if you don't really want to sell: buy the assets right back) and deferring deductions can be excellent ways to reduce taxes over a number of years. My favorite strategy, however, remains the traditional IRA to Roth IRA conversion.

#### The IRA to Roth IRA conversion

Unless exceptions apply, tax and penalty must be paid on traditional IRA withdrawals for those under age 59½. If funds are desperately needed and taxable income is zero or less, such a withdrawal, to a point, may be the lesser evil, as tax and penalty may be substantially less than interest on loans, especially if the funds are not quickly paid back. If only penalty is due, 10% (12.5% for California residents) is a lower rate than most will pay on future withdrawals from IRAs or other tax-deferred retirement plans.

However, there is no penalty on a conversion. The tax must be paid, but if planned right, the tax may be extraordinarily low relative to the long-term benefit. For example, one client was expecting negative taxable income estimated at \$40,000 for 2004—and, crucially, we were given this estimate in November. He was living off of savings and didn't have a need for retirement or other funds. We suggested that he roll \$50,000 from his traditional IRA into a Roth IRA, with a zero income tax on the first \$40,000 and 10% on the other \$10,000. The funds would then be transferred from an account on which withdrawals might ordinarily be taxed at a 34% combined federal and state tax rate to one from which withdrawals made after age 59½, regardless of the amount the sum grows to, will be 100% tax-free. Our client took advantage of this opportunity, which he aptly called “Tax Heaven.”

While conversions from other retirement plans cannot be made, there's an easy way around it. If allowed, roll funds to a traditional IRA to the extent you want to create income. Then do a conversion from the traditional IRA to a Roth IRA.

#### While converting too little can't be fixed, converting too much can be

Despite our best intentions, we can't always predict the precise negative taxable income. Yet, estimates that are off by only \$5,000 can make a huge difference. For example, another client who took advantage of this strategy had taxable income of just \$9,000, which included a planned \$15,000 rollover from a traditional to Roth IRA. If ours were a tax system without the enormously complicating factors of phase-ins of income and phase-outs of deductions, he'd pay a flat 15% tax on up to \$20,000 of additional income. However, due to a phase-in of Social Security income and phase-out of medical deductions (medical costs are deductible only to the extent they exceed 7.5% of AGI and, therefore, as income increases the allowable medical deduction decreases), he would have entered a twilight-zone bracket of 30.5% on taxable income in excess of \$9,000. While his \$15,000 rollover cost only \$900 in tax, just \$5,000 more would have cost him an additional \$1,500.

Could he have corrected such an excess rollover? It turns out, the answer is yes. You have until the extended due date of a tax return to “undo” a conversion. Because it's a bit of a hassle to reverse what's been done, I've been reluctant to suggest this approach, but I've seen too many missed opportunities. If you don't get around to calling, faxing or emailing your expected income and deductions to us in November or early December but you think you're in a position to benefit from this strategy, I'd rather you do something than nothing at all, even if it requires some fixing later. This is one of those rare situations where doing nothing can't be fixed, but doing something you later regret can.

# Recent Success Stories

## from Tax Season and Audit Representation

### The importance of asking the right questions

Years ago I asked a simple question that resulted in a \$125,000 godsend for a client. When he became unable to work due to a psychological disability, I asked, “Do you have disability insurance?” He responded that while he did, surely such insurance didn’t cover a psychological disability. I asked, “Why not? Have you asked the insurer?” He ended up collecting \$25,000 a year for five years.

Curiosity saved a bundle for another client this year, who was told that a distribution to her trust from a deferred annuity in the amount of \$50,000 was taxable. When I asked for a 1099 reporting the taxable amount, she told me the payer (an insurance company) told her it wasn’t required to issue one. Of course they are, I thought, so I called the insurer. They confirmed that the entire \$50,000 was taxable and that they are not required to issue a 1099 when the payee is an entity such as a trust, even though the beneficiary of the trust is an individual who would ultimately be responsible for the tax. This didn’t make sense, so I persisted.

Because of the lack of a 1099 showing this amount as taxable and the fact that I am curious, determined and relentless, I was led to an obscure tax code section that I had never heard of in 30 years of tax practice. This provided the formula from which we were able to calculate that only \$50 of that \$50,000 was taxable, saving our client over \$12,000. See below for details.

### Four-year audit battle

In another “win,” I recently settled on an audit from 1999. This was one of those instances where I said to the client, “shall we make it easy and include a note in the return asking for an audit date?” We took a \$60,000 deduction for something that could have easily been argued either way, although I did everything I reasonably could to defend the position on the tax return we filed. Ideally, because of the fact that about half the deduction saved tax at the lower brackets, I would have liked to split the deduction—deduct half and carry the other half forward and deduct in future years. However, in filing the return, we had to take an “all or none” position.

The auditor disallowed the deduc-

tion, which we appealed. The appeals division can take into account the odds of winning or losing in Tax Court. You’d never dream, but the appeals officer allowed 49% of the deduction. Four years after the audit began, we got almost exactly what I wanted from the outset. Because we were able to use up the carryforward loss on a recently-filed return, the government made virtually nothing, including even the interest they will collect on the tax owed.

This was also a great example of why I often price returns as a “package,” including any required audit defense up to Tax Court. Our fees could have easily wiped out most of the savings from the deduction. The fifty or so hours of work put into the audit, which involved far more than this one item, cost my client nothing extra. He paid for the full package and we provided the service as promised. I shouldn’t admit it, but it was actually quite fun (especially the part where we essentially won). Sorry the government wasted a lot of your tax dollars trying to beat me.

## Annuity details for the technically-oriented

After several phone calls to my client and the payer, I sent an email to my good friend, tax attorney Mel Kreger, who informed me about an obscure code section, 72(u), “treatment of annuity contracts not held by natural persons.” I often say, “I’ve only been doing this for 30 years, so I don’t know everything yet.” I learned that “not held by natural persons” means “held by an entity, such as a trust.” Code section 72(u) provides special rules for deferred annuities owned by “not natural persons.”

The rule for deferred annuities held by natural persons (you and me) is simple: there is no taxable event until a withdrawal is made. A withdrawal is tax-

able to the extent an annuity is worth more than the initial investment, up to the amount of the withdrawal. For example, if \$400,000 is invested and it grows to \$450,000, you pay nothing as long as you don’t touch the funds. However, you’ll pay tax on any withdrawal, up to \$50,000 (withdrawals in excess of the profit are deemed a non-taxable return of principal).

Annuities are in a sense similar to bank CDs (Certificates of Deposit). When you purchase a CD, you promise to let the bank keep the funds for a fixed period provided for in the contract. They let you withdraw the funds prematurely only if you agree to an “early

withdrawal” penalty. The fixed period is typically anywhere from 3 months to several years; the longer the period specified, the higher the interest rate they are willing to pay. An annuity is similar, only the investor, typically an insurer rather than a bank, will pay a higher interest rate than for a CD because you agree to let them keep your funds over a longer time-frame. In exchange for this higher rate, they’ll hit you with a substantial early withdrawal penalty for certain withdrawals made in the first to as many as fourteen years. This penalty is referred to in an annuity contract as a “surrender charge” and decreases over time.

Although the annuity grows in value each year from the start, if you were to ask for your money back early or, in annuity parlance, “surrender the contract,” you would get far less than the theoretical value. In fact, often for the first five to ten years depending on investment results, the “surrender value” is less than your original investment. The contract specifies this amount, so you know where you stand should you decide to take your funds early. There is, however, usually an allowance for partial withdrawals that typically begins several years into the contract (often 10% of the initial investment).

Code section 72(u) requires that

entities (which may flow through to the beneficiary) are taxed on annuities to the extent that the net surrender value plus all distributions received under the contract exceed the net premiums plus prior taxable amounts. Due to the fact that the net surrender value is less than the initial premium paid on many contracts for several years, this excess may be zero, even though the contract is worth \$450,000 if the contract’s owner dies or, better yet, the contract is allowed to mature. If the surrender value on a \$400,000 annuity is \$400,050 (in other words, the insurer’s fee for a full early termination of the contract that has theoretically grown to \$450,000 is \$49,500), the maximum taxable income is \$50

regardless of the amount withdrawn.

On the other hand, I also learned that a deferred annuity held by a non-natural person such as the trust is taxed yearly on any buildup of value to the extent the “net surrender value plus all distributions received exceed the net premiums plus prior taxable amounts.” Although the contract had been held for five years, there had previously been no such excess: the surrender charges during those early years were larger than the theoretical built-up growth. However, in future years there will be an excess and, therefore, net income. I would never have known this either had I not been curious.

## The Cost of Annuities and “Official Looking Documents”

A recent submission of an “official looking document” from a company ties in nicely with the “Recent Success Stories” piece. It might not have been a complete success story. Take another look at the “surrender charge” our client would have paid if she needed to take a complete withdrawal of her funds. Can you imagine forfeiting all the earnings—\$45,000—after four years?

Fortunately, the investment wasn’t a terrible one for this particular client—on the other hand, had she known it was going to be taxed eventually whether or not she took withdrawals, she might not have purchased it. The purveyors of the investment offered below, which looks almost threatening in its style, may be a different story. These are likely bandits, preying upon senior citizens. **My comments are in parentheses.**

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### SPECIAL TAX LAWS PASSED BY CONGRESS

(“special,” making it appear you’re going to be offered a secret that only special people are aware of)

Many Senior Citizens (that’s it, prey on the elderly) qualify, under little-known legislation (wow! This is so special, hardly anyone knows about it!), for a program that allows them to take some of the money that is normally paid to Uncle Sam in Taxes (note “Taxes,” with a capitalized “T”), from interest and dividend income and **PROTECT that money** (protect from what? What if I’m in a low tax bracket, and I “protect” the funds from taxes only to see them inherited by someone in a much higher tax bracket?) in insured (that’s always an excellent sell for the elderly), TAX-FREE or TAX-DEFERRED accounts (by capitalizing TAX-FREE, we can count on greed interfering with reason) for themselves and for their heirs.

Many Seniors qualify for these TAX SAVINGS and **do not know it** (and you wouldn’t want to continue to feel stupid now, would you?). The Federal Government will not notify you of your eligibility (after all, this is really “special”). You must find out yourself (and you definitely don’t want to be left out in the dark, do you?).

If you currently have interest or dividend income on CERTIFICATES OF DEPOSIT, SAVINGS or MONEY MARKET ACCOUNTS, MUTUAL FUNDS, STOCKS (thereby potentially converting 5% and 15% income into 15% and 25% income), or BONDS, and would like to know if you qualify (if you’ve got any money at all, you qualify) for this SPECIAL TAX BENEFIT (Wow! Would I be stupid to miss out on this!), please fill out and return this postage-paid card today.

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We propose a simple idea: send these advertisements to me so I can put them where they belong. If on the off-chance something might be appropriate for you, we can put you in contact with someone who sells a more legitimate version of the investment likely offered in these marketing ploys.