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*"The bubbling brook would lose its song if you removed the rocks."*

—Anonymous

## Tax and Financial Strategies

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# Wealth Creation Strategies

## Energy Conservation Tax Savings—New for 2006

In the interest of saving energy, tax law just got more complex. For 2006 and 2007 only, there is an amazing array of minor to major convoluted tax benefits, including:

1. A credit of 10% for the cost of (a) insulation or other system designed to reduce heat loss or gain, (b) metal roofs, exterior windows, skylights and doors coated with heat-reducing pigments, (c) advanced main air circulating fans, certain boilers and certain heat pumps and air conditioners meeting specified energy efficiency standards. The credit applies for such energy conservation improvements to one's main home only. The maximum credit, which is for the cost of materials only, is \$200 for windows, \$50 for fans and \$300 for heat pumps/air conditioners, with an overall limit of \$500 over the two-year period. While these limits were not borne out of thin air, they were created in the hot air emanating from our representatives in Congress.

2. A 30% credit, up to a maximum of \$2,000 per year, for the installation of

solar hot water property, and another 30% credit for fuel cell property, up to \$500 for each half-kilowatt of capacity installed per year. The credit applies to materials and labor. Needless to say, the credit does NOT apply to swimming pool/hot tub equipment. This credit, also, is for one's main home only.

3. A new credit, replacing the current deduction, for the cost of hybrid motor vehicles. The credit will be based on fuel economy and range from \$400 to \$2,400, depending on vehicle size and percentage of fuel economy compared to that vehicle's 2002 model, plus an additional credit of \$250 to \$1,000 contingent on the estimated lifetime fuel savings for the vehicle. The credit expires at the end of 2009 for heavy hybrid trucks and 2010 for lighter vehicles. There are additional larger credits for fuel cell and alternative fuel cars and light trucks of up to \$12,000 and \$4,000 respectively. However, after a manufacturer sells a total of 60,000 hybrids, the benefit is phased out over a period of four calendar quarters starting with the

second calendar quarter following the sale of the 60,000th vehicle. Significant for many, the credit is not allowed against the Alternative Minimum Tax.

4. Credits for manufacturers of energy efficient homes and appliances.

5. An immediate deduction for lighting, heating, cooling, ventilation and hot water systems installed in commercial buildings that meet certain energy conservation standards. Normally, such items are considered property improvements and must be depreciated over 39 years.

You'd think I was kidding, but my imagination isn't good enough to make this stuff up. The tax code, regulations and rulings now comprise over 45,000 pages. The regulations on another new deduction that few if any of us will ever qualify for, which requires only a one-page form, amount to 136 pages and an 88-page preamble. Our tax system is beyond redemption. Which brings us to the next subject.

## A Flat Tax

I'm often asked what I think about tax proposals, the latest of which is a lower and flatter regime with more limited deductibility for mortgage interest, along with the complete elimination of deductions for state and local taxes. My only comment is that if they manage to

pull it off, take Steve Forbes' suggestion for a fair phase-out of the current mess: allow taxpayers the option of calculating their tax under both regimes and electing whichever one results in the lowest tax. Regardless, although a flat tax might put your favorite tax professional into

semi-retirement, it wouldn't completely take him out. Businesses and rentals would still require knowledge of esoteric rules and, as mentioned in a previous article, the standard deduction under a flat tax would create some interesting planning opportunities.

Of far greater interest than mere proposals is the actual adoption of flat tax systems in former Soviet bloc countries. Following in Hong Kong's steps with its 16% rate are Estonia (24%), Georgia (12%), Latvia (25%), Lithuania (33%), Romania (16%), Serbia (14%), Slovakia (19%), Ukraine (13%) and Russia itself (13%). It seems it's far easier to start fresh than to overturn an existing un-flat system filled with politi-

cally-favored credits and deductions. Perhaps because its citizens have realized that heavy-handed government is the problem rather than the solution, it's apparently easier to dramatically decrease overall government spending in a formerly more socialist state than one less-so. While total tax revenues as a percent of Gross Domestic Product (GDP) for Lithuania, Latvia, Slovakia and Estonia are in the upper 20s and low

30s, they are over 35% in almost all of Western Europe, including France (46%) and Germany (42%). High growth rates, flat-tax regimes and lower total tax revenues are highly correlated: the former Eastern European countries of Lithuania, Latvia, Slovakia and Estonia experienced growth rates of 4 to 9.7% in 2003, while most of Western Europe languished at less than zero to 2.5%.

	Flat Tax?	Tax Revenues as % of GDP*	Growth Rates 2003
France	No	45%	.5%
Germany	No	40%	-.1%
Britain	No	35%	2.2%
Estonia	Yes—24%	33%	5.1%
Slovakia	Yes—19%	30%	4%
Latvia	Yes—25%	28%	7.5%
Lithuania	Yes—33%	27%	9.7%

\*Estimated from charts in *The Economist*, October 23, 2004 and February 12, 2005.

That such ideas are spreading is also of great interest. Italy's chief economic advisor and advisors to the Dutch parliament, recognizing that high taxes increase off-the-books employment and lower revenue and economic growth,

advocate a flat tax. Spain and Greece are considering a flatter regime, while the opposition party in the United Kingdom is pushing for one. Karl Marx's key idea, "From each according to his abilities, to each according to his means," stifles

economic growth to the extent put into practice. Perhaps real-life contrasting examples of the sluggish economies in Old Europe and the burgeoning ones comprising the former Eastern Bloc are helping Europeans understand this.

## The Power of Compound Growth in a Postage Stamp

Big news recently shook the world of philately. A block of four 24-cent airmail stamps, the stuff of philatelic legend, sold for \$2.97 million.

While two million stamps depicting the Curtiss JN-4 biplane were issued in 1918, only a single sheet of 100 escaped the post office with the biplane printed upside down. A sharp eyed collector quickly resold the sheet for \$15,000 to a reseller who split most of it apart and sold most of the stamps individually. A few blocks of four were preserved, with one changing hands in 1954 for \$18,250.

Obviously, the first collector earned a return on investment that's almost

incalculable. More common, and therefore of greater interest to the practical investor, is the annualized return on the \$18,250 investment made in 1954. What do you think the average compounded annual return on that investment was for the 51 years since? The knowledge that it grew by a factor of 163 may throw you off a bit due to the power of compounding.

If you guessed 20% per annum, try again. If \$18,250 was invested at 20% for 51 years, the blocks would now be valued at \$166 million.

Even at 15% per annum, the value would now be \$20 million.

That \$18,250 grew at 10.5% per annum. Many investments did better over the same time-frame. As a non-income producing investment, it had to grow by far more than a dividend-paying stock or real estate with rental income, even assuming only after-tax dividends or rents were reinvested. Worse, if inflation averaged 4% over those years, the true value is only \$474,000. Although long-term, the profit is taxed at collectible rates of 28% federal plus your state rate, leaving even less real after-tax profit.

# The Power of Compound Growth in an Inherited IRA

It's hard to believe that Individual Retirement Accounts and 401(k)s came on the scene barely a quarter century ago. While options for withdrawal from the previously ubiquitous defined benefit pension plans (which pre-determine the income stream in retirement) were limited to equal monthly allowances over one's life or the life of self and spouse, such options for defined contribution plans (which provide no guarantee of retirement income) such as IRAs are now virtually infinite. The assets of a defined benefit plan disappeared after one's death or that of a spousal beneficiary; the remaining assets of IRAs and numerous other retirement plans (including 401(k)s, 403(b)s, SIMPLEs, SEPPs and Keoghs) can be left to anyone. Periods over which payouts may extend are far longer than just a few years ago due to dramatic reductions in required minimum withdrawals for both the original owner and heirs. As a result, many of those reaching their 40s and 50s are inheriting increasingly larger retirement plans left by parents who were using stretch-out withdrawals to minimize their taxes and increase the size of their estates.

Most are aware that spouses are allowed to roll over the IRAs of deceased spouses to their own. However, many non-spouse heirs are unaware that they can elect to withdraw an inherited IRA over the heir's lifespan and that they can do this even if the named beneficiary is a trust, through a

"partitioning" or splitting of the IRA among non-spouse beneficiaries. A partition allows each beneficiary control over her own inheritance and the power to decide on the method of withdrawal: immediate, within five years or over the beneficiary's life using IRS tables. If an executor errs and distributes the IRA to the trust, there is no grace period. The tax must be paid on the additional income by each beneficiary (although it can be deferred a year by making a "645 election" unique to a decedent's estate). The good news is that there is never a penalty on the withdrawal of any amount from an inherited IRA.

Non-spousal beneficiaries often inherit IRAs during peak income-producing years. By opting for the lifetime withdrawal, beneficiaries can stretch the IRA withdrawals into lower-income and hence lower-tax years later in life. They can always withdraw an amount greater than the minimum, which is particularly useful in the case of a loss of job or other event resulting in a lower tax bracket en route to retirement.

A tax-deferred investment generally grows to a far greater sum than one on which taxes are paid up front, a difference that increases over time. The inequality in growth varies by tax bracket, changes in brackets over the withdrawal period and type of investment, which in turn determines whether the growth is taxed currently at ordinary rates or later at lower long-term capital gain rates. Beneficiaries can lose tremen-

dous tax-free build-up of growth by failing to elect the optional lifetime distribution option. While the possibilities are endless, we can get an idea of the loss to the beneficiaries from a simple example.

Two beneficiaries, twins age 55, inherited a \$60,000 IRA, which was partitioned between them. For ease of calculations, we'll assume a 37.3% federal/state tax bracket for 30 years. One opted to withdraw his \$30,000 and invest the after-tax residual at 6% per annum, subject to regular income tax. The other elected to spread withdrawals over the approximately 30 years allowed by IRS tables for that age. Both the IRA and withdrawals were invested at 6%, with ordinary income tax paid on both withdrawals and earnings on sums withdrawn.

The first pays \$11,160 in tax up front, netting \$18,840. Taxes reduce the 6% annual earnings to 3.762%. The residual grows to \$57,253 in 30 years.

Even though the entire IRA is distributed over 30 years and after-tax earnings on withdrawn sums are reduced to 3.762% by taxes, the account of the heir opting for the minimum required withdrawal grows to \$83,677. The difference of \$26,424 is almost equal to the initial sum. The disparity increases if the tax rates drop later, which is common in retirement. Note that most of the increased net worth created via the stretch-out withdrawal in the first example is realized by year 20.

Value of \$30,000 invested at 6% pre-tax, 3.762% after-tax due to 37.3% tax rate over entire period:

Year	Stretch out withdrawal over 30 years	Immediate withdrawal; invest net after-tax	<b>Increased</b> net worth by stretching out IRA distributions
10	\$46,421	\$27,260	\$19,161
20	\$66,403	\$40,999	\$25,404
30	\$83,677	\$57,253	\$26,424

Same as previous, but tax rate decreases to 15% after year 10, with \$10,000 yearly withdrawals commencing until IRA is depleted:

Year	Minimum withdrawal 10 years, then \$10,000 per year	Immediate withdrawal	Increased net worth from stretching out IRA distributions
10	\$46,421	\$27,260	\$19,161
20	\$71,198	\$44,828	\$26,370
30	\$117,084	\$73,719	\$43,365

Note that the increased net worth increases substantially over time due to the lower tax rates on later distributions. This disparity reverses if the beneficiary is in a lower tax bracket in earlier years

and higher brackets in later ones, which is the reason I often encourage withdrawals that “use up” lower tax brackets. Here’s an example of someone who initially pays tax at a 15% rate, but whose

bracket increases to 37.3% after withdrawals of \$5,000 per year, which depletes the IRA after eight years:

Year	Minimum withdrawal 30 years	\$5,000 yearly withdrawal until depleted	Decreased net worth from stretching out IRA distributions
10	\$40,374	\$44,480	\$4,106
20	\$58,511	\$64,349	\$5,838
30	\$84,796	\$93,095	\$8,299

A “warning label” for IRA and other retirement distributions and rollovers

would go far in giving people the opportunity to increase their net cash flow and

net worth by substantial margins, or even avoid financial catastrophe:

### Warning

- Taking a distribution from any retirement account may be dangerous to your financial health.
- There may be options and alternatives of which you are unaware.
- Circumstances, personal needs and expected future income and tax rates all play a role in determining an optimal strategy.
- The best course of action for one may be very different for another.
- Before taking a withdrawal, you are implored to seek counsel from your Enrolled Agent or other trusted financial advisor.

PS: If the decedent failed to take the minimum required withdrawal while alive, the heirs must do so by December 31 of the year of death. Failure to do so subjects the estate to a draconian 50% penalty of the amount that was not withdrawn under the minimum distribution rules.

## Real Estate for Your IRA

One of the more unusual signs of froth in the market is that real estate is suddenly a hot investment for IRAs and other retirement plans. While I haven’t yet had too many phone calls asking about purchasing rental property inside pensions, I’m hoping to head it off at the pass. Here’s why it’s generally a terrible idea:

1. A self-directed plan is required, which may be expensive.
2. Financing is difficult at best and, if

you are able to find a lender, can create taxable income inside the retirement plan to the extent income results from the leverage (really oddball—it’s something called “UBIT,” or Unrelated Business Income Tax). The result is tax where you least expect it: inside the plan.

3. Paying all cash for a \$500,000 or even \$100,000 house may leave your pension woefully undiversified.

4. All costs of ownership must be paid by the retirement plan. If you’re short on cash when the property is vacant or

an expensive repair becomes necessary, you’ve got a problem. A 6% penalty must be paid each time personal funds are added to the account or used to pay expenses, as well as for each additional calendar year such funds are not reimbursed.

5. Mandatory minimum withdrawals are required at age 70½. The value of the account on December 31 is the numerator (the bottom number) in the equation that determines the minimum withdrawal the following year (the

denominator, or top number, is the IRS-table life expectancy). Since you need to know what the property is worth to determine the numerator, a formal appraisal may be required every year, which may be expensive.

6. You could be forced to sell part or all of the property to make required withdrawals if you don't have enough other assets in the retirement plan from

which to withdraw.

7. If you ever attempt to benefit from the investment, which includes staying for even one night or renting to a relative, you may have crossed into the area of "self-dealing," which can result in the entire IRA or pension being disqualified. The entire value of that plan—not just the house, but everything else the plan owns including the house—becomes

taxable income in the year self-dealing begins.

8. If you want to own real estate, there are better choices. Not that it's a terrific time to purchase Real Estate Investment Trusts (REITs) or real estate mutual funds, but they are far more liquid and diversified than directly-owned real estate. And, you avoid management headaches.

## Tax and Financial Myths of the Month

**"Up to \$25,000 in losses [of rental real estate]...can be charged against total income of less than \$150,000."**

A columnist in *Money Magazine* said this in the September 2005 issue. While technically correct, it failed to point out that at total income of \$149,998, a grand total of \$1 in loss is allowed and at \$140,000, only \$5,000 is allowed. Because the allowable deduction is phased in at \$1 for every \$2 by which income (actually, Adjusted Gross Income) decreases below the \$150,000 threshold, the maximum loss is not available until income drops to \$100,000. Consider this statement a "half-truth."

**"The tax from the sale of your home after living in and owning it for 1 year 10 months will be minimal because of the pro-rated exclusion."**

So said a real estate broker to a client. I have a message to those brokers who offer tax advice: don't. Our client, who had a gain of \$100,000, didn't qualify for the pro-rated exclusion. Fortunately, the client emailed us before finalizing the sale. The tax savings by waiting just two more months to sell and move was about \$25,000.

**"You can withdraw from your 401(k) to purchase your first home. Tax will be withheld."**

So said a loan broker to a client. I offer the same message to loan brokers as to real estate brokers: stop giving tax advice. While such withdrawals can be made, a loan from a 401(k) is usually far

less expensive than paying the tax on a withdrawal. Our client, unfortunately, trusted the loan broker. While it fattened the broker's paycheck, our client was out 25% federal, 9.3% state, 10% federal penalty and 2.5% state penalty, for a total of 46.8%. The mandatory federal withholding is only 20% and none for state. A withdrawal of \$62,000 netted \$49,600 for their down payment. They had to borrow on a credit line against the home in order to pay the additional \$16,616 tax owed. This is not, unfortunately, the first time a surprise of this magnitude has occurred. Please, call us before consummating any major financial transaction. It's far less expensive than learning later that you received flawed advice elsewhere.

**"Earn \$1 million and pay no tax."**

A recent headline in Tom Herman's "Tax Report" in the *Wall Street Journal* screamed this, one of many that mislead all-too-many into thinking the wealthy regularly escape high income taxes. They can do so—but only as long as their wealth is shrinking due to generous contributions, high medical bills, casualty losses or business losses, or if they're invested in tax-free municipal bonds—which pay correspondingly less than taxable bonds.

The article went on to clarify: "Of the 2.6 million individual income tax returns that reported income of \$200,000 or more, there were 4,119 taxpayers who owed zero...taxes for 2001, the latest available year." That's .0016%, or one in every 631 taxpayers in that

select group. How might a taxpayer with \$1 million in income end up in such a situation? One way would be by giving away half of it, losing \$300,000 to an uninsured casualty on a rental property, paying \$50,000 in interest on a home loan and \$50,000 in property and state income taxes, along with a \$100,000 deductible business loss (perhaps from passive loss carry forwards that become deductible in the year the business ends). Paying lots of taxes would have been far cheaper than spending and losing all that money.

It's time to put an end to the absurd idea that the rich pay no taxes, or can easily get out of paying them. Dennis Kozlowski tried this and it cost him his freedom. For the record, for 2004, the top 10% of the nation's income-earners paid 65.8% of all income taxes. The top 50% paid 96.5%. The top 1% and 5% paid 34.3% and 54.4% of all income taxes respectively. Even adding in Social Security taxes, which are disproportionately paid by lower income salaried and self-employed workers, the top .1% (that's one-tenth of one percent) are paying 10% of all income and Social Security taxes, the top 20% are paying over 65% and the bottom 20% are paying less than 1%.

**"Big business doesn't pay any taxes. They just write off everything. Why am I stuck paying so much? I need a write-off!"**

This was a complaint of a client who recently asked me to offer ideas for a business that would save taxes. There

are several fallacies embedded in his lament.

1. Big business pays a huge chunk of tax. After write-offs, which are simply business expenses, they are subjected to a 34% federal tax plus state income taxes (which are, in California, a hefty 9.3% of net income). Net taxes paid by American corporations amounted to some \$300 billion last year.

2. The idea implicit in the remark is that a dollar of write-off helps a business avoid a dollar of tax. Wrong. A dollar of write-off—in other words, business expense—saves 34 cents in tax (plus several more cents of state income tax). I'd rather pay the tax than incur unnecessary business expenses, as would any rational business owner.

3. The implicit condemnation—"big" business, meaning "big, bad business"—by attribution denounces its owners. After all, a bad business must be owned by bad people. While this may be true for a few business owners, most businesses are run and owned by people just like you and me. And almost all of us own shares in many of these businesses, largely through our retirement plans. So when we condemn "big business," we really condemn ourselves.

4. Complaining serves to take the focus off the ball—the idea of producing income, on which one will pay more

taxes. I learned long ago that those who concentrate on tax avoidance often fail to get around to making money. We usually score more points by focusing on a positive—in this case, the production of income.

5. While many write-offs make economic sense, one for its own sake does not. Mortgage interest makes sense if houses are reasonably priced; it does not if homes are grotesquely overpriced. Deductible IRAs and other retirement plan contributions make sense for those in higher tax brackets; they generally do not, for reasons I have mentioned in recent newsletters, for those in the lower 10% and 15% brackets. A business makes economic sense if, in the long run, you have reason to believe you will earn enough money to create a decent return on your time and investment. Many people seem to think that a losing business is a great write-off when in fact, it's a lousy one. Never set up a business to create losses. Not only will the IRS disallow the loss if they can prove your intent was never profit-motivated; but you will also reduce your net worth. Recall, too, that for every dollar spent, the tax savings is based on one's tax bracket, which is a percentage of that dollar (never anywhere near the full cost of the outlay). Create a business to generate income, on which you will pay

more taxes and we will do what we can to minimize those taxes via intelligent, judicious and strategic tax planning.

**"I wouldn't know where to put all the cash [from the sale of my home] that would earn as good a return."**

So said a happy homeowner in Los Angeles who paid \$350,000 for a home ten years ago that's now valued at \$1 million. There's a fatal flaw in his thinking: he's looking in the rear view mirror.

Surprisingly, the compound annual rate of increase in the value of his home has been less than 12%. However, incomes have not kept pace. Far fewer can afford to purchase the home at \$1 million than at \$350,000, even at today's lower interest rates. Fewer still will be able to buy at \$1.5 million, or at the \$2.85 million it would be worth ten years hence if the rate of growth continues at 12%. A skeptical observer might suggest that at some price-point buyers will be non-existent.

The homeowner is probably right—there won't be many investments over the next ten years, if any, matching the rate of return on his home for the last ten. That doesn't, however, mean he should keep the investment in his home.

## Interstate Telecommuters Face an Appalling Tax

In an amazing ruling, the New York Supreme Court, in a 4-3 decision, decided that a New York law taxing those who telecommute from other states on all their income was constitutional. In the case at hand, a Tennessee man who worked for a New York employer occasionally traveled to New York on business. The court let stand a tax on all his income earned from the employer, even though he clearly lived in Tennessee and worked in New York at most only 25% of the time.

Incredibly, the U.S. Supreme Court let the ruling stand.

According to Tom Herman and

Rachel Emma Silverman of the *Wall Street Journal* (November 1, 2005), the law says "income from work performed out of the state is taxable by New York unless it's done for the employer's 'necessity.'" The telecommuter acknowledged that his employer didn't require him to work in Tennessee. This could create a double-whammy against such telecommuters, because they may be denied a deduction for living expenses when staying overnight at what is considered their "tax home," which includes the usual work location, when they have made a decision to not live there for personal reasons.

Herman and Silverman point out that "millions of people are working in one state for employers in other states. Tax issues may arise over which state or states can tax a worker's income." The Supreme Court decision, by its silence, may invite other states to act as aggressively as New York. Although some members of Congress have introduced legislation to stop this practice, it is not yet as widespread as was the taxation of pensions earned by non-residents in the early 1990s, which impelled Congress to prohibit such taxation beginning in 1997.