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"Fear not officials - except those who officiate over you."
--*Outlaws of the Marsh*, Shi Nai'an and Lao Guanzhong, 12th Century

Wealth Creation Strategies

Tax and Financial Strategies

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Withholding Will Change, but Don't Change Your W-4—UNLESS…

Tax rates were retroactively chopped effective January 1. However, tax-withholding tables used the OLD rates for the first half of the year. How to make up for the reduced taxes via withholding with a half year to go? Simple: double the reduction from July 1 through December 31 for withholding purposes.

Here's an example of how it will work. The $6,000-single/$12,000-married 10% brackets were expanded to $7,000/$14,000. The withholding tables that employers use will, as of July 1, "pretend" that this bracket was expanded to incomes of $8,000/$16,000. The average, then, will be the correct amount on a full-year basis. Adjustments will be required if you work only during the first or second half of the year, as well as for the usual other reasons (for instance, having other income not subject to withholding).

Another example: the 27% bracket was decreased to 25%. Withholding tables will "pretend" that the new bracket is 23% for the second half of the year. We'll all be rich. But it won't last. Next year, the withholding will be increased to account for the real rate (25%). Enjoy the extra cash flow while you can.

Since the withholding tables will, overall, be taking into account the new tax rates, you don't have to do a thing. Do not change your withholding for this reason. There may be other reasons to do so, but the new tax law will not be one of them—UNLESS you have children.

If you have dependent children under the age of 17 as of December 31, 2003, your child tax credit will, if your income is low enough, be increased by $400, to $1,000 per child. If you are in the 15% tax bracket, this credit is the equivalent of a $6,667 deduction ($1,000/.15). That's worth over two withholding allowances (each allowance assumes you have deductions equal to the personal exemption amount, which this year is $3,050). You can easily see that the additional $400 credit is worth almost (but not quite) one allowance.

If you are in the 25% tax bracket, the entire credit is equal to a deduction of $4,000. Since the increased amount is equivalent to just a $1,600 deduction for those in this bracket, the $400 is worth about half of a withholding allowance. You can't claim a half a deduction (maybe we should be able to), so be careful. If you've got two qualifying children, the additional credit is worth a full allowance.

However, it gets tricky as the income rises and the child tax credit is phased out. If you really want to hone in on your deductions for the rest of this year, send us your year-to-date pay stubs, preferably through June 30, along with other information regarding expected changes in income and deductions for this year. Bear in mind, we reserve the right to add to your tax preparation fee for time spent on such calculations, and this year's calculations could prove a bit more time consuming than usual.

New Federal Income Tax Rates

		Old Threshold		**New** Threshold	
		Taxable Income up to:		Taxable Income Up to:	
Old Rate	**New** Rate	Single Filers	Joint Filers	Single Filers	Joint Filers
10%	10%	$6,000	$12,000	**$7,000**	**$14,000**
15%	15%	$28,400	**$47,450**	$28,400	**$56,800**
27%	**25%**	$68,800	$114,650	Same	Same
30%	**28%**	$143,500	$174,700	Same	Same
35%	**33%**	$311,950	$311,950	Same	Same
38.6%	**35%**	Unlimited	Unlimited	Same	Same

Income is taxed in "chunks." Each "chunk" is taxed at its own rate. For example, a married couple filing jointly pays 28% on the "chunk" of taxable income from $114,650 to $174,700.

Taxes on Capital Gains and Dividends Plummet

The advertised tax rate on long-term capital gains was chopped from a theoretical maximum of 20% to 15%** for sales occurring after May 5, 2003. However, to determine the true rate, several adjustments need to be made. As overall Adjusted Gross Income increases, Social Security income subject to tax increases, while allowable rental real estate losses and deductible IRAs are gradually eliminated. The benefits of itemized deductions and personal exemptions decrease for those with higher overall incomes. Credits such as the child tax credit, educational credits and adoption credit, quickly diminish. Add your state's income tax (in California, up to 9.3% and even higher due to phase-outs), and the rate can range up to 28% for many taxpayers and, in isolated instances, far higher.

On the other hand, the tax on such capital gains is only 5% for taxpayers in the lower (10% and 15%) tax brackets (again not counting other factors). Of course, if the gain increases taxable income beyond these brackets, any remaining profit is taxed at the higher 15% rate (adjusted for phase-ins and phase-outs of income, deductions, credits and state and local income taxes).

The double-taxation of corporate income has been partly eliminated at the federal level. The tax rate on corporate income ranges up to 35% (plus your state income tax—almost 9% in California), plus the ordinary tax on distributions of corporate income paid to shareholders, also known as "dividends." Since the top tax rate on individuals in 2002 was 38.6%, the combination of corporate and individual income tax on corporate dividends could result in an overall federal tax rate as high as 60%. With the double-taxation imposed by many states, the overall rate often exceeded 70%. In an amazing act of clarity, Congress reduced the maximum federal tax on most dividend income to just 15% (5% for those in the lower 10% and 15% brackets). Since the California maximum rate is 9.3%, or almost two-thirds the federal rate, the incentive for high-income earners to move out-of-state has increased. The overall maximum federal tax on net corporate income, including that paid out as dividends, is now 45%, but still a confiscatory 60% some states.

Regular rate	**Regular rate**	**Tax rate on dividends and long-term capital gains****	**Value of net capital losses (up to $3,000 per year)**
Old Rate	**New** Rate	**New**	
10%	10%	**5%**	10%
15%	15%	**5%**	15%
27%	25%	**15%**	25%
30%	**28%**	**15%**	**28%**
35%	**33%**	**15%**	**33%**
38.6%	**35%**	**15%**	**35%**

Now ask what tax bracket you're in. I've been responding, for what purpose are you asking, and for what kind of income? We now add dividends to the huge number of variables when giving a response, in addition to changing the answer for capital gains and losses.

Should you sell your rental property, pay the tax and reinvest the proceeds in high-dividend corporate stock? Don't look now, but the new and improved tax rates are good only until 2008 or, of course, otherwise changed by Congress.

** These rates do not apply to recapture of depreciation or to gains on "collectibles."

Tax Cuts for Everyone

The tax act enacted in May 2003 reduces taxes for almost everyone. However, it's not as much as they make you think.

Perhaps to seem dramatic, the act is advertised as slicing $350 billion off the nation's tax bill. There are two frauds perpetrated by such advertising. One is that spending is not decreasing, but rather increasing at accelerating rates. (Wait until you see the bill for the government takeover of senior prescription medicine.) If spending doesn't drop, but taxes do, government goes to the debt market to finance an ever-increasing deficit. The money, in other words, always comes from somewhere, and there is always a cost to someone. In this case, interest rates don't decrease by the amount they otherwise would, and/or the dollar's value is reduced by a greater

amount than it would otherwise be (also known as "inflation"). On the other hand, there's more pressure on the government to reduce spending when it runs enormous deficits.

The more troubling aspect to the advertised cuts is that the $350 billion is spread out over ten years. Since that's only $35 billion per year, problem number one doesn't seem so bad. In fact, it's downright miserly when the size of the budget is taken into account. Any guesses as to the per cent of the budget this represents? 5%? 10%? Try 1.8%. The budget is an unfathomable $1.94 trillion per year. $35 billion is a drop in the bucket.

There's a consideration that could turn an intuitive-thinking libertarian into a schizophrenic. We like to see things run more efficiently, while at the same time reducing the size of government. The budget maestros use "static-model analysis," which assumes that peoples' behaviors do not change despite a lowering of tax rates, to estimate the size of the tax reduction. Back in 1997, this sort of analysis predicted that the capital gains tax cut from 28 to 20% would result in a revenue loss of $50 billion over five years. In fact, tax revenue from capital gains increased by $100 billion over that time. This is due to the fact that investors were more willing to sell assets at a profit when the tax cost of doing so was less. No doubt, history will repeat: the government will very likely collect more tax revenue as a result of the lowered tax on capital gains, rather than less.

The Bubble Returns

The stock market bubble is making a temporary comeback, despite the fact that the bottom of the bear market so far has been higher than the peak of any previous bull market as measured by dividend/price and book value/price ratios. One way by which the mass psychology has forced prices up is truly amazing. Pensions, formerly a bastion of conservative investors, have issued bonds to raise money that is then invested in stocks.

Public policy generally prohibits retirement plans from leveraging investments. You may have noticed that stocks cannot be margined in your IRA or 401k, nor can you purchase options in these accounts. However, local governments seem to have found a loophole: they issue bonds at an average 6% interest and invest the proceeds in stocks. Obviously, they think they will, on average, earn more than 6% per year. Yet, the average rate of return on securities over the last six years has been close to zero.

Why would state and local governments take such risks? Because it's a bull market and stocks are undervalued, or so they think. Moreover, several issuers sold such bonds in the '90s and came out whole as stock prices skyrocketed. Naturally, today's issuers expect history to repeat. And, today's public pension funds (defined benefit plans, which promise a particular monthly income benefit upon retirement) are almost 80% under funded relative to the benefits they are contracted to provide. The truly abominable aspect to this is that if they lose, taxpayers will be forced to fund not only the pensions to which they are contracted, but also the losses incurred by city, county and state pension administrators. They, in turn, will not pay for their poor judgment, even while collecting those pensions.

Tax System Run Amok

One client qualified for the following tax credits on his 2002 return:

Name of Credit	# of Lines on Form/ # of Lines on Worksheet	Max $ Saved (for 2003)	$ Saved by Client
Child Tax Credit	No form/5 lines	$600/child ($1,000)	$166
Additional Child Credit	13 lines/no worksheet	$600/child ($1,000)	$434
Dependent Care Credit	11 lines/no worksheet	$960 ($1,200)	$117
Earned Income Credit	6 lines/24 lines	$4,140	$196
Hope Learning Credit	18 lines	$1,500/child	$315
Lifetime Learning Credit	18 lines	$1,000 per taxpayer	$0

This client's income was under $30,000. The savings from the various credits ranged from $117 to $434 each. The computer-generated fee was $650. Since each credit saved so little tax, the fee was cut roughly in half.

The fact that a relatively low-income couple could have one of the most complicated returns possible is a compelling indictment of our tax system. Anyone for starting over?

The Politics of Envy

Ruthless politicians who seek power often carry the politics of envy to extremes. By screaming that "the rich" are getting too large a benefit relative to "the poor," they lead the charge in blaming others for problems, currying favor with "victocrats," thereby increasing votes.

This is found most often when tax law changes are debated. Under current law, low-income people not only pay zero income tax, but also can claim a refund of as much as $4,140 in taxes they didn't pay in the form of the Earned Income Tax Credit (EITC). When the tax law was passed in May, Democrats, who almost unanimously voted against the bill, lambasted the Republicans for not having turned the Child Tax Credit, which was increased from $600 to $1,000 under the bill they voted against, into a refundable credit like the EITC. When the Republicans balked, Democratic House minority leader Nancy Pelosi gave new meaning to the politics of envy when she commented, "The Republicans give new meaning to the Biblical phrase, 'Suffer, little children."

The fact that we already pay people to have children they can't afford seems to have escaped Pelosi's attention. Protecting people from the consequences of their behavior seems more a Democratic thing to do than a Republican one, which is, perhaps, one of the reasons why black libertarian talk show host Larry Elder recently re-registered as a Republican. However, many Republicans caved into the pressure to give even more for nothing. As of this writing, increasing the refundable level of the child tax credit seems to be on hold, but the politics of envy make for an interesting, even if disgusting, sideshow.

Roths for Everyone - Even the Low Income

The recent tax act will increase the number of non-tax paying citizens and will add to those who pay tax at lower rates. As long-time readers will recall, I strongly recommend that those in these lower tax brackets avoid contributing funds into deductible retirement plans such as traditional IRAs, 401k's and 403b's, except to the extent the employer at least partially matches contributions. Taxpayers in the lower brackets are generally best advised to invest in non-deductible Roth IRAs, which if handled right allow a permanent tax-free buildup of retirement funds.

However, the tax law continues to confuse. The array of rules surrounding credits and phase-outs of credits, not to mention retroactive tax law changes mid-year, keeping us on our toes. Here are two examples from this tax season in the area of the Low-Income Savers Credit (LISC). In the first one, a partially deductible contribution was required in order to maximize the tax savings.

A head-of-household filer qualified for this credit at a 20% rate on a $300 contribution to her 401k. However, I noted that if we could reduce her Adjusted Gross Income (AGI) by just $100 more, we would increase the credit to 50% of the amount contributed. So, I advised that she invest $100 into a traditional IRA (thereby decreasing her AGI by the required amount) and $1,600 into a Roth IRA. If she had contributed $1,700 to a Roth, the LISC would have been 20% of $2,000, or $400. By having her split the contribution into the two IRAs, we increased this tax credit to 50% of $2,000, or $1,000. We thereby reduced her out-of-pocket cost to $1,700 minus the additional credit of $940 (she was already getting a $60 credit on the $300 payment to her 401k), or $760. So, it cost her $760 to invest $1,700, for a cool 124% instant rate of return.

The second example involved a single filer, who qualified for a 50% credit on up to $2,000 invested in any retirement plan. However, despite having income barely under the $15,000 threshold at which point the 50% savings begins, the maximum investment that saved 50% was only $1,200. This was due to the fact that his tax was only $600. Because this credit is not a "refundable" one, I advised investing just $1,200 into a Roth-IRA. Generally, folks at this income bracket don't have extra dollars to spare, but this was even worth borrowing for on a short-term basis, especially since his income is increasing substantially in 2003. Of course, I suggest that those who can afford it plow as much as allowable ($3,000/$3,500) into a Roth, even if the tax is zero.

The maximum possible LISC for single people with $15,000 or less of income in 2003 is $795. Therefore, a contribution of $1,590 is the most that will provide any savings, despite the law claiming to provide a 50% tax savings on any contribution up to $2,000. And, since the credit drops to 20% of $2,000 for those with AGI between $15,000 and $16,250, $795 is the maximum possible savings for single people.

In the first example, if we could perfectly plan ahead and her employer matched 50% of a 401k contribution, we would suggest a $2,000 contribution to the 401k. She would save $1,000 from the credit and $300 in additional savings from the $2,000 deduction, or $1,300. Her out-of-pocket cost, then, would be $700 for a $3,000 total (employer and employee) investment, for an immediate return of 428%. The trouble is, if she goes $1 over the $22,500 in taxable gross income for the year, our plan is foiled.

Roth IRA Close-Outs

Roth IRAs are wonderful savings and retirement vehicles. They are truly awesome in their power to shift assets to succeeding generations. Beneficiaries of these IRAs can allow the investments to grow, while slowly taking withdrawals over the beneficiary's life. The growth of the assets can exceed the required withdrawals for decades.

However, the best of plans may fail for those invested in stocks during bear markets. Many owners have losses inside their Roth's. They may have invested, say, $10,000 and have only $4,000 left. What can be done for such a Roth investor?

It's essential to understand that Roth's are very different from other retirement plans, in which generally pre-tax dollars are invested. Roth's take after-tax dollars, which can be withdrawn at any time without tax or penalty. The earnings, if any, must be withdrawn after reaching age 59 1/2 (or five years from the date of the first Roth investment, if made after age 54 1/2). Our losing investor can let his $4,000 ride, hoping to recoup his losses, or he can withdraw any amount. But is there a deductible loss?

It turns out, there may be. However, he must withdraw all funds from all of his Roth IRAs. If he withdraws $3,999 (or the value plummets to $1), there is no deduction. He has to take that last dollar out and only then can he deduct.

Still, there may be no tax savings. Since Roth IRAs have been deemed not to be capital assets, there is no capital loss. Instead, the loss is taken as a "miscellaneous itemized deduction" on Schedule A. This does the hapless Roth owner no good unless he benefits from itemizing personal deductions. Further, the total in the "miscellaneous" column (which includes employee business expenses and investment-related costs) must exceed 2% of Adjusted Gross Income before it is added into the totals on Schedule A. Since miscellaneous deductions are added back into Alternative Minimum Taxable Income, when the loss (combined with other such AMTI items) is too large, the savings is capped.

Reaping tax savings from a loss on Roth IRAs requires very careful planning. When all Roth's are closed out, the five-year holding period for withdrawing profits tax-free starts over. However, there seems to be nothing in the law prohibiting the withdrawal of all Roth IRA funds, thereby creating a potentially deductible loss, while making this year's contribution the next day. There may even be a psychological benefit to "starting over."

The Importance of Reporting All Your Income

I tell clients, "Report all your income. While we can argue deductions with the IRS, unreported income leaves you open for criminal fraud." Avoiding a visit to Leavenworth is an obvious reason for not stumbling into black and white areas. Plus, you just don't want to get heartburn over being audited by the IRS. If the audit is over deductions and we've got a leg to stand on, you shouldn't get sick over it.

But there are two other, very practical reasons for reporting all income. One is related to decisions over retirement plan contributions. When the due date for filing has passed, you cannot change your decisions regarding IRAs. If, when filing, we determine that any additional deductions will save tax at the 15% rate, I usually suggest Roth IRAs. If an audit pushes your taxable income into the 25% bracket, you missed an opportunity to deduct an investment in a traditional IRA that would have saved more tax than we originally calculated. As is true for computers, garbage in; garbage out.

Once the extended due date is past, you cannot add to self-employed retirement plans such as Keoughs and Simplified Employee Pension Plans (SEPPs). What do you think an IRS agent's response would be to, "Gee, if I'd known that my income was $20,000 higher, I would have contributed (more) to my retirement plan"? Aside from, "too late" and "keep better records," he might respond that you're lucky he's not giving you more trouble.

The other reason relates to choices when depreciating business equipment and other capital items. We need to know the correct net income to determine which method to use. The options for first-year depreciation of, say, $50,000 in new equipment and 20-year or under new improvements used in a rental real estate operation include $5,000, $10,000 or $30,000. The choices for depreciating $50,000 in equipment used in a regular (non-real estate rental) trade or business vary from $5,000 to $50,000. Deciding how slow or fast to depreciate requires that we have a good idea of your marginal federal, state and self-employment tax brackets, along with expected marginal tax bracket in future years and your particular perceived time value of money (generally related to the highest interest-rate loan you have). As regular readers are aware, we don't like wasting deductions at low brackets and we love paying more taxes now if we think we can save 50% more by claiming the deductions over the next five years.

One of the most bizarre sets of equations we run into when preparing tax returns relate to relatively low-income self-employed taxpayers with children. Due to the complex interplay of the Earned Income Credit, Self-Employment tax, income tax and child tax credits, we have to run the numbers to find the marginal tax rates for various

levels of depreciation and retirement plan contributions. Often, the marginal rate is high but can change dramatically after as little as a $1,000 increase or decrease in net income. Because of such dramatic affects from relatively small changes in income, it's crucial that low-income earners, or normally high-income earners having a bad year, be as precise as possible in calculations of income and deductions.

Tax Season Potpourri

Everything went pretty smooth this past tax season; however, there are a few minor glitches we'd like to mention.

First, as most of you know, it is imperative that you inform us of any major changes to your financial situation during the year so that we can make adjustments, advise and save you money wherever possible.

We also realize how busy you are and know that most of you don't want to give any more thought to taxes than is absolutely necessary. However, the newsletter *is* an adjunct to our services and, while not every article is relevant to your situation, it is important to at least scan the letter to raise questions that you can ask us. The tax law is far too complex for us to think of every nuance for every client when we see you only once a year.

The letter is also a terrific benefit that no other tax professional provides. It's not "canned," as are virtually all others. It's inspired by real-life situations that you, the readers and our clients, provide. We can't discuss every possible variation on the theme suggested in the articles, but that's what phone calls, faxes and e-mails are for. It's also the reason we attach a very bright-colored sticker to the cover letter sent out with all client tax returns. The note makes it very clear that **if you want us to help minimize your taxes, you should contact us as soon as you know there's a large tax- or financial-related change occurring in your life.**

The other misunderstandings this season, few though they were, revolved around questions of billing for consultations and extraordinary changes in tax returns from one year to the next. We charge for consultations, usually adding the investment in our services to the tax return fee if for less than thirty minutes and generally billing throughout the year for longer consultations. If there is a highly unusual situation, we will add an "expert" fee to the normal one, even though we are supposed to be expert at all of this. Sorry to say, the tax law is far too complex to be expert at every single line of the tax code.

Tax return fees have varied from $75 to $2,000. When a particular fee increases from $75 to $300, or from $200 to $750 in one year, it should be understood that it is not because our prices have skyrocketed but rather because of the far greater time, complexity, risk and/or expertise in a particular client's tax return. Bear in mind, those fees can drop by as much as they increased if and when the situation becomes simpler.

The only other major impediment to a perfect season involved the query in our "By-Mail" package where we ask how much you'd like to invest in retirement plans and whether you'd like to be put on extension. Very few respond timely. If you answer the questions and provide us with your "official-looking" documents per the instructions, the value of our services to you may increase substantially. Just take a look at the "Roths for Everyone" article in this issue. If we had not been informed of the total income timely, terrific tax-savings opportunities would have passed us by.

A Battle of Words

Book	Number of Words
War and Peace	660,000
The Bible	774,746
The Internal Revenue Code	over 2.8 million

The recent tax law didn't improve the situation. I wonder if this comparison would protect us in case an auditor suggests, "You should have known the law."