Inside Highlights

- **Earthquake Insurance: Time to buy? pp. 1-5**
- **Dear Doug: Should I buy gold with IRA funds? p. 5**
- **Medicare premium surcharge: Another reason for Roth conversions pp. 6-7**
- **Dear Doug: Confused over Roth conversions vs. Roth contributions pp. 7-8**
- **Dear Doug: What if I need converted funds? p. 8**

"Interest rates are integral to the pricing of assets. A country without an interest rate has a stock market with a price, but not a value."

—Frederick J. Sheehan (www.aucontrarian.com)

"Fed-created liquidity...has vastly exceeded any productive use and has instead fueled asset inflation and speculation....[and] liquidity-driven speculative frenzies tend to end badly."

—Randall Forsyth, Barron's

Tax and Financial Strategies

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WEALTH CREATION STRATEGIES

Is Earthquake Insurance Worth the Price? The Japanese 9.0 Makes Us Think About The Big One. Premiums Have Dropped; It's Time to Reconsider.

The recent disaster in Japan, with a devastating tsunami following the undersea earthquake, raised an interesting question: should I purchase earthquake insurance? I last wrote on the subject 15 years ago, shortly after I eliminated our coverage because premiums, deductibles and exclusions had skyrocketed after the Northridge earthquake and I felt the benefits of insurance were no longer worth the price. Perhaps as a residual effect of those higher premiums, the gradual but dramatic reduction in premiums since seems to have gone unnoticed. Currently only 12% of Californians with homeowners insurance have earthquake coverage. Yet it's a much better value now than at any time since the Northridge quake. This doesn't count the fact that the odds of a destructive earthquake increase every year we go without one—and California hasn't been hit hard for nearly 20 years.

A chimney is not a home and other factors

Several key factors enter into the equation as to whether or not earthquake insurance is likely a good value: the cost of premiums, the insurance deductible, an estimate of the damage insurance would cover should an earthquake occur and, last but not least, tax consequences for both premium payments and any uninsured losses. Net equity in your property also matters; we'll assume you have enough equity to make insurance worth considering (or that you care enough about your credit or moral issues to insure your lender). The present value of the premium payments matters as well—in other words, would you invest the premiums you otherwise would pay and, if so, what might you earn on those premiums until the Big One happens? These factors and a few examples may help you decide what's best (and of course we're available to consult on such matters). However, there's no cut and dried answer as to whether the expense is worth the potential benefit, which under standard California policies offer only limited coverage for contents and temporary living costs and never include any repairs outside of your house.* This is not a Cadillac policy.

Premiums can be amazingly inexpensive in overlooked areas that could suffer catastrophic losses, including the area of the New Madrid earthquakes of 1812 near Memphis, TN. Long before the Richter scale was invented these temblors were felt a thousand miles away, suggesting an event of at least a magnitude 8.0. Because it's been nearly 200 years since a major earthquake in the country's mid-section, premiums can run as little as a few hundred dollars a year for a 2,000-5,000 square foot building (which may not even be built to withstand a moderate earthquake). This compares favorably with the $2,000 that coverage used to run for a 2,000 square foot home in earthquake-prone areas of California. On the other hand, after the decline in rates over the last decade and a half, coverage for such a home may run as little as $1,000 and even less (in fact, some areas, such as Bakersfield, are inexplicably and ridiculously low-priced). You can find an estimate for the cost of covering your California property (one-to-four unit residential buildings only) at www.earthquakeauthority.com. (According to my insurance agent the private-public partnership insurer, the California Earthquake Authority, appears to be well-funded despite its government origins, partly due to reinsurance back-up from participating private insurers.)

Moderately large deductibles vs. huge unaffordable ones

The deductible, however, was and is a big concern. Moderately large deductibles, the amount for which you are "self-insured," are generally profitable over the long-run. You will almost always save much more in premiums in the long run with $1,000-$3,000 deductibles on all property and casualty

insurance policies—homes, rental properties, motor vehicles, business and liability coverage—than you will ever collect in insurance reimbursements for insured events. However, since a 15%-of-total-value deductible is normal for earthquake insurance (although 10% deductibles are now available as well), a $200,000 structure is uninsured on the first $30,000 (or $20,000) of damage. Such large out-of-pocket deductibles, which essentially make you the insurer up to the amount of the deductibles, are unaffordable for many and nearly eliminate the value of third-party insurance coverage in moderate-sized earthquakes. This is why a rational analysis requires an estimate of likely *covered* damage from The Big One, or from the Sierra Madre fault system if you happen to live near it (or any other fault capable of blowing a 7.5 magnitude quake).

The 6.7 magnitude Northridge earthquake over 17 years ago reportedly caused nearly $40,000 in damage to the home I purchased shortly after the quake (and after the badly done repairs had been made—keep in mind, construction workers are very busy and often not sober after such catastrophes). If construction costs have matched the increase in the cost of living since, similar repairs would run $60,000 today. Our homeowners' insurance policy is $400,000, 15% of which is $60,000. We'd pay the $1,200 yearly premium that www.earthquakeauthority.com estimates earthquake coverage would cost for exactly no coverage at all if it happened all over again (the damage wouldn't exceed the deductible). We could pay $1,750 for a 10% deductible, which might pay out up to $20,000, for which we'd need a major event once every 11.4 years ($20,000 divided by $1,750) to break even. This doesn't take into account that much of the damage was to outdoor structures, which no longer are even covered.

However, there were plenty of homes that sustained $150,000 in damage ($225,000 in today's dollars). These were mostly two-story homes without shear wall or one-story homes in areas of liquefaction (such as near the Los Angeles Riverbed through parts of Sherman Oaks, where the ground shook like jelly). I'd likely suggest the purchase of earthquake insurance for anyone living in a two-story home or on soft ground [even at $2,000 in yearly premiums, with one event causing $225,000 in damage every 82.5 years ($225k - $60k = $165k divided by $2,000), you'd statistically break even with such coverage—not counting tax consequences, described below]. The question is what will the inevitable San Andreas 8.0 earthquake (or 7.5-magnitude Sierra Madre fault system event) do to structures? While there is no hard research showing what a given magnitude earthquake "feels" like at various distances from the epicenter (due to variability of soil and other geological conditions), I'm willing to bet that our Northridge home, which is about 50 miles from the nearest point on the San Andreas fault and 20 miles from the nearest point on the Sierra Madre fault system, would likely suffer no more damage in those earthquakes than in the Northridge quake, which was right underneath it. Seismologist Lucy Jones of the U.S. Geological Survey at the California Institute of Technology (Caltech) agrees with my thinking, but pointed out we can't prove this without an actual test. She also observed that wherever you are in the L.A. area there's a fault capable of blowing off a 6.5-magnitude quake within ten miles and that if your house hasn't been through a quake already, you really don't know what the outcome will be.** The office house six miles from the rupture suffered only $14,000 in damage, which isn't surprising since most single-story frame-construction houses will likely withstand the maximum estimated 8.2 San Andreas event right underneath (meaning they won't collapse, even if they suffer a lot of damage).

Tax consequences, while often overlooked, may play a determining role in deciding whether earthquake coverage is worth purchasing at current prices. There are potentially huge differences in tax savings from a loss depending on whether the damage is to your residence or income property, the property's "**basis**" (generally, cost or inherited value less depreciation for tax purposes) and your personal tax situation. At the risk of losing 90% of my audience, it's time to talk about the tax aspects of earthquake insurance.

What is "basis"?

Basis = { original cost plus improvements less depreciation for tax purposes
OR
value on date of inheritance plus improvements since inheritance less depreciation for tax purposes

Your loss probably is not your deduction

Tax savings don't significantly change the math on a $225,000 loss: if such a loss is possible, earthquake insurance is probably a good value at today's lower rates. However, the tax savings from a less catastrophic loss can make self-insurance more desirable and earthquake insurance much less so than if taxes were not an issue. The tax savings essentially acts like a limited form of insurance: your out-of-pocket loss is reduced by both insurance and any tax savings resulting from a deductible loss. Bear in mind, however, that if your tax bracket is low, your tax savings will be minimal or non-existent. Let's first look at the tax effect of losses on your home or 2nd home. We'll assume a high enough tax bracket*** to make the tax savings worth counting when deciding whether to obtain insurance.

Losses on primary and secondary residences are deductible only to the extent actual damage exceeds 10% of your Adjusted Gross Income plus $100 (isn't that silly? Like $100 is going to make a significant difference—which it won't, so we'll ignore it.). The deduction counts only after your actual itemized deductions exceed the standard deduction.**** We'll assume you're already itemizing or close to doing so.

Should you insure your home?
Let's assume a $100,000 loss on your California residence, for which the replacement cost and, therefore, insurance coverage is $300,000. Your earthquake deductible, at 15% of total coverage, would be $45,000 (or $30,000 with a 10% deductible). Insurance would pay $55,000 (or $70,000 with that smaller deductible). If your income is $200,000*** you'd likely save about $9,000 in taxes on your $45,000 out-of-pocket loss ($45,000 less 10% of AGI or $20,000, times 36% tax savings), for a total of $64,000 in insurance and tax savings. Your net out-of-pocket cost, then, would be $36,000.

Without insurance, assuming your "basis" is high enough (discussed next) you'll end up with an $80,000 deductible loss ($100,000 loss less 10% of AGI, or $20,000), which will likely save about $29,000 in tax and leave you $71,000 out of pocket. The difference between having insurance and not having it is, in this instance, about ($71,000 less $36,000 =) $35,000. If coverage costs $1,000 per year (non-deductible, since this is your home), you break even if such an event occurs once every 35 years (so if you were to sustain this level of loss every 35 years or more frequently, you're statistically better off buying the coverage).

Out-of-pocket on your $300,000 home, yearly policy cost = $1,000, high bracket taxpayer: Insured vs. Uninsured

$100,000 Loss	**Insured event**	**Uninsured**	Savings with insurance	Years to breakeven w/o insurance *****
Loss	$100,000	$100,000		
Deductible	$45,000	$100,000		
Tax savings	($9,000)	($29,000)		
Your cost	**$36,000**	**$71,000**	$35,000	**35 years**

However, deductible losses are limited by your "basis" in the property. If your home including improvements cost only $50,000, your deductible loss is limited to ($50,000 less 10% of AGI, or $20,000 =) $30,000, the tax savings from which is probably no more than $10,500 for the same taxpayer. A loss without coverage would cost, then, $89,500. Earthquake coverage would reimburse $55,000 which, with $9,000 in tax savings ($45,000 deductible less 10% of AGI, or $20,000 = $25,000 x 36% tax rate), results in total insurance and tax-savings "coverage" of $64,000, resulting in a net cost of $36,000. The ($89,500 minus $36,000 =) $53,500 difference means that an insured earthquake victim suffering the same loss as above but with far lower "basis" breaks even on the cost of premiums if such an event statistically occurs at least once in every 53.5 years. Note that a $225,000 loss would be catastrophic for such an individual without insurance: *the tax savings from a loss caps out at $10,500 due to the "basis" limitation on the tax deduction*, leaving this uninsured victim out-of-pocket by $214,500. Low-income taxpayers may also save little or nothing in taxes regardless of the size of the loss. Insurance, then, may be a particularly good value for a homeowner with a large possible loss and low cost basis in his home or a projected small tax savings.

Out-of-pocket on your $300,000 home, yearly policy cost = $1,000, low-income taxpayer or one with low basis: Insured vs. Uninsured

$100,000 Loss	**Insured event**	**Uninsured**	Savings with insurance	Years to breakeven w/o insurance *****
Loss	$100,000	$100,000		
Deductible	$45,000	$100,000		
Tax savings	($9,000)	($10,500)		
Your cost	**$36,000**	**$89,500**	$53,500	**53.5 years**

$225,000 Loss	**Insured event**	**Uninsured**	Savings with insurance	Years to breakeven w/o insurance *****
Loss	$225,000	$225,000		
Deductible	$45,000	$225,000		
Tax savings	($9,000)	($10,500)		
Your cost	**$36,000**	**$214,500**	$178,500	**178.5 years**

What about your rental property?
On the other hand, earthquake and other casualty losses on rental properties are fully deductible without regard to income (and without regard to passive loss limitations, which ordinarily limit overall net rental property losses to a maximum of $25,000 per year, with any excess carried forward). The fact that losses are fully deductible on rental properties makes such losses more affordable, especially for those in higher tax brackets. However, the breakeven point for deciding whether to purchase such insurance is quite different, largely due to the deductibility of premiums, deductibility of losses without regard to income and lower basis for similar properties due to depreciation.

Assuming a $100,000 loss on your California rental property, for which the replacement cost (and, therefore, insurance coverage) is $300,000, your earthquake deductible (at 15% of coverage) would be $45,000 (or $30,000 with a 10% deductible). Insurance would, as with your home, reimburse $55,000 (or $70,000 with that smaller deductible). Assuming a 35-38% tax bracket, you'd save roughly $16,000 in tax on the $45,000 out-of-pocket loss, for a total of $71,000 in insurance and tax savings, leaving you $29,000 out of pocket.

Without insurance, with no "10% of income" limitation, you'll end up with a $100,000 deductible loss (assuming your "basis" is high enough—discussed next), which will likely save nearly $36,000 in tax and leave you $64,000 out of pocket. The difference in out-of-pocket costs in this example, then, between having and not having insurance is ($71,000 less $36,000 =) $35,000. Because the premium paid on a rental property is deductible (assuming the passive loss limitations don't preclude a current deduction) the after-tax cost of a $1,000 yearly premium is $650 for those in the 35% combined federal-state tax bracket. You break even if such an event occurs once every ($35,000 divided by $650 =) 53 years (so if this level of loss is likely at least once in 53 years statistically-speaking you'd buy the coverage).

The "basis" problem is a bigger and more common one for rental properties. A property may have cost $200,000, but your after-depreciation basis may be down to land value if fully depreciated. While the actual cost of repairs might theoretically be deductible, the overall tax deduction may be limited due to the $25,000 loss limitation (or zero if your income is over $150,000). This increases the value of earthquake coverage for any property with a low basis.

Is earthquake insurance worth the premium?

Tendency: purchase earthquake insurance if:	Tendency: do not purchase earthquake insurance if:
Live on or near major known fault	Live far from major known fault
Multi-story property	Single story property
"Soft" ground (liquefaction possible)	Home is on solid ground, not swampy landfill
Low "basis" (and for rentals, repairs may be limited due to passive loss limits)	High "basis" (after-depreciation on rental property)
Low premium	High premium
You will never save and invest the premiums	You will invest the premiums and earn a high rate of return on those investments
Plenty of net equity (which if a rental implies large net income potential)	Little or no net equity
Personal risk tolerance is low	Personal risk tolerance is high

After weighing the variables, we've tentatively opted to forego coverage on our Northridge home but obtain coverage on our Granada Hills rental property (which happens to be our office) primarily due to low post-depreciation basis (this analysis forced me to change my view of things!). Of course, if the San Andreas breaks tomorrow or, in a more moderate quake, the slab cracks down the middle of our home, we'll wish our home was insured as well. If it doesn't happen in our lifetimes, we'll wish we'd saved our money. But that's what property and casualty insurance—fire, homeowner, vehicle and, yes, even earthquake coverage—is all about!

* Pool houses, pools, guest houses unless regularly used (separate policy may be required), decks, patios, decorative brick and walkways (except to the extent of providing safe passage into your home) are all excluded and chimney repairs are limited to $5,000. The basic policy covers only $5,000 in contents. While additional coverage can be purchased, the policy never covers obviously breakable items (china, crystal and the like).

** Ms. Jones also pointed out that many builders have been known to cheat on the codes. In addition, if you have a pre-'94 home with a crawl space or basement, unless it has been retrofitted by attaching the cement foundation to the wood framing, even your single-story home is susceptible to severe damage and possible collapse if it does not have shear walls.

*** You may be able to increase your income by enough to "use up" the lower 15% tax bracket via Roth conversions in the year of the loss—yet another propitious use for such conversions. Of course, if the quake occurs near the end of December and the strategy takes a bit of time to implement, you may be out of luck.

**** For 2011, $5,800 for single people, $8,500 for heads of households and $11,600 for joint filers; for those 65 and over add $1,450 for singles and heads of households and $1,150 per person for joint filers. In addition, for über-geeks, casualty losses are deductible for purposes of calculating the alternative minimum tax.

***** This does not include an adjustment for having invested those premiums for all those years. The longer you have to invest before a destructive earthquake occurs and the higher the rate of return, the shorter the time-frame needed to break even without insurance. For example, a $1,000 yearly investment over 22 years earning 3% after inflation and tax grows to nearly $35,000, reducing the breakeven point for how often you need an insurable event to have made the insurance worth the premiums to about 22 years in the first "insured vs. uninsured" table. Because an earthquake could occur long before an accumulation of invested premiums becomes substantial, we've gone so long without a major event and the after tax post-inflation rate of return in the current investment climate could be tiny, I've chosen to ignore this factor. You may want to consider it.

Dear Doug: Should I Buy Gold Inside my IRA?

Dear Doug,

Do you think putting money from my IRA into metals is a good idea? What are the tax implications? I keep hearing/reading that double digit inflation could wipe out my savings.

Regards,
Worried about inflation

Dear Worried,

In my opinion, absolutely not.

First, you'll pay extra for an IRA in which you are allowed to hold metals. Ordinary bank and brokerage account IRA trustees do not hold physical metals; you'd need a special custodial account, which costs several hundred dollars a year. If you're thinking about taking the money out of the IRA and buying metals, you'll pay tax (and possibly penalty) on the withdrawal.

Second, metals are at far greater risk of government confiscation than shares of companies. Stocks that might be considered "metal substitutes"—mining companies—are probably less likely to be taken in any "national emergency," and in fact have done well in past deflationary *and* inflationary times.

Third, and this is more an answer to the implied question, "should I own metals," consider how the inflation in housing occurred: easy money and artificially low interest rates, which translated into excessive borrowing, allowed buyers to pay more for properties than they would have otherwise, thereby driving up prices.

Now consider what happens if the opposite occurs.

The Federal Reserve, rightly maligned by those who believe that gold is money, controls about $3 trillion in "cash" but has little control over $50 trillion of "debt." If you redefine "money supply" from the usual "cash" to "cash and credit," you may conclude that if debt shrinks we will get "deflation." This is quite different from what occurred in the cash economies (where there was little if any debt) of the Weimar Republic (1923's pre-Hitler Germany) and more recently under the despotic rule of Robert Mugabe in Zimbabwe, where excessive "money" printing induced hyperinflations.

That's not to say I don't want some metals—but only in hand (and in a very safe place) and preferably purchased at lower prices. Consider the fact that the average inflation-adjusted price of gold over the last 50 years is somewhat less than $500 per ounce and it's currently priced at over three times that long-run average. In addition, the number of years of the last 50 during which the market value has been higher in inflation-adjusted dollars than it is now is less than one. (The same is true of most other metals at this moment, including silver.) Do you really want to bet against 50 years of history?

Then why has the price of metals skyrocketed over the last several years (especially since mid '09)? Zero interest rates may have a lot to do with it. It essentially costs almost nothing in foregone interest to hold metals, or any other commodity (and stocks, too), which increases the demand for such commodities (and stocks) and drives up their prices. Now consider the opposite: what happens if (when) interest rates skyrocket (which won't require much of an increase in short-term rates—moving from less than 1% to the long-term average of an estimated 5% is a 400% increase)? Federal Reserve Chairman Ben Bernanke has stated he wants to keep interest rates low in order to persuade people to invest in risky assets. It would be a gross understatement to suggest the Chairman is supremely arrogant in acting like he knows what the price of money should be (interest rates constitute that price) and what sort of assets investors should put their cash into. I don't see how this can end well. (And note, too: real estate prices crashed during a period of declining to stable interest rates.)

In the long run, I want to own some metals, especially gold: after all, the nature of government cartelized banking systems everywhere is to inflate and debase fiat currency (i.e. "money" not backed by anything more than exotic paper), which means it tends towards worthlessness over time (consider: would you rather own a 1933 $20 gold piece or a 1933 $20 Federal Reserve Note?*). However, I do not see how sustained re-inflation can occur until much of the debt is paid down, renegotiated (with many "owners" of that debt taking "haircuts") and bankrupted. I wouldn't say don't purchase shares of companies that produce such metals, which may be undervalued at current levels vs. the metals themselves. This suggests that if the metals continue to increase in price (which I doubt, but I've learned no one can predict the peak of a parabolic move), the shares could increase by a greater percentage. Conversely, if the metals drop in value, share values of gold and other metal producers may drop by a smaller percentage. You can always purchase such shares inside retirement accounts.

Since you're not the only one who's asked and typically the public is the last to join the bandwagon, the run in metals may be close to an end for now—but as I often tell my wife, I could be wrong. If you think I'm wrong or want to hedge your bets because you own none and are willing to purchase metals at current inflated prices, please do so with previously taxed funds—not retirement accounts. And if you decide to withdraw funds from retirement accounts in order to purchase metals, please first ask us what the tax consequences will be.

* Assistant professor Tom McNamara of the ESC Rennes School of Business in Rennes, France, asked this simple yet brilliant question in a letter to the editor of *The Economist*, June 18, 2011.

Medicare Premium Surcharge for Medicare Recipients: Yet Another Hidden Tax and Phantom Tax Bracket

In "The Wealth of Individuals: Part 8" (Issue #44 of *Wealth Creation Strategies*) I explained why it can be immensely profitable to do Roth conversions before collecting (and, especially, when delaying the start of) Social Security. I also discussed why such conversions often yield large long-term tax savings even while collecting Social Security, especially if married. Because marginal tax rates quickly rise to exorbitant levels on single Social Security recipients with moderate incomes, the opportunity to "income average" via Roth conversions at low tax rates is almost always reduced and often eliminated after a spouse dies. Due to lack of space, I didn't explain an additional reason such conversions can make a heck of a lot of sense: the Medicare premium surcharge.

Sneak attack—only our sneaky government does the attacking

This little gem was quietly added to the law in 2003 for tax years beginning in 2007 (note that the law struck in the next election cycle when we'd all forget who voted for this monstrosity). As is true of so many tax increases it was hidden, in part because it's not called a tax and the "surcharge" is based on income two years prior. So, if income in 2007 exceeded certain thresholds, the surcharge was imposed in 2009 (and likewise the 2010 surcharge was based on 2008 income, etc.) It also went relatively unnoticed because fewer than 5% of seniors were initially affected. However as you will see, when it hits it can hit hard and, because the Obama Anti-Care legislation that promised no tax increases froze the thresholds at which the surcharges strike (hence, beginning in 2011 they are unadjusted for inflation), an estimated 14% of seniors will be affected by this hidden tax and resulting exorbitant phantom tax rates by the end of the decade (and who is willing to bet it won't be more like a quarter to one-half of seniors?!).

Barely exceeding the thresholds can, as you will see below, really hurt. However, without Roth conversions few seniors have much control over their incomes. With the one-year suspension of Required Minimum Distributions (RMDs) for those over age 70 ½ in 2009, many seniors learned all about conversions. The elimination of the $100,000 income limitation for conversions in 2010 caused many more to see the value of using Roth conversions to control and smooth income (which for decades I have referred to as "self income-averaging"). A number of clients are bringing their total incomes to just under the threshold at which the surcharge strikes (and if they go over, they "undo" just enough of the conversion to avoid the surcharge, which would hit, remember, two years later). Many clients with other income and RMDs that will likely increase by enough to trigger the surcharges over the next decade have opted to reduce the amounts left inside traditional IRAs and, therefore, reduce future RMDs by increasing the amounts they are converting to Roth IRAs. The optimal planning strategy is either don't exceed a threshold or create enough income to take you to just below the next higher threshold.

The surcharges at the various income levels follow, which are accurate for most but not all seniors because of an odd combination of events that likely won't reoccur*. Please study this chart. You might see why a number of clients (and it could be anyone over age 55, including you), especially married ones in higher-than-15% marginal tax brackets, have opted to do conversions in order to decrease the odds of the surcharge striking (on top of the exorbitant tax rates discussed in issues #40 and #29 of *WCS*), particularly when there's only one of you left.

Medicare premium surcharges for 2011-2019

Individuals with MAGI[1] of $85,000 or less and married couples with MAGI of $170,000 or less are unaffected.	**Part B Medicare yearly premium surcharge per Medicare recipient[2]**	**Part D Rx drug premium yearly surcharge per Medicare recipient[2]**
Individuals with MAGI above $85,000 up to $107,000 Married couples with MAGI above $170,000 up to $214,000	$553	$144
Individuals with MAGI above $107,000 up to $160,000 Married couples with MAGI above $214,000 up to $320,000	$1384	$373
Individuals with MAGI above $160,000 up to $214,000 Married couples with MAGI above $320,000 up to $428,000	$2214	$601
Individuals with MAGI above $214,000 Married couples with MAGI above $428,000	$3044	$829

[1] **MAGI is** "Modified Adjusted Gross Income," which is **AGI** plus ordinarily non-taxable municipal interest income and a few highly unusual categories of income you probably don't have.

[2] Based on "MAGI" two years earlier. Note that figures in these columns are doubled for married couples if both are on Medicare.

Legal extortion does not enhance productivity

Note the extraordinary phantom tax brackets created by barely exceeding these thresholds. If you're single and income as measured by MAGI is $1 above $85,000, you pay a Medicare premium surcharge of $697 (assuming you opt in to Part D: $553 + $144 = $697). Since the surcharge is based on income, let's call it what it really is: a tax. That's a 6,970% marginal tax rate on $1 of additional income. If your income is $1,000 above the first threshold, you still pay that extra $697 in tax. Gee, at least your marginal tax rate drops to less than 70%—but by that income level you're generally in the 25% regular federal plus 9.3% California bracket, so you pay a combined 104.3% tax on that last $1,000 "chunk" of income. The lowest possible additional marginal tax rate on incomes up to $107,000 is nearly 3.2% ($697 divided by the difference between the first and second thresholds, or $22,000). Note, too, these additional surcharge taxes and real effective tax rates are doubled for two Medicare recipients filing joint at MAGI incomes over $170,000. So, two Medicare recipients with $180,000 in MAGI pay a surcharge of $1,394, or 14% of the last $10,000 of income. They're likely already paying a regular tax at the 28% federal rate and, for California residents, 9.3% state rate on the last "chunk" of income, so the *real* marginal tax rate is 51.3%. At $175,000 of income you can double the surcharge tax *rate*, which subjects the last $5,000 of income to a phantom 65% tax rate. Penalizing success is a terrific way to destroy long-term incentives and increase the odds that people won't save too much for their retirement, which changes behaviors in ways that, in the long run, cause people to decrease their incomes, thereby lowering tax revenues and standards of living. Such "cliff-like" and exorbitant tax rates do not make for rational tax policy.

These additions to tax and absurd effective marginal tax rates further increase the value of smoothing income via Roth conversions and doing such conversions while both taxpayers are alive. Consider a married couple with $100,000 to $170,000 in yearly income including Required Minimum Distributions from retirement plans (which includes IRAs) and $500,000 left inside retirement accounts. Once one spouse dies, the surcharges will strike. One strategy: convert enough to go up to but not over the $170,000 threshold (and perhaps the 28% nominal tax bracket, which hits at a different point—$139,350 in *taxable* income for 2011), for as long as both are alive and the retirement accounts are still in the mid-six figure area or greater.

Another crucial feature of these surcharges is that they are based on MAGI, which is before personal exemptions and the standard or itemized deductions. The latter includes mortgage interest, state and local income and property taxes and, for those seniors who enjoy Las Vegas, gambling losses. As an interesting aside (and a deplorable one for gamblers), gross gambling winnings are included in MAGI, while gambling losses are deducted as an itemized deduction and only to the extent of winnings (in other words, they can't be netted to arrive at MAGI). So, even though you have no net gambling winnings, you might have enough *gross* winnings to trigger Medicare premium surcharges. How's that for fairness? (Unless the government's surreptitious goal is to discourage gambling, but how many gamblers understand this and numerous other tax penalties imposed on them?)

You can request an adjustment to your premium if there has been a significant reduction in income since the measuring point two years ago and the reduced income is due to one of six specified "life-changing events." The specified events include marriage, divorce, death of a spouse and partial or full work stoppage. (The two other events are esoteric ones that are not likely to occur in any of our lifetimes.) However, a lucky streak isn't one of those events (even if your net winnings end up at zero or less).

* The suspension of Social Security cost-of-living increases for the last two years and an increase in regular Medicare premiums for those who have not had premiums withheld from Social Security benefits likely won't reoccur.

Dear Doug: I'm Still Confused Over Roth Contributions vs. Roth Conversions

Dear Doug,

I know you've discussed this before, but would you summarize the differences between Roth contributions and Roth conversions?

Regards,
Bewildered

Dear Bewildered,

This does get confusing. One highly intelligent client missed the perfect opportunity to do a Roth conversion last year because he confused the time frames for conversions and contributions. Since opportunities like this can result in enormous long-term tax savings (see issues #29, #40 and #44 of *WCS* for a detailed explanation), I'd be delighted to review the differences.

The short answer is a **contribution** to a Roth is made from funds not held in any retirement account and a **conversion** to a Roth is made from pre-existing traditional IRAs, including rollover IRAs. There are enormous differences between the two in allowable amounts, income requirements, income limitations, tax consequences and deadlines.

Roth contributions are the $5,000 ($6,000 if age 50 or over) contributions anyone earning at least that much from employment, self-employment or alimony can contribute yearly to Roth IRAs, so long as income (technically, "modified" adjusted gross income) is less than $105,000 for single filers and $167,000 for those married filing jointly for 2011 (with phase-outs to zero allowable contributions at $120,000 single and $177,000 joint).

Such contributions can be made any time during the year or by the end of the regular tax filing season the following year (generally April 15). The contributions are non-deductible and allowable amounts are reduced by amounts contributed to traditional IRAs for that year. In other words, if otherwise eligible you can contribute to both in any mix of traditional and Roth IRAs up to $5,000 ($6,000 if age 50 or over) each year.

Roth conversions are any part of traditional IRAs moved ("converted") to Roth IRAs. You pay tax only on the amount converted. The old income limitation, which previously prohibited those with MAGIs over $100,000 from doing Roth conversions, was eliminated for years beginning in 2010, so now anyone can convert. However, you cannot "go back" and convert for a prior year; a conversion counts only for the year in which you convert. On the other hand, you can "undo" (change your mind, technically called "recharacterize") any part or all of a conversion by the extended due date of the tax return for the year of conversion. This makes Roth conversions the ultimate in planning tools in terms of flexibility and ability to correct mistakes. However, the one mistake that cannot be corrected—the one made by the client referred to above—is a failure to convert *during* the year. In his case, he could have converted nearly $20,000 at a zero tax bracket. Another client, who simply forgot, could have converted about $35,000 at a zero bracket and a third, who didn't understand the potential long-term tax savings inherent in conversions, could have converted about $30,000 at a tax cost of less than $2,000. On the other hand, several clients over-converted by substantial sums—one overdid it by almost $50,000—and "changed her mind" on that amount (leaving, as it turns out, only a few thousand dollars of the conversion in the Roth IRA). By recharacterizing the nearly $50,000 she saved about $18,000 in current taxes and is instead is planning to convert at a rate of about $9,000 per year over the next six years for a total expected tax cost of less than $7,000, saving more than $11,000 in taxes over the six-year plan. How's that for a tax savings strategy?

Dear Doug: I'm Doing Roth Conversions, but What if I Need the Money for an Emergency?

Dear Doug,

You suggested that I do Roth conversions while postponing the start of Social Security in order to increase my Social Security benefits and reduce long-term tax liabilities from IRA withdrawals. I've implemented this strategy and, with limited income from part-time work and a bit from savings, I have enough to pay my regular bills. However, what happens if I need a new roof or some other emergency pops up that could decimate my savings?

Signed,
Concerned about an emergency

Dear Concerned,

You're gradually shifting funds from your traditional IRA to your Roth IRA at low tax rates, so that at age 70½ when you are required to withdraw from your IRA and you are collecting Social Security you will not be taxed at exorbitant rates (as discussed in issues #29, #40 and #44 of *WCS*). I'm delighted you've acted upon my suggestions.

I don't suggest a strategy like this unless we have some protection against Black Swans (unpredictable and unexpected events that could negatively affect you in a big way). Since you've already paid the taxes on the funds you've converted to the Roth, you can withdraw those funds at any time tax-free. Problem solved.

Some people are under the misconception that the funds can't be withdrawn from a Roth IRA for five years. This is just plain wrong. The five-year rule applies only to earnings. Objection overruled.

In addition, you own your home free and clear. Should you find yourself needing an even larger sum—for example, a new roof, new siding, a new car *and* a 365-day cruise—you can borrow against the equity in your home or do a reverse mortgage (although I usually suggest the latter only as a last resort). In the meantime, by doing conversions now and paying taxes at low rates, your long-term tax obligations are dropping substantially. Without those conversions, your marginal tax rate would likely be much higher after age 70½. Those saved tax dollars might just be enough to pay for that new roof when you need it!

HEADS UP!

MID-YEAR CHANGE IN IRS BUSINESS MILEAGE RATE

The IRS changed the optional mileage rate from 51 cents per mile to 55½ cents per mile effective July 1, 2011. If you use your car for business, we will need *business use* miles for the first half of the year and for the second half, separately. We'll also need *total* miles for each half of the year. If you haven't already done so, please record your odometer reading and date of reading *now*!

THOUGHTS ON THE STOCK MARKET

For an idea of where I think the markets are headed, re-read the top stories in issues #39 and #42 of *WCS*, along with pp. 7-8 of issue #38, p. 8 of issue #42, pp. 5-8 of issue #35 and pp. 6-7 of issue #34 ("Dear Barack"). If you're interested in discussing how this affects you and possible actions to take, please contact us.