Inside Highlights

"Suppose you are an idiot—and suppose you were a member of Congress...but I repeat myself."

—Mark Twain

Tax and Financial Strategies

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Wealth Creation Strategies

Who Are You?

You all know me. You know I'm curious and crave knowledge, wisdom, competency and new ideas—a typical INTJ, for those familiar with the Myers-Briggs Type Indicator (in which I am certified). You know I work hard and some of you know I can play hard—I'm a pretty good snow- and water-skier and my wife Marty and I enjoy hiking and traveling. I've held a free-market libertarian philosophy for almost four decades and own some 4,000 books. I love writing and sharing ideas with the goal of helping improve lives, having done so via this newsletter and its predecessors for almost three decades, preparing tax returns and acting as your Enrolled Agent and sometimes Certified Financial Planner. If you've known me for less than ten years, you probably don't know I suffered from a very bad lazy eye until my mid-40s and only a few of you know I had prostate cancer, caught it very early and took care of it. You may know I learned about addiction the hard way, realized that other non-addicts don't have a clue about the malady and that helping to bridge the gap in knowledge about the disease between addicts and non-addicts has become an important part of my life. I've published four books on the subject (including the first ever linking addiction to financial abuse) for which I've received accolades and heartfelt thanks from dozens of people I've never met, along with 45 reviews on Amazon.com, 35 of which are five-star. Now you know more about me than you did and I'd be delighted to share more, should you ask (and yes, ladies, I will suggest that you tell your men to have their PSA checked). But enough about me—let's talk about *you*.

You are an eclectic group ranging from nurses and engineers to plumbers and stunt actors. You are child actors, clerks, contractors, retirees and even other Certified Financial Planners. Several of you are attorneys, deputy district attorneys and police officers. Many of you are photographers, teachers, real estate agents, loan officers, writers, artists and musicians. Several dozen of you have incorporated businesses and each year I prepare returns for over two dozen of your ancestors who left assets in trust.

A few of the unusual occupations in which you are engaged include beekeeper, a baseball scout for the Los Angeles Dodgers (who's 80-years-young) and (oddly enough) three plant nursery owners. In the "six degrees of separation" domain each of you know someone (me) who knows a person who makes his living as an online newsletter publisher, a horse trainer, a chiropractor, a geologist, and a cell phone chip designer—whose product is in every cell phone. Through me, you are connected to a transportation policy researcher who is on a first name basis with several current governors and the current and former U.S. Secretaries of Transportation, as well as a couple who serves on the Board of Directors of the U.S. subsidiary of the international charitable organization Caring for China. You also know, through me, a retiree who modeled for Dior in the 1940s, one who parachuted with the 82nd Airborne Division into Germany during WWll and a good friend and stunt double for actor David Janssen in the long-running TV series "The Fugitive."

Some 20% of you own rental property, about a third have your own small business and, surprisingly, almost 40% have enough funds outside of retirement plans to require the filing of a schedule B (which is filed for anyone with interest or dividends exceeding $1,500). A bit over 3% of you benefited from the low income savers' retirement credit. While some survive on little, with 3% qualifying for the Earned Income Tax Credit, several of you are multi-millionaires without including the value of your main home. About 2% of you qualified in 2006 for a house or car energy savings credit and, sadly, over 15% were stuck paying the Alternative Minimum Tax. A surprising (because almost no one understood my article on the subject) 3.4% began implementing the High-Income Earner Traditional-to-Roth Conversion Strategy by making a non-deductible traditional IRA contribution for 2006. One had a temporary surge in income, made the contribution for '06 and the next day converted it to a Roth at a tax cost of zero. Unfortunately, only a tad over 1% took advantage of Health Savings Account contributions and tax-free withdrawals.

About two-thirds send information via mail-in, drop-off, email or fax, so there are many of you I rarely see. You live all over the United States and there about three dozen whom I have never met in person, including several less than an hour's drive away (but who wants to risk getting stuck in traffic?). Of those I've personally met, there are probably fifty or more I haven't seen in at least a decade and many in over two decades. About a dozen of you married spouses I haven't met but with whom I conduct virtually all our business (I've hardly spoken with you since you married). Almost every one of you was referred by another client and many decided to use our services after reading this newsletter (a hard copy or the one at www.DougThorburn.com), finding that my style fit yours. Almost half of you are married and several are registered domestic partners. Two of you share the same first and last name, are unrelated and not a Smith or a Johnson.

Currently, 81 of you reside in 26 states outside of California, the most interesting of which from a perspective of distance and number of clients are Colorado and Georgia.

In years past, I have had clients reside in or derive income from all but ten states. Your purchases and sales of property in most of these have helped provide the broad perspective about real estate you've read in these letters. Nine of ten have told me you prefer life in your new home state, suggesting that net out-migration could continue.

Clients residing in other states

State	#	State	#	State	#
HI	2	OK	1	NC	4
WA	7	NE	1	TX	4
OR	6	MO	2	GA	7
NV	9	TN	2	FL	3
AZ	8	IL	1	DC	1
ID	2	IN	1	CT	1
UT	2	OH	3	MA	1
MT	1	VA	2	NY	1
CO	8	SC	1		

An update on migration

Clients moving:	2003	2004	2005	2006
Into CA	1	2	1	1
Out of CA	11	9	6	7

Several dozen of you have IQs that I'm sure are well over 140. You have fought diseases the rest of us have never heard of and the usual array we know all too well. You've suffered gut-wrenching divorces and addictions as well as wonderful personal, spiritual and economic success and growth. Many are immigrants (including at least two of the wealthiest) and hail from Argentina, Peru, Chile, Columbia, Mexico, Japan, Taiwan, Hong Kong, Korea, India, Philippine Islands, Canada, Jamaica, Russia, Armenia, Lithuania, Romania, Italy, France, Germany, Britain and, I'm sure, a few others I will hear about soon.

You are, in short, a microcosm of the greatest melting pot the world has ever known and I am truly privileged to know and work for you.

Curiosity and Time to Ponder as an Antidote to Misreading Instructions

Every tax Season brings wonderful examples where I get to dig for the truth, resulting in opportunities raised or problems solved. There were several classic instances this Season, one surprising in its scope. But I almost didn't bring out the shovel.

Boxes on W-2s provide information. If the one marked "retirement plan" is checked, funds are being funneled by employer, employee or both into a 401k, 403(b), profit sharing or other pension plan. This informs us that a traditional IRA isn't deductible if Adjusted Gross Income (AGI) exceeds the phase-out range **. Since the marginal tax rate for such taxpayers (depending on other deductions) is often 25% or higher, a traditional IRA may be preferred over a Roth IRA, but is precluded if the box is checked (in which case, a Roth is suggested if AGI doesn't exceed the Roth IRA limits). Because of the ramifications, it's essential that the box is correctly marked. In fact, we depend on it.

Occasionally I have questioned the checkmark but almost always found that our client was in an employer-provided pension that, because the employee didn't fund it, was all but invisible. In early April, however, I wondered about the information conveyed on one W-2. My client was taxed at a high enough marginal rate for me to suggest a traditional IRA, but the "retirement plan" box was checked. I often approach such challenges to information indirectly and commented, "Too bad you're in a retirement plan, although I can see it's not a 401k," which would have been apparent. There was no response. Intent on eliciting the truth, I added, "On the other hand, I'm surprised your employer, a temp agency, is funding a pension." My client responded, "I don't have a pension!"

A series of phone calls to and from the employer's payroll department ensued. I discovered that the employer's adviser thought the box should be checked if the employer *offered* a 401k. When I told her that was not correct she pointed to page 13 of the 16-page instruction manual for properly completing the half page form W-2 and said "there!" I then proceeded to show her she'd misunderstood the instructions. After a bit of wrangling, she apologized (profusely, to her credit) and told me she'd issue a corrected W-2 with the box un-checked. My client was in fact eligible to make a prior year deductible contribution of up to $4,000 to his traditional IRA, and with a corrected W-2, the IRS would know this was allowable.

As the only person to raise the question, I figured my client must have been unusual (he should, after all, have enrolled in the optional 401k). Curious, I asked the adviser how many other W-2s she'd have to correct. "About 300," she responded. I almost gasped, considering that 300 or so taxpayers didn't think they could make deductible IRA contributions because of erroneous information on their W-2's. Unfortunately, it was about April 12 when all this transpired, probably too late for most of the other employees. My client made his contribution and saved over $1200.

Perhaps few of the other recipients of incorrect W-2s would have contributed to IRAs had they been accurately informed of the deductibility. However, I should have asked the question the year before. My client had the same employer with the same box improperly checked. It was April 2006 and I was perhaps even more crazed after doing 75-hour work weeks for ten weeks than in April 2007. My client promised he'd be first in 2008. Hint: the best time for me to ponder radical ideas such as, "Maybe the W-2 is wrong," is January-February.

**For 2007, $80,000 to $90,000 for joint filers and $50,000 to $60,000 for single taxpayers.

"What Tax Bracket Am I In?"

At some point, this is a question almost every taxpayer asks. The response is far more complicated than Albert Einstein, who famously declared he could not prepare his own tax return (when the law was far simpler), could possibly have imagined. Before even beginning to respond, the Enrolled Agent tax professional must ascertain the purpose of the question and, in particular, what kind of income or deduction is being contemplated and how much is at stake?

There are three reasons the simple question, "What tax bracket am I in?" is meaningless without further clarification:

1) The incremental tax on additional income and the incremental savings from additional deductions are frequently not the same, even though the additional income and deductions are all within the same advertised tax bracket.

2) The tax on different types of income and tax savings on different deductions can be radically different, even though the additional income and deductions are all within the same advertised tax bracket.

3) The additional tax and savings may change abruptly when countless thresholds are reached—again, *even though the additional income and deductions are all within the same advertised tax bracket.*

Therefore, the question must be split into three. Far more verbose but more accurately:

1) How much additional tax will I pay on an additional chunk of [name type of income] income?

2) How much will my tax drop on an additional chunk of [name deduction] deductions?

3) How much additional income/deductions of this type can I earn/deduct before the percentage cost/savings change, and what is the percent cost or savings above or below that point?

The first question is required due to the fact that different types of income are taxed at different rates. For example, a taxpayer in the nominal 15% bracket pays only 5% federal income tax on long-term capital gains, 15% on ordinary income and roughly 30% on self-employment earnings.

The second is necessitated by virtue of the fact that deductions can save zero for a taxpayer in the 15% tax bracket who doesn't itemize, 15% for one who does, 30% on expenses offsetting net business income (but only 15% for one with a business loss) and 50% or more from phase-ins of the Low-Income Savers Retirement Credit and Earned Income Credit.

The third question is essential because real tax rates can change instantly and dramatically once certain thresholds are breached. The result is a series of convoluted, oddball, "unseen" tax brackets that defy logic and common sense, but which sometimes create large tax-savings opportunities.

A well-known talk radio financial guru recently told his audience that unlike three decades ago when marginal tax rates were as high as 70%, there are no longer any great ways to save on taxes. His implication seemed to be that with maximum stated rates of "only" 35%, our focus should be on the production of income and creation of wealth. While those goals should be the center of attention (within ethical boundries, of course) the crazy-quilt pattern of unseen brackets creates opportunities that should not be ignored. Nominal tax brackets are still set too high and effective tax rates are, in many instances, far higher than advertised. Because of this, legal tax avoidance can rationally supplement sound financial planning principles and wealth-building strategies not only at income levels we would assume, but also at income levels we might not otherwise consider.

"Advertised" Tax Brackets (2007)

Advertised tax bracket	Single, up to taxable income of:	Head of Household, up to taxable income of:	Married Filing Joint, up to taxable income of:	Married Filing Separate, up to taxable income of:
10	$7,825	$11,200	$15,650	$7,825
15	$31,850	$42,650	$63,700	$31,850
25	$77,100	$110,100	$128,500	$64,250
28	$160,850	$178, 350	$195,850	$97,925
33	$349,700	$349, 700	$349, 700	$174, 850
35	Infinite	Infinite	Infinite	Infinite

Common "unseen" tax brackets

Here are some examples of just a few of the officially non-existent tax brackets, who they can affect and what opportunities may arise for those affected.

The Child Tax Credit

Real tax rate: 30% (39% CA state) on additional income for those who are in the advertised 25% bracket.

Who's affected: Taxpayers qualifying for the child tax credit with **Adjusted Gross Income (AGI)** in the child tax credit phase-out range and taxable income in the advertised 25% bracket. This includes married taxpayers with one qualifying dependent child under age 17 and AGI between $110,000 and $130,000 and those with two qualifying children and AGI up to $150,000. It also includes single parents with AGI between $75,000 and $95,000 for one qualifying dependent and up to $115,000 for those with two such dependents (and an additional $20,000 for each additional qualifying dependent).

Opportunity: Taxpayers who think they are saving 25% on such "above-the-line" deductions as 401k contributions and deductible traditional IRAs are actually saving 30% plus their state income tax, often making an increase in such deductions a "no-brainer" to the extent allowable.

Real v. Advertised Rates for the Child Tax Credit: Married **

AGI Over	**Real Tax Bracket One Child Under 17**	**Real Tax Bracket Two Children Under 17**	**Advertised Tax Bracket**
$100,000	25%	25%	25%
$110,000	30%	30%	25%
$130,000	25%	30%	25%
$150,000	25%	25%	25%

** Married Filing Joint with taxable income over $63,700 and less than $128,500

Real v. Advertised Rates for the Child Tax Credit: Single **

AGI Over	**Real Tax Bracket One Child Under 17**	**Real Tax Bracket Two Children Under 17**	**Advertised Tax Bracket**
$65,000	25%	25%	25%
$75,000	30%	30%	25%
$95,000	25%	30%	25%
$115,000	25%	25%	25%

** Single with taxable income over $31,850 and less than $77,100 or Head of Household with taxable income over $42,650 and less than $110,100

The Tuition Deduction

Real tax cost or savings: up to 5,210% for those in the advertised 25% bracket.

Who's affected: Taxpayers at or near the phase-out range qualifying for the tuition deduction. The maximum allowable tuition deduction drops from $4,000 to $2,000 for married taxpayers the instant AGI crosses $130,000 and from $2,000 to zero when AGI jumps even $1 over $160,000. Conversely, the deduction jumps from $2,000 to $4,000 when AGI drops below $130,000.

Opportunity: A couple with expected AGI of, say, $131,000 and tuition somewhere in excess of $2,000 should, if possible, increase their retirement plan (401k, 403b, SEPP or deductable IRA) contributions by $1,000, which increases the tuition deduction by up to $2,000. For example, a couple paying tuition of $4,000 or more would save 25% of a $3,000 ($1,000 retirement plan plus $2,000 additional allowable tuition deduction) increase in deductions, or $750. If they also have a child who qualifies for the child tax credit, the savings increases to 30% of the $3,000 reduction in income, or $900. A California taxpayer saves another 9.3% of the $1,000 retirement plan contribution, bringing the total savings to $993. Not a bad return on a $1,000 investment.

Real v. Advertised Rates for Retirement Plan/Tuition Deduction for Hypothetical Taxpayer with $130,500 Total Income

Increase 401k, etc. by:	Allowable Tuition Deduction	Tax **	Additional Tax Saved	**Real Tax Bracket**	**Advertised Tax Bracket**
0	2,000	15,965			25%
499	2,000	15,836	129	26%	25%
500	4,000	15,315	521	**5,210%**	**25%**
1,000	4,000	15,185	130	26%	25%

** Married couple starting with taxable income of about $86,000 before additional retirement plan deduction and subject to the Alternative Minimum Tax.

Real-life situation: The additional savings on a $1,000 IRA contribution was ($129 + $521 + $130 =) $780, or 78% of the contribution. They could have saved ($129 + $521 =) $650 on a $500 contribution, for a 130% savings.

But various kinds of income and deductions are not created equal. Here is a sampling of the various real tax brackets this hypothetical taxpayer is subject to, all at the same time.

Tax cost or savings on an additional $1,000 of income or deduction for this taxpayer

Type of Income or Deduction	Tax Increase or Decrease	**Real Tax Bracket**	**Advertised Tax Bracket**
All ordinary income	$250	26%	25%
Wages, under Social Security maximum	$326.50	33.65%	32.65%
Long-term capital gains	$150	15%	15%
Self-employment income	$383	38.3%	40.3%
IRA, 401k, 403b, SEPP	($780)	**78%**	**25%**
Property tax	$0	**0%**	**25%**
Mortgage interest	($260)	26%	25%
Charitable donations	($260)	26%	25%
Employee business & investment expenses	0%	0%	25%

The Alternative Minimum Tax Phase-in

Real tax rate: 35% (plus state) for those who are in the advertised 28% bracket.

Who's affected: Taxpayers subjected to the **Alternative Minimum Tax (AMT)** whose taxable income exceeds $128,500 ($77,100 single and $110,100 Head of Household). Add state tax and the savings for retirement plan contributions swells to 44.3%.

Opportunity: Increase 401k and other pension contributions.

The Alternative Minimum Tax and Certain Deductions

Real tax savings: 0% on deductions such as property tax and employee business expenses for those who think they are in the advertised 25% bracket or higher.

Who's affected: Taxpayers for whom the AMT is larger than the regular tax. Property taxes are "deductible," yet don't save a federal dime for those subject to the AMT. This is also true for employee business and investment expenses, as well as certain other deductions and credits. The real-life example above is a case in point.

Opportunity: Since the savings for additional property taxes are zero, improving an existing home (little if any increase in property tax) may be preferable to buying a new one (could suffer a substantial increase in property tax). Other strategies apply to other deductions.

Low Income Savers Retirement Credit and IRA or Certain Other Qualified Plans

Real tax savings: often 25-55% and even higher for those in the 10-15% advertised tax bracket.

Who's affected: Those who qualify for the **Low Income Savers Retirement Credit (LISCR)**. The credit drops from 50% to 20% of allowable contributions the instant AGI exceeds $15,000 single/$22,500 Head of Household/$30,000 married.

Opportunity: Take advantage of the LISCR up to the point at which the credit is triggered and save up to $1,000, or the actual remaining tax liability if less.

Real v. Advertised Rates for the Savers Retirement Credit—Example

Traditional IRA contribution	AGI	LISCR Credit	Net Tax After Credit**	*Incremental* Tax Savings	**Real Tax Bracket**	**Advertised Tax Bracket**
0	$25,000		$1,590			15%
$500	$24,500	$50	$1,465	$125	25%	15%
$1,000	$23,000	$200	$1,240	$225	**45%**	**15%**
$2,000	$22,600	$400	$890	$350	35%	15%
$2,400	$2,400	$400	$830	$60	15%	15%
$2,500	$22,500	$1,000	$215	$615	**615%**	**15%**

** Unmarried head of household and forgoing the dependency deduction for the child.

The overall savings resulting from a $2,500 IRA contribution for this taxpayer is $1,375, or 55% of the total, making this one of those "no-brainers" I often mention—if funds are available. Another view: the out-of-pocket cost for a $2,500 investment is $1,125. Wow.

Alternative Minimum Tax Phase-Out

Real tax rate: 28% for those in the 35% advertised tax bracket.

Who's affected: Taxpayers with AMT taxable income in the AMT phase-out range, which generally begins to get phased out at $400,000 ($282,000 for single taxpayers) and is generally fully phased out when AMT income (which is often close to the AGI) reaches $600,000 ($500,000 for single filers). The marginal tax bracket is 20% less than the advertised one (28% vs 35%).

Opportunity: Create additional income via a traditional-to-Roth conversion, by realizing capital gains or some other measure.

Real v. Advertised Rates for the AMT Phase-Out—Example

AGI	Tax	Tax Increase	Real Tax Bracket	Advertised Tax Bracket
$416,000	100,669			35%
$426,000	103,988	3,319	33.19%	35%
$436,000 *	106,788	2,800	**28%**	**35%**
$446,000	109,588	2,800	28%	35%
$496,000	123,588	14,000	28%	35%
$506,000	126,951	3,363	33.63%	35%
$516,000	130,521	3,570	35.7%	35%

* Note that $60,000 additional income can be earned at a 28% real tax rate.

It Pays to Plan

Most taxpayers will never know if one of the countless phantom real tax brackets hits home. Until our government gets more honest, spending the time to deal with such deceitful tax brackets can more than pay for itself. In the next issue of *Wealth Creation Strategies* you'll see how painful these real tax brackets can be for retirees with Social Security income, but also how splitting income among two or more years or taking more in one year than would intuitively make sense can dramatically reduce the long-term tax bill.