

Inside Highlights

- ♦ **High-income earner Roth strategy** p. 1
- ♦ **Retiree-IRA-charity strategy** p. 3
- ♦ **Low-income IRA strategy** p. 4-5
- ♦ **How to take title to real estate** p. 7-8
- ♦ **Lower tax rates increase tax collections** p. 8

"Until now there's never been a period where [new house purchase] cancellations have spiked in the absence of a recession."

--Amy Crews Cutts, deputy chief economist, Freddie Mac

Tax and Financial Strategies

Copyright ©2006 by Doug Thorburn, E.A., CFP (818) 360-0985

Issue #27 Winter 2006-2007

Wealth Creation Strategies

New Roth IRA Strategy for High Income Earners: Will it Work For Me?

The short answer is, yes, for some. But to understand who "some" consists of we need to explain the pros and cons of non-deductible IRAs. Try to follow, because this strategy could apply to you.

I have long advised against investing in non-deductible IRAs, which are traditional IRAs for which either a deduction is not allowed due to income limitations, or for which an election is made to forego a deduction. While funds grow tax-deferred, there are several more-than-offsetting disadvantages:

1. Form 8606 must be filed each year informing the IRS of non-deductible contributions and, once mandatory withdrawals begin, for the rest of your life. Although the form is confusing and time-consuming, the IRS can impose a penalty for each year it's not filed when required.

2. The tax benefit at retirement is minimal relative to the time and trouble. Here's why. Your previously-taxed contribution is assumed to be withdrawn over your lifetime. The Form 8606 calculation determines the non-taxable portion of withdrawals based on the fraction of total non-deductible contributions divided by total fair market value of all your traditional IRAs.

If you made \$25,000 in non-deductible contributions over your lifetime and the fair market value of your traditional IRAs, including rollovers from 401(k)s and other retirement plans, is \$500,000, the fraction that determines

the non-taxable withdrawal is 25/500, or 5%. The taxable portion is, therefore, 95% of that year's withdrawal.

The required minimum distribution at age 70 ½ for a taxpayer with \$500,000 in IRAs is about \$18,000. While you'll avoid tax on 5% of \$18,000, or \$900, you'll pay tax on the remaining \$17,100. The calculation must be repeated every year until, should you live long enough, you've withdrawn the already-taxed portion, at which point all remaining withdrawals become fully taxable. Should you die first, your heirs will get the benefit of the withdrawal of the balance of non-deductible IRA contributions by using Form 8606—if they figure the form out and have all your old tax returns so they can determine the correct fraction and remaining non-deductible balance.

3. Since the creation of Roth IRAs in 1998, most people who were ineligible for deductible IRAs have been allowed contributions to Roth IRAs, which are vastly superior.

New Law

A 2006 tax change, which allows a traditional IRA-to-Roth conversion in 2010 for those with incomes exceeding \$100,000, alters this traditional counsel. Understanding the opportunity requires an explanation of several basic aspects of law and, for lack of a better term, philosophy:

1. Law: Rollovers from traditional

IRAs to Roth IRAs are allowed for those with Adjusted Gross Income of less than \$100,000 (married or single).

2. Philosophy: Such rollovers are generally ill-advised. After all, why pay the tax now when it can be paid later? (The exception is for those in the zero bracket and those in low tax brackets who expect to be in substantially higher tax brackets for the rest of their lives. Taxable income should always be created if possible when the tax rate is zero, or nominal compared to what it will likely be later.)

3. Law: IRA contributions can be made by anyone, not to exceed the lesser of \$4,000 (\$5,000 for those at least age 50) or work-related ("earned") income.

4. Philosophy: Roth IRAs are generally the preferred retirement vehicle for those in lower tax brackets, while deductible retirement plan contributions are preferred for those in higher brackets.

5. Law: Deductible IRA contributions are phased-out in 2006 at Adjusted Gross Income of \$75,000-\$85,000 for married couples (\$50,000-\$60,000 for single people) for active participants in employer or self-employed retirement plans. Most plan participants who qualify for deductible IRAs are in the lower tax brackets, while most who do not qualify are allowed Roth IRA contributions (in other words, their incomes are between the phase-out range for

deductible IRAs and the much higher phase-out range for Roth IRAs).

6. Philosophy and practical effect: Roth IRAs are usually preferred for those in higher tax brackets unless income exceeds the phase-out range for Roth IRAs.

7. Law: The phase-out for allowable Roth contributions has been \$95,000-\$110,000 for single taxpayers and \$150,000-\$160,000 for married couples since their creation. These ranges will finally begin shifting up in 2007, to \$99,000-\$114,000 for single filers and \$156,000-\$166,000 for married filers.

8. Fact: Those who qualified for the IRA to Roth conversion generally qualified for Roth IRAs contributions, so there was no advantage to making non-deductible IRA contributions over Roth contributions.

Here's where it gets interesting. Let's say your income exceeds the Roth IRA thresholds and you're not allowed a deductible IRA contribution because you, your spouse or your employer is contributing to a 401k or other retirement plan. Let's also assume you have no traditional IRAs, because you've neither contributed to one nor rolled into one from another retirement plan (in other words, all your retirement funds are still in a 401k or similar plan). You can make that Roth IRA contribution—sort of. Here's how.

IRA contribution limits are \$4,000 for 2006 and 2007, increasing to \$5,000

for 2008 and 2009, with an additional allowance of \$1,000 per year for those aged 50 and over. Allowable contributions for the four years total at least \$18,000 (\$22,000 for those who were 50 or over in 2006). You make non-deductible IRA contributions, because you don't qualify for deductible IRAs and your income exceeds the Roth thresholds for all four years. You convert it all to a Roth IRA in 2010. Essentially, you just made four years' worth of Roth IRA contributions.

Remember: you have no other traditional IRAs. If you've retired, you haven't yet rolled your retirement plan into an IRA. If you've switched employment, you haven't touched your retirement or you rolled it from one non-IRA plan to another (for example, most employers will accept a rollover into a 401k from another 401k). Let's say your non-deductible IRA contributions totaled \$20,000 and the value of the IRA at the beginning of 2010 is \$24,500. You immediately do the IRA-to-Roth conversion and pay tax on the \$4,500 profit. You just made a \$20,000 Roth contribution for the price of the tax on whatever the gain is by the date of conversion (in this example, no more than \$1,980 for the highest-income taxpayer in a high-tax state). If you're married, double the numbers.

If you have \$10,000 in other previously-deducted IRAs and convert the entire \$35,000, you'll pay tax on \$15,000.

If you convert only part, you're stuck doing that crazy calculation (15/35ths will be taxable and 20/35ths non-taxable) for the year of the rollover and all future IRA withdrawals. Therefore, I would generally advise to go for it with gusto: either invest as much as possible in non-deductible IRAs beginning with 2006 contributions, which can be made until April 15, 2007 and convert your entire IRA in 2010, or don't even think about it.

Apparently, the law as currently written allows conversions for those whose income exceeds \$100,000 not only in 2010, but also in subsequent years. Therefore, subject to being barred at the whims of Congress, beginning in 2010 you'll be able to bypass the Roth IRA limits by making a traditional IRA contribution and then immediately converting it to a Roth.

Once the Roth is held at least five years and you are over 59 1/2, all Roth withdrawals will be tax-free. You may want to review my article, "I Can't do My Roth IRA Because..." in the Summer-Fall 2006 issue of *Wealth Creation Strategies* to see how beneficial this may be. Essentially, the law that forbids many of you from making Roth IRA contributions can now be inexpensively skirted by those with little or no traditional IRAs. The potential downside is that Congress, which has all-too-many days of deliberations between now and 2010, could change its mind.

Expect More "Tax Enforcement"

Tax enforcement, a euphemism for "audits" and "collections," dropped significantly into the early 2000s before spiking up since. With the Democratic win of the legislative branch of government, many are expecting tax hikes. However, many pragmatic Democrats, including Senator Chuck Schumer of New York, may not take the bait. According to *The Wall Street Journal*, Schumer claims that most of his colleagues are saying, "No, we shouldn't go for tax hikes.' Instead, he says, they will focus on 'tax enforcement'" and that we

can expect more audits. It doesn't take an understanding of calculus to see that we can expect an increase in the rate of increase in "tax enforcement."

This means that the IRS may be given more funds and more teeth. It also suggests that Congress may be quite receptive to IRS requests for greater enforcement tools, including increased emphasis on the requirement that businesses and rental property owners file 1099s for services. One idea floating around is to expand the scope of those to whom 1099s are issued to include

corporations, which up until now have been largely excluded from such requirements. Another is to impose bigger penalties for non-compliance. So, you may as well get into the habit of issuing 1099s to non-corporate entities you pay \$600 or more in a calendar year in the course of operating your business or rental property. Which means have the payee complete and sign form W-9 in exchange for the check you write. Increased penalties can be retroactive.

How Can I Benefit from Charitable Giving if I Don't Itemize Personal Deductions?

Those over 70 ½ have a unique opportunity, but need to act now

Taxpayers have a choice of “personal” deductions that serve to reduce taxable income: “itemized” deductions, or a “standard” fixed deduction. The former includes mortgage interest, state income taxes, property taxes, charitable gifts, employee business expenses and an assortment of more esoteric and rare expenses, costs and losses. The latter is a flat \$5,150 for single taxpayers and \$10,300 for married couples

(\$6,400/\$12,300 for those aged 65 and over) in 2006. You compare itemized with standard and generally deduct the larger of the two.

The more mature often own their homes debt-free or nearly so and frequently take the standard deduction. This usually includes those over 70 ½, who must take yearly “required minimum distributions” (RMDs) from retirement plans. Relative to income,

many are big donors to charities. Yet, donations don't save a dime in tax for those who don't itemize. Even for those who do, the savings may be inconsequential because taxes are saved only to the extent actual deductions exceed the standard. For example, the itemizer in the chart below, even if his personal deductions consist solely of charitable donations, saves only \$125 in taxes over the non-itemizer with identical income.

	Standard Deduction person	Itemized Deductions person
Adjusted Gross Income	\$50,000	\$50,000
Less Personal Deductions	(\$6,400)	(\$6,900)
Less Personal Exemption	(\$3,300)	(\$3,300)
= Taxable Income	\$40,300	\$39,800
Tax	\$6,639	\$6,514

This has just changed for a select few. Congress has given those over 70 ½ with IRAs who give or want to give to charities a gift, albeit a fleeting one.

From August 17, 2006 to December 31, 2007, those over 70 ½ can donate as much as \$100,000 per year from their IRAs *directly* to qualified charities, without including the distribution in their income. This applies to IRAs only (not other retirement funds) and the funds cannot be touched by the IRA owner, even for a split second. Crucially, such funds count towards the yearly RMD, which serves to reduce taxable income even for those who don't itemize. We would think the reduction in income provides the equivalent of a deduction for charitable giving. Actually, in many instances for the taxpayers affected, it's *much* better.

The reduction in income reduces Adjusted Gross Income (AGI). Reductions in AGI, known as “above the line” deductions, can save far more tax dollars than itemized “below the line” deductions, because (among a vari-

ety of possible plusses) they reduce Social Security income subject to tax. Because of this, even those who itemize deductions may be better off donating part or all of the RMD to charity in lieu of writing checks the old fashioned way.

Take a taxpayer whose income is in the range where each \$1,000 in additional income increases taxable Social Security by \$850. A *reduction* in each \$1,000 of non-Social Security income results in \$850 less taxable Social Security, reducing total income by \$1,850. This can save as much as \$463 in federal income tax, while a cash donation of \$1,000 will save the itemizer no more than \$250 and the non-itemizer nothing. This is powerful stuff. But there's more.

Let's assume you live on the RMD of, say, \$10,000, but you donate an additional \$4,000 by directly transferring the funds to the charity of your choice. You have reduced the fair market value of your IRA by an extra \$4,000, which results in a reduction in future RMDs, serving to reduce income and corre-

sponding tax in later years.

Many of you taking RMDs in the \$10,000 to \$20,000 per year range make yearly donations of a couple or a few thousand dollars to charities, but don't itemize. For 2006 and 2007 only (so far), such donations are best made directly from the IRA. Those of you who do itemize can increase the tax savings by making donations from the IRA, thereby reducing AGI. Those with non-IRA retirement plans may benefit by rolling over such plans to IRAs, which allow such direct donations.

An example of the potential tax savings for a moderate income person is shown on the next page. A taxpayer age 70 ½ earns \$32,000 from sources other than IRAs and Social Security. He receives \$15,000 in Social Security, must withdraw \$4,000 from IRAs, donates \$4,000 to charity and takes the standard deduction. How much tax will he save by making a direct contribution from an IRA?

\$4,000 donation made from:	Pocketbook	IRA
Income other than Soc Sec and IRA	\$32,000	\$32,000
IRA withdrawal (or income)	\$4,000	\$0
Soc Sec subject to tax	\$12,575	\$9,175
Less: Std Deducton	(\$6,400)	(\$6,400)
Less: Personal Exemption	(\$3,300)	(\$3,300)
Taxable Income	\$38,875	\$31,475
Federal Income Tax	\$6,276	\$4,426

He saved \$1,850 by making a direct contribution from his IRA rather than making the donation the old-fashioned way.

Dear Doug: Tax Shelter Available. Shouldn't I Invest?

The latest in the series of countless questionable tax shelters since the birth of the Internal Revenue Code appears to be related to Hurricane Katrina. An Internet pitch suggests purchasing property, getting far more depreciation than is normal and “ZEROING OUT” taxable income. The “overwhelming opportunities” are creating “enormous interest” and the “previous bus tours” to the areas affected were “so successful” that additional “BUS TOURS” are being arranged; the “sooner the better—ESPECIALLY IN TIME TO STILL CLOSE IN 2006.”

What a bunch of hype.

I'm skeptical of any investment touted for purposes of saving taxes. While there are all sorts of benefits to investing in the Katrina area, those who already know the area have undoubtedly

scoured the opportunities. I'm always interested in good value...but by definition, such value usually exists where others haven't begun to look. In addition, tax credits and specific-industry or location favored deductions increase the demand for whatever the credit or deduction is for, driving up prices or making personal economic sense of something that wouldn't without targeted tax benefits.

The shelters of the 1980s are an excellent example of the aftermath of an artificial increase in demand created by tax law. Tax savings from commercial properties, windmills and solar panels either drove up prices or lured uneconomic investments at unsustainable prices, which evaporated once the tax incentives disappeared. Tax credits merely attempted to compensate for the

excess cost of solar power over competing energy sources. When the cost of energy declined in the '80s, solar and wind-power investments became an obvious waste of societal and personal resources. We're seeing another round of this today.

Remember a specific case of a simple economic truism that doesn't seem to get taught in government schools: \$75 per barrel oil leads to \$30 per barrel oil if the cost of producing the marginal barrel is \$29.99 (producers will increase production until the market price barely exceeds the additional cost of production). The fly in the ointment is that governments, which are more likely to spend any largesse by giving bread and circuses to the masses than by reinvesting in more production, control 90% of the world's reserves.

Low-Income Retirement Savings Contribution Credit is Permanently Extended

Individuals with Adjusted Gross Income (AGI) of up to \$25,000 (\$50,000 for joint filers, \$37,500 for qualifying heads of household and all adjusted for inflation beginning in 2007) will continue to get both a deduction and a credit for contributions made to 401(k)s, 403(b)s, certain other elective retirement plan contributions and IRAs. The credit, which had been due to expire, has been made permanent.

The credit is a fascinating testimonial

to the fact that helping people by offering targeted credits and deductions complicates tax planning and filing. The choices we make on tax returns, including those relating to depreciation deductions, other retirement plan contributions and their mix can have a dramatic effect on the size of the Retirement Savings Credit. In one instance, a \$300 contribution to a traditional IRA and a \$1,700 contribution to a Roth IRA resulted in income tax savings of \$1,045,

while a \$2,000 contribution to a Roth would have saved only \$400. Our client was in the nominal 15% tax bracket, but as I've frequently pointed out, tax brackets lie. (In fact, the first listing under “articles by subject” in *Wealth Creation Strategies* at www.DougThorburn.com is titled, “Income Averaging, Withholding, Tax Brackets and Other Lies.”) In another case, electing to accelerate depreciation of \$100 and investing \$1,400 into a Roth IRA resulted in a

\$700 tax savings; without making the depreciation election, the savings would have been only \$280. The July-August 2002 and July-August 2003 issues of *Wealth Creation Strategies* provide more details and some examples of this valu-

able, but inherently complicated credit.

Reaping windfalls such as these requires a careful look at alternatives. Since the precise numbers are so crucial to the final calculation and IRA contributions can be made after we have all

the facts, the best time to consider the possibilities is late January or early February. If your AGI is in the lower ranges and funds are available, please plan accordingly.

Spousal Travel Deductions: Some Pigs are More Equal Than Others

George Orwell was rather prescient. The ultimate totalitarian society depicted in his book *1984*, Oceania, exists today in the land of Kim Jong Il. The less statist society portrayed in *Animal Farm*, in which some are more “equal” than others—those who rule live under a different set of rules than the ruled—thrives in present-day America.

Such preferences are rampant in the halls of Congress. Politicians frequently don't live under the laws the rest of us must adhere to when it comes to minimum wages, Social Security and many other regulations and compulsions. Federal workers, including Congressmen, have their own very special medical plan, with a lot more choices than Hillary-care would have offered. And Congressmen are allowed special

tax deductions and income exclusions that the rest of us can only dream of.

One of these rules ordinarily requires that the employer's cost of bringing along a spouse on a business trip be added to income. Not Congressmen, who claim an exclusion of income because their spouses are like a First Lady, performing vital ceremonial functions on every trip. The fact that your spouse may be an essential part of your dining experience with business associates is irrelevant.

Finally, a D.C.-based taxpayer watchdog group, Public Citizen, is calling for an investigation into the claim by lawmakers that they are exempt from this rule. They note that the Presidential First Lady is considered a de-facto federal employee with a staff, title and

budget, but that the spouses of the 535 members of Congress are neither considered an employee nor given staff, a title or a budget. Rep. Howard Berman, D-Van Nuys, is the top Democrat on the House Ethics Committee and has taken 22 trips with his wife and four with his daughter since 2000. Rep. Brad Sherman, D-Sherman Oaks and a CPA, agrees that lawmakers' spouses must prove their business role on trips in order to exclude the cost from income. Sherman has not taken any trips with family members and points out that the IRS should provide explicit “guidance” to assist Congressmen, who wrote the law, in determining their tax obligations.

You just can't make this stuff up.

Federal Telephone Excise Tax Excised; Refunds Coming

In a grand testimonial to the idea that we frequently cannot determine whether even long-standing laws are constitutional, after being on and off the books for over 100 years the long-distance telephone excise tax has been ruled illegal. The IRS threw in the towel after losing its battle over the tax in several U.S. Court of Appeals cases and announced a halt to collections as of August 1, 2006, along with a refund for amounts billed since March 1, 2003. Some \$10-14 billion in refunds are expected to be paid.

Individuals will be allowed to claim either the actual amount paid or a “standard refund amount” of \$30 to \$60 on their 2006 tax return, depending on the number of exemptions claimed on this return. Those who don't feel like spending time to tally the federal excise tax paid on those old phone bills I know you've all saved will claim the standard amount. Businesses can use a formula to figure their refunds or claim actual amounts from bills, which their owners should find in their “receipts that back up the checks” files (subcategory: tele-

phone bills) for the years in question. The formula approach requires comparing the tax on the April bill, which includes both local and long-distance federal excise tax rolled into one line-item, with the tax on the September bill, which includes only the local excise tax. Multiply this difference by 41 (the number of months for which a refund is available). Despite the fact that my business phone bills are fairly large, the calculation yielded less than my standard personal refund. In other words, it wasn't worth my time.

The Estate Tax: Eliminate, or Compromise

The estate tax has been with us since shortly after the income tax was born in 1913. Like its brethren, the rate has skyrocketed and, to a lesser extent, come back to earth. An opinion on its lack of merits for libertarians like myself is a simple one and support for its abolition could easily be based on three simple truths: 1. The federal government is too large, too powerful and anything we can do to constrain the spending spigot is good; 2. The estate tax is an additional layer of tax on assets that have in many cases already been taxed; and 3. It creates a disincentive to save and invest, since so much of one's hard-earned wealth will be taken from the children to whom it is bequeathed. As *The Wall Street Journal* put it in an op-ed piece June 1, 2006, a wealthy person will sometimes "be inclined to consume more than he otherwise would, or just quit working sooner than otherwise." Those who don't believe that "the wealthy" would do this should consider their own behavior in terms of working overtime at a 50% marginal tax rate.

Support for the tax is more com-

mon among non-libertarians. They figure the tax is irrelevant for all those whose net worth at death is less than \$2 million (\$4 million if an appropriate living trust is created and funded by a married couple) and it hits only the wealthiest among us. Yet, the government's take was \$21 billion in 2003, a drop in the bucket relative to total federal taxes collected of over \$2 trillion and even less of a drop in an \$11 trillion economy.

Who might be lobbying in favor of the death tax? Financial detective work requires that we follow the money trail. The life insurance industry would likely lose billions of dollars from policies designed to pay the tax so that, in effect, the balance of the estate goes tax-free. *The Los Angeles Times* found that the primary source of funds of an anti-death tax repeal group known as the Coalition for America's Priorities happens to be—can you guess? Yes! Life insurers! *The Wall Street Journal* cited then-Governor of Oklahoma Frank Keating's 1990s argument against the death tax as among the best ever: "I believe death taxes are un-American. They are rooted in the

failed collectivist schemes of the past and have no place in a society that values entrepreneurship, work, saving, and families." More recently however, Mr. Keating, now president of the American Council of Life Insurers, said: "I am institutionally and intestinally against huge blocs of inherited wealth. I don't think we need the Viscount of Enron or the Duke of Microsoft." A change of jobs and monetary incentives can lead to a change of heart in unprincipled people.

Only two of 60 major nations around the world have a death tax higher than ours, which is 46% on estates over \$2 million. Germany's is 30%, Ireland's is 20% and Italy's is 3%. Countries as diverse as Canada, China, India, New Zealand, Russia, Sweden, Switzerland and Thailand have no death tax. We should either join them or compromise with a 15% rate on assets with unrealized capital gains held at death or, preferably, on just the gains.

Registered Domestic Partners to File 2007 California Returns Married or Married Filing Separate

In a logical extension of California's domestic partnership law, Governor Arnold Schwarzenegger signed legislation requiring that Registered Domestic Partners (RDPs) have the same tax filing rights and obligations under California state income tax law as married couples. This can be good news, or bad.

It may be good news for RDPs with widely disparate incomes, as their combined tax burden could drop, just as it does for single people without children who marry. It may not be such good

news for those with children who under current law may file as Head of Household. When two individuals earning similar (or, in many cases, not-so-similar) incomes marry, their combined tax usually increases, often by thousands of dollars. It's also going to create additional complications in an already overly complicated tax structure that includes hundreds of differences between California and federal tax law. Since the federal government is not expected to adopt this new rule anytime soon, RDPs

will file federal returns as they always have. Therefore, RDPs will have a different filing status for California than for federal purposes.

We just have to remember that messes often lead to opportunities. Unregistered domestic partners may now have an additional incentive to register and registered partners may want to consider undoing their registration.

Will My City Make Me Pay for a Business License?

Cities are looking for increased revenue by requiring that businesses obtain and pay for licenses. Because of the increase in home-based businesses over the last few decades, they can no longer simply comb business districts to insure compliance. Instead, with the help of the Franchise Tax Board (FTB), they comb tax returns for Schedule Cs, Es and Fs—sole proprietorships, rental properties and farms. They also look at partnership and corporate tax returns. If the address on the return is in their city, they look for a city license. If one isn't on the books, the taxpayer is sent a letter

demanding compliance. The granddaddy of cities that go after businesses is Los Angeles (and yes, I've not only been paying for decades but was once even audited by the city). In a program that began only a few years ago, there are now some 65 cities receiving FTB data.

Most of the time, business owners don't even think about the possibility that they may have a city license obligation. Do you write software from home? Do you sell jewelry, nutritional aids or other products on e-bay? You may be required to obtain a local license, typically from an "office of finance" or "city

clerk's office" (located near the beginning of your White Pages in the "government" section under your city). Rules and fees vary by city, with virtually no uniformity. The cost may be a flat fee or based on revenue or number of employees. It can vary by type of business and where the work is performed (inside or outside the city). If you're a contractor, good luck—you may need a license in every city in which you work. It is truly a patchwork quilt, which we'll be happy to guide you through to the best of our ability.

How Should I Take Title to Property?

There are several ways for spouses to take title to property, which can easily confuse the uninitiated. Yet, proper titling is important for many reasons, two of which relate to death. The title determines 1. who inherits the property and 2. the cost basis for purposes of a later sale by the heir(s).

The question of inheritance is a legal one. Since I'm not an attorney, I can't suggest how to take title. However, it's well established that property held in "joint tenancy" will go to the co-owner(s) when one of the owners dies. This overrides the instructions of any will or trust. (Suffice it to say that while property held as "tenants in common" goes to whomever the will or trust instructs, such titling is for non-married individuals.) A probate (a costly legal "proving" of a will) can be avoided by vesting ownership in a trust, which also tends to limit the damage that can be created by disgruntled heirs.

However, cost basis in the hands of the survivor(s) involves tax law, under which I have a limited license to practice (that's what the Enrolled Agent designation confers). Heirs get a "stepped-up basis," which means they get to pretend they purchased the property for its fair

market value (FMV) on the date of the decedent's (the dead person's) death. Let's say the property cost the decedent \$20,000 and it's worth \$500,000 when he or she dies. The original cost of the decedent's share becomes, on that day, completely irrelevant. Instead, only the half million dollar value matters, which is that "stepped-up basis" mentioned above. If the heir(s) sell the property for a half million, the "cost basis" gets "stepped up" to the current value and tax is completely avoided. (In fact, they may even get a deduction for a capital loss to the extent of selling costs.) If the heir(s) keep the property and it's a rental (or a former residence is converted to a rental), they get to start the depreciation all over again using the new FMV as the starting point.

Unfortunately, these rules also apply to situations in which the FMV of the property has declined, which could become relevant to those who purchased property in the last few years. If you paid \$500,000 but it falls in value to \$400,000 when the owner dies, the heirs get a "stepped-down" basis for purposes of both depreciation and later resale.

The rub revolves around the question of, "what did you inherit?" If title

was held as joint tenants, only the decedent's share of the property (typically, one-half) was inherited and, therefore, the increased (or decreased) cost basis applies to only that portion. If, on the other hand, title was held as "community property," the surviving spouse is deemed to have inherited the entire property and gets the full step-up in value. Community property goes through an abbreviated probate unless title is in the name of a trust. Trusts provide the best of both worlds—full step-up and no probate.

In 2001, California expanded the options for married couples who either don't need a trust (many believe that not everyone needs one) or haven't yet gotten around to setting one up. The new option is to hold property as "community property with rights of survivorship." Apparently, this titling is rarely used because many Realtors® and others involved in handling real estate transactions either aren't aware of the option or are afraid to mention it because of the fear they may be deemed to be practicing law without a license. Yet, even without a trust probate is avoided **and** the survivor gets the full stepped-up basis.

	Joint tenancy	Community Property	Community Property with right of survivorship
Probate?	No	Yes	No
Step-up (or step-down) in basis?	Decedent's share	100%	100%

In the meantime, married couples who don't get around either to creating a trust or re-titling the property can write up and sign a "community property agreement," which might read something like this: "We, (your names), agree that our real property is and always has

been community property." This agreement allows title to remain as joint tenants, but will subject the property to about \$3,000 in costs for a legal process known as a "community property set-aside." Because there are other legal ramifications involved such as those

involving previously inherited property and future divorce (however unlikely), your attorney's advice is strongly recommended.

Lower Taxes Raise Taxes—Huh?

Say what you will about Mr. Bush, but with a Democratic takeover of Congress, we can only hope politicians of all stripes learn a practical lesson from the President: lowering tax rates increases tax collections. The Laffer Curve—named after economist Arthur Laffer, who reportedly drew the concept on a cocktail napkin in the late '70s—shows that as tax rates fall, government revenues increase up to a point. The idea helped instigate President Reagan's lower-tax revolution. (Few recall, but the pre-Reagan era included tax rates as high as 70%, which Reagan helped lower to 28% for a brief period in the late '80s.) But when we consider basic human nature, we shouldn't be surprised.

Consider your interest in overtime. For many, it's a godsend. However, if your combined federal, state and Social Security marginal tax rate is normally 28% and the increased earnings subject you to a 42% rate, aren't you just a little bit less interested? Others—both rich and poor—feel the same way. Some will work less, while others will shift the mix of income and deductions by taking greater advantage of retirement plans and other legitimate (and, sometimes, not so legitimate) tax shelters. The wealthy, particularly, must have recently

shifted big time. In 2001, before the Bush tax cuts took effect, the top 1% of income earners paid 34% of all federal income taxes, while in 2004 (the latest year for which figures have been released) the same 1% paid 37% of all federal income taxes. And it appears that the bulk of the increased collections resulted from the most dramatic tax cuts of all—the nominal maximum tax on dividends and long-term capital gains, which were 39.6% and 20% respectively, both reduced to a stated maximum of 15% (22.5% for capital gains subjected to the AMT phase-out, down from 27%). Ordinary income tax cuts dropped the stated maximum rate from 39.6% to 35%. Yet, total personal income tax collections have soared by over 30% since 2004.

The government forecasts tax collections by assuming that behaviors do not change or otherwise respond to higher or lower tax rates. This is, to be blunt, an idiotic assumption that only a government could make. It's the equivalent of a company assuming that sales will remain the same regardless of product price. The result, unexpected by those using this "static budget analysis" and those who don't grasp the concept that costs have an effect on supply and

demand, has been a gusher of tax revenues, resulting in far lower deficits than forecast. Total tax collections increased in 2005 by almost 15% and appear to be headed for an almost 12% increase in 2006. Despite the fact that U.S. government spending went up by almost 8% in 2005 and 9% in 2006, far in excess of the rate of inflation, the deficit decreased to 2% of total GDP, far below the 2.7% average of the last 40 years and far lower than the deficit in many European countries as a percent of their economies.

Please bear in mind libertarians criticize both sides: while we do not support deficits, we advocate lower tax rates *and* decreased government spending pretty much across the board. Republicans went on a spending spree the last few years and Democrats have contended that the Bush tax cuts primarily benefited the wealthy. Some also warn that they will increase taxes if given the opportunity, ignoring the fact that there wouldn't be a deficit if the Republican-controlled Congress had stifled spending the way they did under Clinton.