Inside Highlights

"Just as hangovers are inevitable consequences of drinking too much alcohol, depressions are the consequences of malinvestments triggered by artificial credit creation by central banks."

—James Dale Davidson,
former Chairman, National Taxpayers Union.
I would add "easy bankruptcy laws" to the source of credit creation.

Tax and Financial Strategies

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Wealth Creation Strategies

The Real Estate Bubble, Part III

In a sign of exuberance rarely before seen in any market, 17 out of the 20 least affordable metropolitan area markets in the U.S. are in California. According to a real estate flyer, the lowest priced single family residence in Manhattan Beach, California, a 2 bedroom 2 bath, 1450 square foot home built in 1951 on a 50 x 121 foot lot about a mile and a half from the beach, is offered at $899,000. The 804 square foot two bedroom one bath homes in Encino Park, built on mostly 50 x 100 foot lots shortly after WWII, originally sold for about $5,000. They are now selling for $500,000 (a multiple of 100—substantially greater than inflation alone).

Outlying markets from Riverside, California to St. George, Utah have also been affected. House prices in St. George have jumped about 50% since my wife and I pondered investing there in November 2003. This seems to have followed on the heels of the Las Vegas market, about an hour and a half west, which increased by a similar amount during roughly the same period. However, Las Vegas, a city of about 1.5 million, has 19,000 houses for sale. The San Fernando Valley, with a similar population, after bottoming in March 2004 with 1,300 listings, currently has about 2,200. Its peak was just over 14,000 during the bust of the early '90s. While we might expect more listings in Vegas with its higher turnover, the sales-to-listings ratio has recently been averaging only 50%. The equivalent number in the San Fernando Valley is closer to a far healthier 80%. The market began its long collapse in the early '90s only when the ratio plummeted to less than 30% in the summer of 1989. In the meantime, the bubble may be in the process of bursting in San Diego, where the number of listings has doubled from 6,000 to over 12,000 in the twelve month period ending in June, suggesting a collapse in the sales-to-listings ratio.

Other signs of extreme froth, the first five of which are derived from *Barron's* review of a report by David Rosenberg, a Merrill Lynch economist, include:

1. About 42% of first-time buyers in 2004 purchased with none of their own funds.
2. According to the Federal Deposit Insurance Corporation (which has an interest in this, since it insures bank accounts), 38 states have recently seen home-price appreciation far outpace personal incomes. Nationwide, home prices have been growing almost 7% faster than incomes.
3. New household formations are estimated at 1.6 million yearly, a demand for which is being more than met with about 2 million new housing units built per year.
4. The National Association of Realtors® reports that investors made 23% of home purchases over the last year, while second-home buyers comprised an additional 13%. In Las Vegas, 44% of home purchases were for "investment" over the same period.
5. Rents for single-family homes are reportedly falling in markets from Gilbert, Arizona where the supply of rentals has doubled in the last year, to South Florida and San Diego, where incentives such as a month's free rent are now standard fare.
6. The ratio of house price to median household income is greater than one standard deviation from the historical mean in 60% of the country.
7. Even though many seem to be recognizing a possible bubble, 83% of economists polled by the *Wall Street Journal* believe there is no national bubble in real estate.
8. Average home prices in the U.S., Australia and Britain have increased by more in the last eight years than Japanese home prices increased in the nine years of the extraordinary Japanese bubble, which peaked in 1989. Japanese prices are at levels last seen in the early 1980s, down on average by a stunning 40% from their peak.
9. Mortgage lenders are further loosening underwriting standards. Some

lenders have increased the allowed ratio of total debt to total income from 38% to 45%. Some banks are qualifying borrowers based on the ability to make the minimum payment on option Adjustable Rate Mortgages (ARMs) rather than a fully amortized payment. Required payments on option ARMs assume a "teaser" rate of as low as 1% per annum, which converts the unpaid portion to an increased loan amount (i.e., negative amortization).

10. Some lenders are booking the entire amount owed in interest as income even when the borrower remits only the minimum payment, which may be just a portion of the interest. Some might consider reporting such non-cash earnings as income to be "financial statement fraud." Such shenanigans, when they roost, could make the Savings & Loan crisis of the 1980s look like child's play.

The New Bankruptcy Law

An End to Spending as We Know It

How will it affect you?

The new bankruptcy law takes effect October 17, 2005 and has the potential to contribute not only to the next economic downturn, but also to increasingly depressed spending over several economic cycles. A slow but inexorable effect is more likely than an immediate one because quantum changes buried in legalese only trickle into the mass consciousness. A monumental change in tax law may offer a recent example of this creeping awareness.

The change in the taxation of profits from the sale of main homes that took effect in 1997 has had a long life. Homeowners and investors seem to have slowly realized that the potential for a tax-free profit could convert one's home into a multi-faceted tax shelter. This eventually resulted in increased demand, contributing to what might be considered nearly hyperinflationary price increases had consumer goods been similarly affected. Just as the surge in values picked up after only a few years, as more people benefited from tax-free gains (and spending power through increased equity lines), the downside effect of a more restrictive bankruptcy law on spending could begin slowly, ending in a torrent.

As home price appreciation has accelerated, the consumer has increasingly spent with abandon. Consumer debt as a percent of disposable income has grown from barely over 10% as late as 1985 to almost 13.5% today. Household debt as a percent of wages remained under 50% until the mid-1950s and less than 100% until 1983. In a parabolic rise on a long-term chart, it has advanced from 140% in the late '90s to 180% today. Adjusting for inflation, total median household debt has almost doubled in fifteen years, while median income has increased by less than 20%. The ratio of total debt to Gross Domestic Product has skyrocketed from 120% to 300% in just 25 years. Those who have little or no debt may not think this affects them. However, credit expansion beyond an ability to repay, particularly for consumables, causes economic distortions that eventually must be corrected. The period of correction is called "recession" or "depression." In other words, everyone will be affected, at least to some degree, by consumer retrenchment.

Why bankruptcy?

Bankruptcies, while plummeting from over one million per year in 1986 to less than 600,000 in 1993 have since more than doubled to about 1.5 million annually. The bankruptcy act of 1978 tossed out the last vestiges of Depression-era attitudes toward bankruptcy, making it relatively easy and shameless for individuals to file under Chapter 7, which wipes the slate clean—with all debts forgiven by the court. A relative few file under Chapter 13, which requires a plan of repayment to creditors—and lowered spending during this period, usually five years. With a requirement that one live within one's means and repay creditors at the same time, there's a huge disincentive to select a Chapter 13 over a Chapter 7.

There are many reasons for bankruptcy. Some people—call them criminals—simply game the system. Others err in spending due to over-optimistic assumptions of a future ability to pay, which can result from an unexpected job loss or, alternatively, an inflated sense of one's prospects and abilities. One bankruptcy attorney told me that nasty divorces likely involving at least one alcoholic were the source of at least half of his business. Impaired judgment due to alcoholism can result in massive overspending—as the alcoholic Ted Bundy said, "He who dies with the most toys, wins." There may be a simple lack of awareness of the principles of compound interest, an educational failing for which government schools should be held in contempt.

There is one upside to seemingly profligate spending: generous bankruptcy provisions tend to increase entrepreneurial activity. Specific exemptions under bankruptcy vary greatly among the states and between the U.S. and Europe. *The Economist* magazine points out that homeowners in states with higher or unlimited exemptions were 10-35% more likely to own a business than those in low-exemption states, and less likely to go through the extra expense of protecting themselves from creditors through incorporation. Studies also show that attitudes toward risk in Europe, which has stricter bankruptcy laws, are far more conservative than in the U.S., which may in part explain lethargic economic activity on the Continent. One downside, then, to the new bankruptcy law is a potential decrease in risk-taking entrepreneurial behavior.

How will consequences become more severe?

The new law requires that would-be bankruptcy filers undergo credit counseling by an approved nonprofit budget and counseling service. The IRS says it has received more than 600 applications from credit-counseling services in the past 20 months seeking non-profit status. (This classification exempts them from consumer-protection laws, including the national Do-Not-Call Registry. Being able to avoid obnoxious sales calls during dinner could motivate some to do everything possible to avoid bankruptcy.)

The bankruptcy overhaul that takes effect October 17 also requires a debtor's completion of an approved personal financial-management course as a condition of a discharge under Chapter 7. While some people need this, many don't and others can't be helped via conventional methods. Some need it due to shortcomings in government schools, which don't even teach students how to balance a check book, much less the nightmare of compound interest working against you (though it is a miracle when it works for you). Others don't need it, because while handling their financial affairs in a mature fashion, they became a victim of financial abuse, were involved in an accident for which they were underinsured, or experienced a one-time financial cataclysm such as divorce. Quite a few—from observations and discussions with bankruptcy attorneys, I suspect 50%—can't be helped by classroom study because of alcohol or other drug addiction, which limits the ability of the rational brain, the neo-cortex, to restrain impulsive behaviors and compulsions of the lower brain centers. Such impulses and compulsions often include spending beyond one's means in an effort to inflate the ego. Having the most toys can be a great way by which to wield power over others. (I describe this at great length in my books, particularly *Drunks, Drunks & Debits* and the latest, *Alcoholism Myths and Realities*.)

The law will require more paperwork than ever. A debtor must, under the new law, file copies of federal tax returns, pay stubs, income projections and anticipated increases in income with the bankruptcy court. The documentation is made available for inspection and copying to any interested party. Debtors must also furnish photographic documentation establishing their identification. While some will object to perceived violations of privacy, increased disclosure will tend to decrease fraudulent bankruptcy filings.

A "means" test will be imposed that will force people earning more than their state's median income into Chapter 13. While an estimated 84% of all filers earn less than the median income, the rigors of paperwork may up the odds that more people will exercise restraint in spending. In addition, the new law requires the bankruptcy courts to follow IRS rules for determining allowable living expenses under a Chapter 13 filing—which, as you might imagine, are stricter than current bankruptcy law allows.

How can we protect ourselves from being forced into bankruptcy?

Even if your debt is under control, there's always the possibility that things could take an unexpected turn for the worse. For example, an accident for which you are determined at fault could put you in debt to the victim. Think insurance will cover it? It may not if you are covered under California's minimum required liability of just $15,000 per person, $30,000 per accident and property damage of just $5,000. These limits were set in 1967 and have never been changed, even though inflation since then should have increased the minimums to roughly $135,000, $270,000 and $45,000 respectively. Imagine the true costs of seriously injuring someone or totaling anything more than a ten-year-old Ford in today's litigious society. Responsible people will be increasingly motivated to up their maximum limits of liability.

While rich debtors still have loopholes, they are limited. A few states allow the shielding of assets in special state-sponsored asset protection trusts, while others (Florida and Texas) have an unlimited exemption for one's fancy home (so O.J. is safe). These holes remain due to Congress's concern over interfering with states' rights, which may no longer be an issue after the recent Supreme Court decision in Raich, which tramples the rights of states to allow medical use of marijuana. However, the law increases the duration of a debtor's domicile from 180 to 730 days for purposes of determining which state law governs the debtor's selection of property exempt from bankruptcy. It sets a limit of $1 million for both traditional and Roth IRAs exempted from bankruptcy claims, with apparently no limit for SEPPs, SIMPLEs, 401-Ks and other employer-sponsored retirement plans. Assets rolled into IRAs from these plans are also exempt assets, but should not be co-mingled with regular IRAs. The incentive to invest in retirement assets just increased—even responsible people can make mistakes that aren't covered by the usual insurance policies or liability limits.

Will people become more responsible?

Generally, blaming creditors for the plight of the over-extended because they offer too much credit is like blaming the liquor industry for the unquenchable thirst of alcoholics. The imposition of consequences for irresponsible behaviors, to the extent that many bankruptcy filers have acted irresponsibly, is consistent with the ownership society, in which the individual owns the profits as well as any losses. An unfortunate side effect of the new law is that a person using a credit card to splurge and gamble in Vegas is treated the same way as one victimized financially by a con artist. However, as an awareness of the new law propagates, people will modify their behavior in positive ways. They will obtain insurance where they didn't before have it, increase maximum levels of liability on existing policies and exercise greater caution in dealing with strangers. But possibly the best part of the new law is that it expresses the sense of Congress that states should develop curricula relating to personal finance designed for use in elementary and secondary schools. Then, perhaps, young Americans will not become, as Robert Scheer sanctimoniously writes in the *Los Angeles Times* (March 15, 2005), "prime targets for predatory lenders, plastic-peddlers who just love to offer easy lines of credit to kids without jobs or even degrees." Now that would be progress!

Roth 401(k)s and 403(b)s Available in 2006

The 8-year anniversary of the invention of a non-deductible retirement plan that can be withdrawn tax-free, the Roth IRA, will be marked by a logical expansion of the concept: the Roth 401(k) and Roth 403(b), both referred throughout this article as the Roth 401(k). While a wonderful addition to the array of retirement savings opportunities, optimal planning for contributions will be challenging.

The IRA vs. Roth IRA decision can be postponed until full-year numbers are in. This gives us the opportunity to determine tax savings among alternate choices, which through 2006 can include the tax effect of a Low Income Savers Retirement Credit (LISRC). Generally, traditional IRAs are appropriate only for those in the 25% federal tax bracket or higher, reserving Roth's for those in lower brackets. After all, a deduction that saves only 15% could easily be taxed at a higher rate when withdrawn. Because Social Security income is usually taxable, at least in part, this is true even in retirement.

However, if a traditional IRA reduces Adjusted Gross Income to the point at which the LISRC kicks in, preferences may change. Unfortunately, because the breakpoints at which the credit makes its appearance are precise, planning ahead for the optimal contribution level is challenging at best. For example, if an unmarried Head of Householder has income of $26,000, increasing a $1,000 contribution to a traditional IRA or 401(k) by $1 increases the LISRC from 20% to 50% of a contribution of up to $2,000. While that's a no-brainer for the IRA, you can't change a 401(k) allocation after year-end.

In addition, many straddle the 15% and 25% brackets, the breakpoint of which is about $59,000 for married couples. If taxable income is $61,000 before retirement contributions, a $2,000 deduction saves tax at the 25% rate, while any additional deduction reduces tax by only 15%. Ideally, the first $2,000 contribution should be made to a deductible plan, with any additional funds allocated to a Roth. Obviously, due to unexpected changes in income during the year and no way to change an allocation to a 401(k) after-the-fact, the best of plans can lay in ruin.

With the increase in IRAs to $4,000 per person ($4,500 for those over age 49) for 2005, some might suggest forgetting about 401(k)s for those who can afford no more than the IRA maximums. However, since most companies match contributions up to a certain level and this is "free" money to the employee, contributions should almost always be made up to the point at which the company stops matching. While company matches will still be made in pre-tax dollars, the allocation of employee contributions will in many cases be a vexing one.

The Roth 401(k)s will be available in 2006. Unlike Roth IRAs, there is no income limitation on the right to make Roth 401(k) contributions. However, those with high incomes (AGIs in excess of the $150-160k phase-out for joint filers and $95-110k for single filers) are almost always in tax brackets for which I generally suggest making only deductible contributions. When leaving an employer, Roth 401(k) balances can be rolled into Roth IRAs. While not all employers will allow the option of a Roth 401(k) because of its "sunset" provision in 2011, it is expected that most will. You may want to plan accordingly this November.

There's Hope

The AMT Hits a Senator

The Alternative Minimum Tax (AMT), originally expected to snare only one in 500,000 taxpayers, is now entrapping close to three in one hundred, including many of you. With a percentage increase amounting to roughly 15,000% over the original projections, it was only a matter of time before a few Senators would be affected by this abomination. What's amusing is the relatively insignificant amount of tax that seems to have caught one senator's attention.

Sen. Charles Grassley, R-Iowa and chairman of the Senate Finance Committee, said he paid an extra $75 in 2004 due to the AMT. Many of our clients, even with optimal planning, are now paying hundreds and even thousands of dollars in additional tax annually because of the almost incomprehensible set of rules that create this tax. The AMT is difficult (and sometimes even impossible) to avoid by those with combined incomes of $150-500,000. Sen. Grassley pointed out that "it's become mainstream," and "if we do nothing, the situation will get worse." Nice to see he's concerned about a few dollars in his pocketbook, but note to Sen. Grassley: it has already gotten worse.

In an unusual display of solidarity, four senators, including one other Republican and two Democrats, have introduced a bill that would repeal the AMT. Because of its "cost" in government revenues over ten years—$611 billion—quick action should not be expected. However, now that it's got the attention of someone who should have been affected from the get-go, at least there's hope.

Death and Taxes

The estate tax looks like it will stay on the books, despite the fact that it raises very little as a percentage of the total federal take. Wealth Envy is still a problem for many. Some seem to think that the only way to bust up large concentrations of wealth is via this tax, which now reaches a confiscatory 47% on estates over $2 million. Yet, a number of countries normally thought of as workers' paradises have no estate tax, including Canada and Sweden. The formerly totalitarian countries of China and Russia have no equivalent. Nor do the relative free market meccas of New Zealand and Switzerland. And of 60 major nations, only two have higher death tax rates than ours.

The current exclusion (assets that can be given during one's lifetime in excess of a yearly gift tax exclusion plus the amount bequeathed upon death), $1.5 million per person, is due to increase to $2 million in 2006 and $3.5 million in 2009. While scheduled to disappear altogether in 2010, it reappears under current law in 2011 with a vastly reduced $1 million exclusion, with tax rates up to 60%. Neither repeal nor a return to the old regime is likely.

The amazing thing about this tax is that the effect on the economy and overall federal tax revenues may be negative. According to the *Wall Street Journal*, a study by Consad Research found that estate tax repeal would boost the economy so much that overall federal tax revenues would likely increase, due to improved incentives to save and invest. In the meantime, 18 states have failed to phase out their own death taxes along with the federal levy. Two, Connecticut and Washington, have just created estate taxes of 16% and 19% respectively, a move that will likely drive the wealthy to less onerous taxing climates such as Florida, which, along with having no state income tax, has a constitutional prohibition against estate taxes. Statistics support this idea: a 2004 National Bureau of Economic Research study found that states lose about a third of estate tax because "wealthy elderly people change their state of residence to avoid high state taxes." These states also lose the income and sales tax they would otherwise collect from wealthy seniors. The other states still levying death taxes are Illinois, Maine, Maryland, Massachusetts, Minnesota, Nebraska, New Jersey, New York, North Carolina, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, Tennessee, Vermont, Virginia and Wisconsin.

Tax Myth-of-the-Month

"A Roth IRA is Almost Always Better than a Traditional IRA"

This myth can be found in the July 2005 *Reader's Digest* reprint of a *Kiplinger Personal Finance Magazine* report. "With its promise of tax-free withdrawals in retirement, the Roth IRA is almost always the better choice…." Their case hinges on the fact that many investments held inside IRAs yield low-tax long-term capital gains and dividends, and that Roth IRAs require no minimum distributions after age 70 1/2 as do traditional IRAs. All the same arguments hold true for traditional 401Ks vs. Roth 401Ks, as well as for other deductible retirement plan contributions vs. Roth's. While their points are correct, these advantages do not "almost always" trump the traditional IRA.

First, lower tax rates on long-term gains and dividends are due to expire in 2009. We have no idea what such rates will be in five years, much less in the 20 or 30 many have before hitting retirement age. I wouldn't want to bet the farm on any particular tax regime for future planning.

Second, while Roth's require no minimum distributions, most retirees need cash to live on. Actual withdrawals exceed the required minimum distribution by most retirees in many years. At best, this is an argument to hedge one's bets, not to invest every dime in Roth's.

Third, those in 25% or higher tax brackets while working will likely be in equal or lower brackets during retirement. Those who were eligible for either traditional or Roth IRAs are better off with the former if they end up in a lower bracket during periods of withdrawal. The math works out equally for those in the same bracket: $10,000 invested pre-tax equals $7,500 invested post-tax if the $10,000 is later subject to the same 25% tax rate, assuming identical investments. In other words, as Rolf Auster, CPA puts it in an excellent article on Roth conversions in the May 2005 issue of *Practical Tax Strategies*, "traditional and Roth IRAs are mathematically and economically identical at any given tax rate." In addition, he points out that the conversion decision (should you convert an IRA to a Roth?) is identical to the decision of whether to contribute to a traditional or Roth IRA in the first place.

Fourth, those in high tax states who later retire in low-tax or no-tax states have an additional incentive to invest in pre-tax plans. After moving, the former home state has no claim on retirement funds. Several clients who have retired to Nevada saved 37% (the old 28% federal rate plus 9% state rate) on retirement contributions and are now paying 15% on withdrawals. Nice arbitrage.

Over-generalizations such as "Roths are almost always better" are dangerous for one's financial health. As always, all the possibilities, advantages and benefits should be considered with a healthy dose of skepticism as to our ability to predict the future. While I'm far more comfortable with generalizing that those in the federal 15% bracket should stick to Roth IRAs and the upcoming Roth 401Ks, even here there are exceptions.

Misleading Financial Advertisements

Last year's winners for misleading financial advertisements, including those that err by omission, centered on donations of motor vehicles. It's difficult to select any one as this year's winner, but the contenders are:

1. "Cash Call," which runs a very unpleasant ad seemingly every half hour on my favorite FM station, "smooth jazz" 94.7, with the slogan "call today, cash tomorrow." Money can be wired within a day in an amount of $2,600 to $20,000 for a mere (unadvertised) 18-40% annual percentage rate. Why are they advertising so heavily now? Perhaps because by the time the debt becomes almost insurmountable for anyone to repay, the new bankruptcy law will have kicked in, increasing the odds that "cash call" will ultimately collect.

2. Advertisements that continue to request charitable donations of used vehicles. New legislation allows a deduction in excess of $500 only for the actual amount for which a charity is able to sell a car, usually far less than its theoretical "fair market value." Charities are using a loophole that allows a deduction for the market value when it keeps and uses the car or makes a bargain sale of the donated vehicle in "direct furtherance" of its charitable mission (i.e., sells it to a needy person at well below private market value). However, a new regulation effectively knocks out any reasonable deduction: the "fair market value" is now defined as the "private party" price, which is often a fraction of "dealer" price. The concept of "fair market value," or "the price a willing buyer pays a willing seller," is terribly vague. "The price a willing private party is willing to pay a willing private party" can be far lower than "the price a willing private party is willing to pay a willing dealer."

3. The HMS Capital loan, also known as "The Bill Handel" loan, advertised extensively on talk radio. It's actually a very interesting idea that can go horribly wrong, which I suppose is the reason Handel, the brilliant and very amusing KFI 640am talk radio host 5-9am weekdays and 6-11am Saturdays (with "Handel on the Law"), forthrightly states the loan is for "sophisticated" people with good credit ratings. Its uniqueness lies in the fact that it acts as a credit line to the extent paid down. If you start with a $300,000 loan and pay it down to $200,000, you can re-borrow up to the difference, or $100,000, any time during the first 10 years of the 30-year term of the loan. In addition, you can pay interest only during those first 10 years and to the extent you pay down the loan, drop your required minimum payment accordingly. However, there are at least three downsides. First, after the initial ten years, during which time you can pay interest only, it must be fully amortized, which may result in a far greater payment than anticipated. Second, while the rate starts at 1.5% below prime (currently, the prime is 6.5%), it floats with the prime. If rates increase, you could be in trouble. Third, the interest paid on re-borrowed funds in excess of the first $100,000 is not deductible to the extent used for non-deductible purposes such as paying off consumer debt and purchasing consumer items that are not home improvements. This additional interest is not deductible at all for purposes of calculating the Alternative Minimum Tax. The loan agent with whom I spoke told me he uses this feature of the loan to buy consumer items. He then pays down the loan and re-borrows from time to time. He also told me his CPA informed him that all mortgage indebtedness is deductible up to $1 million regardless of the use of funds. I'll be blunt: he's wrong. Repeatedly paying down the loan and "refilling" it can create a bookkeeping nightmare in terms of allocating deductible and non-deductible mortgage interest.