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"….It's clear that both Bill Clinton and George W. Bush believed people who cannot afford to buy homes should nonetheless be given mortgages—and as politicians unschooled in how markets work, they were both blind to the disastrous consequences."

—Gene Epstein, "Economic Beat," Barron's January 16, 2012

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WEALTH CREATION STRATEGIES

The Housing Crash, Seven Years In: Is the Bottom in Sight?

Nearly seven years ago I wrote a series of pieces on what I began calling the greatest bubble in the history of mankind: the housing mania. While I live in one of several maelstroms, California, every Western state, many Eastern ones and even some in the country's mid-section also experienced frenzies. According to *The Economist*, no less than 40 other countries worldwide were in the midst of great housing manias, including almost every economic power except Japan and Germany. At the time, I figured many markets would crash 50% or more and bottom around 2012. Now that we're here, it's time to take a look at what happened, what the future may hold and try to answer the question all kids going someplace ask: are we there yet? I will show the bottom line is a conundrum: while we are still in a bubble, it may be "ok" for some to buy.

If we are to have any hope for success in crystal ball gazing future economic events, we need to understand government policy contributing to the recent madness, as well as institutions, rules and regulations supporting such policy. Aside from mankind's propensity to, as Mark Twain put it, repeat mistakes in rhyme ("history doesn't repeat itself, but it does rhyme") and for the collective mood to control events, there were several specific propellants without which the craze could not have become the greatest in modern times. Contrary to the popular myth that the Bush administration "deregulated" banking and finance, we lacked free markets and suffered under massive government regulations and mal-incentives affecting every nook and cranny of housing and banking; therefore, free markets and a lack of regulation did *not* provide the fuel for the bubble. If they had, the even less free markets today might compel us to conclude we won't repeat the mistakes. Not only will we—we are now.

How to blow a bubble

A key public policy, which has taken form in innumerable rules, regulations and agencies governing housing and finance, along with one particular structural issue, provided the underpinnings of the U.S. craze. The fact that it was worldwide gives credence to Robert Prechter's theory of Socionomics: that social mood drives financial, macroeconomic and political behavior, and not the reverse. The specific policies, or the form they took, simply varied from country to country. The overarching public policy was encouragement of home ownership by government.*

The New Deal created, among many agencies, the Federal Housing Administration (FHA), which purportedly made it "easier" for people to buy homes by providing government-subsidized mortgage insurance. This set the stage for the housing mania. The Clinton and Bush II administrations simply expanded on the policy in a way that got the bubble going, big-time, by making it possible for unqualified borrowers to finance homes and qualified ones to purchase "more" home than they otherwise would have.

First, the Clinton administration expanded the scope of and put teeth into the "Community Reinvestment Act" (CRA) which essentially blackmailed private banks into lending to people who couldn't possibly repay their loans. They did this by telling uncooperative lenders (i.e., those who were reluctant to make such loans) they would be refused regulatory authority to expand and grow. Thus the phrase "subprime mortgage" earned its way into the lexicon.

Bush tacitly supported the policy by christening the idea "the ownership society."** He stood aside as two quasi-government corporations, Fannie Mae and Freddie Mac, began buying ever-more questionable loans originated by private bankers. Such loans included much higher loan-to-value ratios (lower down payments) with far more flexible loan terms than ever before, including negative amortization and "pay option" loans (where the borrower decides how much to pay each month). The quasi-government mortgage companies also purchased loans allowing borrowers to "state" their income, which was an open invitation to lie; nearly everyone obtaining such financing did so. This "creative financing" could not have occurred had government stuck to its proper role of protecting private property, including protection from fraud and falsifications. Worse, government provided malincentives, which private bankers merely responded to as would be expected. Fannie and Freddie also encouraged questionable appraisals.*** And just as government pricing and standards for Medicare sets the norm for private in-

surer's reimbursement policies, so did the quasi-government corporations' standards set those of private bankers—with the bully pulpit of the CRA breathing down their necks if they didn't conform. This is not a free market; it's a state corporatist (fascist) one.

The main structural issue is the fact that we live in a semi-capitalist system built on quicksand: a government owned and operated fiat-based (i.e., paper) monetary system, which is less than solid because it sends false price signals to market participants. The government, through a quasi- and nominally private monopoly of banks (the Federal Reserve, or "Fed") feigns knowledge by allowing bureaucrats to control, in certain key areas of the economy, interest rates (which is simply the "price" of money). This non-free market system allowed government (in turn driven by the collective mood) to set the price of money (interest rates) far below what that price likely would have been had it been subject to the will of consumer-kings in a free market gold-based (or some other commodity-based non-fiat) monetary system. The reason for this is artificially low interest rates send false signals to homeowners as well as investors, by "signaling" them to buy things they wouldn't otherwise purchase (because lower prices increase demand). In other words, at higher (free market) interest rates people would allocate capital differently. Government interventions in the economy in general create misallocations of labor and capital, resulting in too many or too few goods produced and sold in various sectors vs. what would be produced and purchased if consumer choices were unimpeded. Control over interest rates is the key intervention in monetary policy, which is the foundation for the semi-capitalist system. As a consequence, greater extremes of booms and busts occur than if markets were truly free. If the distortions to price signals of this foundation (money) are great and long-lasting enough, the entire system could not only totter, but fail.

The role of government intervention in creating the housing mania

Agency or regulation	What the agency or regulation does	Outcome
Community Reinvestment Act (CRA)	Coerced lenders into making loans to subprime borrowers	Lowered credit standards, decreased required down payments, increased flexibility in loan payments (negative amortization, pay-option loans), all combining to increase the percentage of bad loans made
FNMA, Freddie Mac	Bought loans originated per the standards above by nominally private lenders	Increased the quantity of bad loans originated
Federal Housing Administration (FHA)	Originates loans per the standards above	Increases the number of bad loans
Federal Reserve (the "Fed")	To some extent, controls interest rates, keeping them lower than would occur in a free market; now indirectly buys mortgages at lower-than-market rates	Increases affordability for housing at given prices for housing, thereby driving prices higher than would occur in a free market or preventing prices from moving lower than they would in a free market

What the "pop!" of a balloon sounds like

There are several reasons the fallout from the bursting of the bubble is likely not over. One is that social mood allows Federal Reserve bureaucrats to continue to set the price of money at a much lower level than would likely occur in a free market monetary system. Almost all mortgages are "government insured" or purchased by government agencies such as the FHA at subsidized (i.e. lower-than-free market) rates. A 30-year loan at the fifty-year median and average 30-year mortgage rate of roughly 7.5% would result in a monthly payment nearly 47% greater than one at the 4% rates currently available. Now that borrowers must prove their incomes, the reduction in affordability at a 7.5% rate would reduce the number of borrowers who could qualify for home loans at current prices by a substantial amount, which would (absent other government interventions such as a return of liars' loans, which I think exceedingly unlikely) require price reductions of roughly 30% for the monthly mortgage payment to remain the same. The table below illustrates this idea.

Reduced borrowing power (suggesting eventual price decline) at various interest rates, starting with a $200,000 loan:

Interest rate	Mortgage amount required to keep monthly payment at $955	Borrowing power decreased by
4%	$200,000	N/A
4.5%	$188,500	5.75%
5%	$178,000	11%
5.5%	$168,250	15.875%
6%	$159,300	20.35%
6.5%	$151,100	24.45%
7%	$143,600	28.2%
7.5%	$136,600	31.7%

While housing at current rates is more affordable than at any time in history in many areas (most metropolitan areas in CA *not* included), this wouldn't be true at rates much above current ones without commensurate declines in the price of real estate. Karl Case, the co-creator with Robert Shiller of the Case-Shiller real estate price index, believes mortgage rates absent government intervention would rise 3% to properly price market risk. Housing prices would likely collapse accordingly.

What's changed and what hasn't?

	Bubble years '03-'07	Current bubble
Govt. operated monetary system	✓	✓
Artificially low interest rates	✓	✓
Much lower down payments than pre-bubble	✓	✓
Flexible loan terms (including pay option, negative amortization & liars' loans)	✓	

Skin in the game reduces foreclosure odds

The other key item suggesting the housing crash isn't over in many areas is the FHA is still allowing down payments as low as 3.5%. Isn't this the kind of extreme (27 to 1) leverage that got us into trouble in the first place? Such tiny down payments are a fraction of those generally required in the "old" days, which for decades until the bubble-icious 2000s averaged 20%. The single most crucial variable in predicting whether a loan ends in foreclosure is the amount of negative equity. The lower the down, the higher the odds negative equity will eventually occur and, therefore, the greater the ultimate likelihood of foreclosure. Purchases requiring 3.5% from the borrower, with 96.5% lent by the bank are several times more likely to be foreclosed on than those requiring the borrower invest 20%. Until 1995, the share of mortgages requiring less than 3% down *never* exceeded 3% or so. This share reached 40% in 2007. I suspect that when the next gargantuan bailout occurs (the FHA) taxpayer-voters will revolt and demand that down payment requirements be nudged back towards 20%, which will eliminate all but the most vigilant savers as homebuyers. The reduced supply of buyers at higher interest rates and in a regime of much higher down payments will put the final nail in the coffin of the late, great housing bubble. Until this occurs, the collapse is not likely over.

The clues lie in the shadows

Several other policy-created problems relating to the fallout from the real estate crash will serve to exacerbate any continuing downside (or at least help prevent any upside) in housing prices over the next several years, even *if* interest rates remain stable:

1. In 2007 alone, the percentage of borrowers who were at some point 90 days or more behind in payments was 20%. These borrowers will not be able to easily qualify for a mortgage in the near-term. This 20% doesn't include those who had already lost their homes prior to 2006 or who took out a loan after 2007 and then fell behind.
2. 23% of current homeowners owe more on their homes than the homes are worth. These are all potential foreclosures and short sales, which will help keep supply up and prices down. As noted above, this is the single most crucial factor leading to foreclosures.
3. There is still a huge shadow inventory, which in many areas comprises years of supply. Such inventory includes homes already bank owned ("REOs" in the trade, or "Real Estate Owned"), those currently in foreclosure, those on which the lender hasn't foreclosed even though payments haven't been made for at least 90 days (in many cases, years) and those on which borrowers will become at least 90 days late because of number 2 above or for other reasons, including loss of income.
4. Foreclosure rates may skyrocket after an expected settlement between many states and banks over the robo-signing fiasco (in which computer-generated foreclosure and eviction document signings contained procedural defects). This legal bottleneck is one reason the average 90+ day delinquent loan has not made a payment for 388 days and the average number of days since a payment was made on a home that is finally foreclosed has jumped to an incredible 631 (in other words, it's taking an average of one year and nine months to foreclose which, in "normal" times, takes six to nine months).
5. While in 2005 half of all loans for housing were originated by or sold to government or Government Sponsored Entities (GSEs), today the figure is over 90%. As Karl Case puts it, the government is "all in." The taxpayer will put up with the losses only for so long; this will not (and cannot) go on forever. While Fannie and Freddie (the two big GSEs) have been forced to tighten lending standards, the FHA has barely done so. While the FHA made 5% of all home loans in 2005, its share ballooned to the 25-30% range for years 2008 through 2011. The FHA 90+ day delinquency rate is already nearly three times higher than that of the GSEs (and FHA borrowers default more quickly: the percentage is 7% by about the 13th payment, when roughly 1.5% of GSE borrowers have defaulted). Bad loans will soon overwhelm the FHA, which will go to Congress pleading for a bailout. I believe if they get bailed out, it will only be if they agree to tighten lending standards and require larger down payments, which will further shrink the pool of available and willing buyers—again, adding to downward pressure on prices.

6. The history of bubbles is one of over-correcting to the downside. Prices after the British and Swedish real estate mini-bubbles of the late '80s, for example, undershot their "fair value" (as estimated by *The Economist*) by nearly 35% by the mid-90s.

Back in 2005 I would never have thought government planners with their unfathomable arrogance in "knowing" what is best for their minions could prolong the agony of falling prices and economic malaise beyond seven years. However, using the public policy instruments listed above I believe they've managed to do so. The various "first-time home buyers" tax credits should also be mentioned, which as a psychological inducement in slowing the collapse clearly "worked" for a time. It continues to amaze that public policy, which feigns to make housing more affordable, is doing everything it can to prevent housing from becoming more affordable by letting prices drop to market clearing levels. However, markets eventually trump government interventions; all-knowing bureaucrats and politicians can only delay the inevitable for so long. This can only worsen the ultimate outcome.

When it might be ok to purchase in a bubble

On the other side of the coin, even though there is a likelihood of a continuing drop in many if not most real estate markets, there are three general cases where buying may be ok so long as the time-horizon for expected ownership is sufficient. I'd suggest a minimum of ten years. However, mortgage rates and down payment requirements will likely increase sometime in the interim, resulting in an additional substantial decline in housing prices from which it will likely take years to recover. Therefore, a fifteen-year or longer time-frame might be more appropriate, especially for those in the more over-priced locales.

The first kind of buyer who *could* do ok by purchasing now is the all-cash buyer with the dollars sitting in a bank earning a majestic 1% per annum. Let's assume a townhome you could either buy for $200,000 or rent for $1,200 to $1,400 per month ($14,400 to $16,800 per year). The cost of buying includes ($200,000 x 1% =) $2,000 in yearly foregone interest income, $3,600 per year homeowner association fees (if for a home without such fees, the long-term maintenance and replacement of systems costs are similar), $1,000 average yearly inside maintenance costs and property taxes of $2,400 (in most areas of California), for a total cost of $9,000 per year. This compares quite favorably with the $14,400 to $16,800 in yearly rental costs. However, transaction costs must be overcome on a purchase and possibly, as suggested above, a continuing decline in value. The savings from buying vs. renting cover buying and selling costs of 7% (2-3% less than on a purchase involving a loan) in a tad over two years. Enough rent could be saved within seven years to offset a reduction in value of 20%, or $40,000. On the other hand, this assumes interest rates on savings remain at 1%, which probably is not going to happen and one of several reasons a minimum ten-year time horizon is suggested. However, there are numerous intangible benefits to home ownership that should be considered, even in a non-ownership society, such as not being forced to move and being able to decorate as you wish.

The second type who might do well buying now (again, only with a long enough time frame in mind) are those living in areas where the rental cost is higher than the "total" monthly payment. If you can borrow $180,000 at 4% on the same $200,000 purchase as above, your monthly costs include $600 interest, $75 property mortgage insurance premium (required on property loans with less than 20% down), $383 maintenance (using the above assumptions, including both association fees and inside maintenance), $200 property tax and $17 in foregone interest income on the down payment, for a total cost of $1,275, not counting income tax savings (which, depending on the taxpayer's situation, could be zero to $280 monthly).

While this doesn't compare as favorably as an all-cash purchase, depending on other factors it could make sense, especially if it also qualifies under the third type of situation: the proposed purchase is in a location where the median price-to-income ratio is around three or less, which is roughly the 70-year average nationwide (the lower the ratio, the lower the downside risk). This multiple is still around six in the metropolitan Los Angeles-to-San Diego areas (for example, a median price of $300,000 in an area in which the median household income is $50,000 equates to a price-to-income ratio of six), but is less than three in Pittsburgh, PA, Phoenix, AZ, Atlanta, GA, Detroit, MI, Las Vegas, NV and Nashville, TN, among many other areas in the country.****

There are numerous other criteria that should be considered: the area's growth prospects, your own personal needs and preferences, and price vs. cost of construction (property selling for 25% or more below cost of construction, which does not consider the cost of land, should command our interest unless the area is in serious decline). The number of months' supply of existing homes for sale can be an excellent barometer of a market's health. That figure is currently about 10 nationwide, which is substantially greater than the four-to-five month figure that's considered healthy. Shadow inventory, which includes units not yet on the market that eventually will be (because the borrower is behind in payments) should be included in such figures, but are not. Such inventory probably increases the months of supply figure to about 15 nationwide, which translates to 50% greater supply than listed in multiple listing services. However, there are numerous areas in the still-bubbly areas of Los Angeles and other metro-California areas where shadow inventory is double and, in some places, multiples greater than the figures listed.

To summarize, we probably still have a ways to go on the downside, with the best case in most areas a continuing malaise for as long as a decade. Real estate bottoms tend to be long, drawn out affairs, suggesting there's no compelling "price" reason to rush into a purchase. Converting the numbers in the $200,000 all-cash-condo purchase in the above example to net "income" of 3.7% to 4.9% (depending on gross rents) as

an investment could sway an investor to buy now rather than later. However, this return on investment isn't compelling, given the fact single family homes and condos yielded 5% for decades until the bubbly 2000s. Considering vacancies, management costs (not included above) and headaches, along with risks inherent in residential income property ownership, one should tread extra carefully until and unless higher returns (7.5% *might* get my attention) become available.

* Leaving aside the arrogance of government bureaucrats and politicians thinking they know best how to live our lives and spend our money, it's flawed policy. Renting is, for many, quite appropriate.

** While the mainstream of human progress is the protection of private property, government's role should be relegated to protecting it from thugs, foreign and domestic. It has no business playing the role of cheerleader.

*** Imagine yourself having been for a couple of decades in the business of lending or making appraisals and offered a choice: make such loans or appraisals, or exit the business. While you might have exited the business, many people, who are desperate for the income and untrained in other occupations, wouldn't—and didn't.

**** This ratio was 11 at the peak of the mania in Los Angeles, and still stands at over nine in much of Australia and Canada and an incredible 15 in Vancouver Canada; according to *The Economist*, "Australia, Canada, Britain, the Netherlands, New Zealand, Spain and Sweden all have higher household-debt burdens in relation to income than America did at the peak of its bubble," which is likely to end very badly for those countries.

"Use" Tax Must Be Paid: No More "Tax-Free" Amazon Purchases

Since the early 2000s we've been informing you through this letter and via our "by-mail" package cover letter that California was getting—how shall we put it?—angry over the lack of compliance regarding "use" tax, or sales tax you should have paid on purchases but didn't. While residents have been required to pay such tax since the mid-1930s, non-compliance (i.e., "lost tax revenues") could never have amounted to much in the pre-Internet age, when your only options were catalogue, telephone and overseas (with a $400 per year exclusion) purchases, the purchase of used goods and bringing purchases made in other states with you to California (or your state of residence). With far greater losses in revenue at stake due to Internet sales (along with the obvious inequity that sales tax is avoided by making purchases from on-line retailers having no physical presence in the state—such retailers are not required to collect sales tax*), California has been threatening Amazon and other out-of-state retailers there'd be hell to pay if the status quo continued. Now, just as we're likely on the verge of some sort of interstate sales tax collection agreement, California has gotten more serious and oddly, in a way, a bit more reasonable.

"Use" tax replaces "sales" tax on sales governments don't monitor

To quickly review, every California resident is required to pay "use" tax in lieu of sales tax on purchases of goods brought or sent into California from other states, where California sales tax was not collected. (For our 75 or so clients in other states that impose a sales tax, this should read "every resident is required to pay 'use' tax in lieu of sales tax on purchases of goods brought or sent into your state from other states, where your state sales tax was not collected"). This tax applies to Internet purchases from retailers like Amazon, which collect no sales tax from California residents, as well as residents of other states where they do not have a physical in-state presence. This does not apply to retailers with an in-state presence, including the likes of Wal-Mart, Barnes & Noble, Home Depot and Costco, even though you made Internet purchases from these companies, because they are required to (and did) collect sales tax. The rules continue to apply to catalogue and telephone purchases, as well as to purchase of goods physically brought back to California from any other state or country. Any sales tax paid in the other state is subtracted from the statutory tax based on your residence. Technically, it gets worse: if you live in an area of L.A. with a 9% tax rate and purchase something in an area of Ventura with an 8% rate, you are theoretically required to pay the difference as "use" tax. Oh, what fun when government runs amok.

In addition, consider that you pay "use" tax on purchases of used cars and trucks. Have you ever wondered why you don't pay such tax on purchases of other used items? Because vehicles are registered—allowing the state to track and assess tax—and other personal items are not. You actually owe tax on purchases of other used items. While this is usually impossible to police, consider a business owner purchasing a piece of equipment for his business for $1,000: because the cost was an even number, we have a pretty good idea that sales tax wasn't paid. A depreciable item on a tax return costing a round number dollar amount is something the state could easily find.

"Use" tax is owed for any goods on which sales tax would normally be paid, but wasn't. This includes:

1. **Internet purchases**
2. **Catalogue and telephone purchases**
3. **Goods purchased in other counties, states or countries and then brought home (less any sales tax paid to other states or counties)**
4. **Purchases of used items**

A "choice" between the devil and the deep blue sea

California has finally gotten a bit more realistic about "use" tax, but with an eye towards greater enforcement. Following in the footsteps of about ten other states, an optional "use tax look-up" table is now provided. The tax is based on income and, as such, allows *most* taxpayers to avoid tracking such purchases. "Most" isn't "all" because the table can be used only for non-business purchases. Therefore, you cannot use it for your business, whether a (Schedule C) sole proprietorship or corporation. In addition, its use is prohibited if even one purchase subject to "use" tax during the year exceeded $1,000. So, you must still calculate *all* purchases subject to use tax if you bought anything on which use tax must be paid for your sole proprietorship, your corporation or if you made any single non-business purchase exceeding $1,000. In lieu of using the "look-up" table, you may pay the tax based on actual purchases, which you'll obviously want to do if you buy very little from Amazon and other out-of-state retailers. If you use Quicken or another bookkeeping program, you can easily categorize by payee and get a good idea of how much you purchased from such retailers (but keep in mind, "shipping" costs are not subject to California tax). Here's the table, along with equivalent cost of purchases for those whose local sales tax rate is 9%:

California "use tax" look-up table

Adjusted Gross Income range	Use tax liability	Equivalent purchases assuming 9% sales tax
Less than $20,000	$7	$78
$20,000-$39,999	$21	$233
$40,000-$59,999	$35	$389
$60,000-$79,999	$49	$544
$80,000-$99,999	$63	$700**
$100,000-$149,999	$88	$978
$150,000-$199,999	$123	$1,367
More than $199,999	AGI x .0007	***

**For example, a 9% sales tax on $700 of purchases is $63.

***Multiply Adjusted Gross Income by .0007 to arrive at the "look-up" use tax. If your AGI is, for example, $250,000, your use tax based on this method is $175 ($250,000 x .0007 = $175). From this we can calculate that California thinks seven tenths of one percent (.07%) of income is owed in uncollected sales tax. Since sales tax averages 8.5% across California, we can conclude they think roughly .82% of income is spent by Californians on things for which sales tax "should" have been collected but wasn't.

You might imagine the state is going to be looking for "use tax" on your tax return this year. We ask that you tell us either the actual amount of purchases made on which you did not pay sales tax but should have, or tell us to use the "look-up" table. I believe we can no longer complete returns without your definitive instructions on this issue, annoying though it may be for everyone. Tell us if you include and pay all such tax via a sales tax return you file for your sole-proprietorship business.

To review:

You cannot use the "look-up" use tax table for business purchases.

You cannot use the "look-up" use tax table if any one purchase for which such tax is owed exceeded $1,000.

If you do not tell us your actual purchases on which you owe "use" tax, we will use the table amount.

If you tell us your actual purchases, we will calculate the "use" tax based on where you live. Be sure to tell us if we need to subtract sales tax paid on purchases made in other states and counties and provide us information required to calculate how much to subtract.

Assuming nothing sticks out, it is not our job to second-guess your decision to use or not use the "look-up" table, or the amount of purchases on which use tax might be owed. It could be zero—which, in fact, I'm sure it will be for many of you. However, keep in mind you sign your tax returns under penalties of perjury. If you choose to track actual purchases and pay less than the table amount, be prepared to provide proof to the state that such purchases were less than implied in the table (which means you must keep all personal spending records for four years past the extended due date for filing the tax return, or three years from the actual filing of the return if later). We might surmise that those claiming they owe less than the table amount will be subject to much higher risk of scrutiny and those who pay the table amount or more will likely be left alone.

*The obvious inequity applies both to buyers and sellers. From a libertarian perspective, taxes should be applied equally (even if taxes should be fewer and rates should be much lower). Buyers who avoid paying sales taxes tend to care less about tax rates, increasing the odds that rates increase for the rest of us if only because tax-decrease supporters may lose a vote. In addition, sellers that do not collect sales tax have an "unfair" advantage over retailers who collect such tax. This has seriously hurt some retailers in California, including those selling camera equipment as well as computer and other hi-tech electronics (Best Buy is now considered by many to be the showroom for Amazon). While libertarians believe government has overstepped its bounds and should be shrunk by some 90% or so, they also believe that law should be equally applied (sometimes referred to as "equality under the law"). You might imagine this is a difficult issue for your favorite life-long libertarian. However, I admit to favoring tax equality, even if most of what is law discourages production and, consequentially, results in lower living standards for us all in the aggregate.

Spring Cleaning: Just How Long Should You Keep Those Records?

We're often asked when you can safely toss or shred old paper records. Since there are many exceptions to the general rules, this is a tricky question. Not even I think of every possible reason I might want to keep something when tossing records and, as a result, on occasion I've discarded something I shouldn't have (and, as you might guess, I can usually find anything from the archives within minutes). In addition, consider the needs of future archeologists: we've pieced together much of ancient civilizations from old tax and financial records (and biographers and ancestors have also surely been aided by such records in reconstructing lives). Bear in mind, receipt paper exposed to light quickly degrades; either file these quickly or make copies of them. With these caveats in mind, here is a list of suggested labels for each type of record (which you might use on your file folders), period of years to keep them *after* the extended due date of the tax return and other considerations.

File name, by year	How long to keep*	Other considerations
Tax returns	Forever	They take little space and, on occasion, I've found old returns of immense value
Personal, non-deductible receipts/bills/ invoices that back up the checks/on-line payment: spending on personal utilities and other consumables	A year or two, but four if you are self-employed (to prove you have a personal life), as well as to prove "use" tax liability	Consider the potential for research: which restaurant was it where you enjoyed that fabulous meal?
Personal, non-deductible receipts, etc. that back up the checks: furnishings, jewelry, vehicles and the like	Variable, but ideally until you dispose of the item and at least four years if you are self-employed or to prove "use" tax liability	Think how helpful it would be to be able to prove ownership and cost to an insurer if you suffer a burglary or fire
Personal receipts of the above two items that back up credit card statements, and the statements themselves	See the two files immediately above, but since credit card statements take so little space I'd keep those forever	All in one folder, so perhaps divvy up between the type of item listed above
Personal cash receipts, etc.	See above	This file is probably thin, but be mindful of the notes above
Personal checking account statements	IMHO, forever, but many could toss after four years	They take little space!
Home improvement receipts, etc.	Until four years after the sale of your home (or 2nd home)	Even if any gain is excluded, you'll need these if you convert your home to a rental
Personal deductible receipts, etc. that back up checks and credit cards	Four years	Year-end mortgage statement, property tax bills, charitable donations, employee business expenses
Medical records	Four years	Or as long as needed for reimbursement and legal purposes
Investment purchases and sales: non-retirement accounts (generally, one folder per account)	Until four years after a security is sold (and, since they take so little space, I'd keep the year-end statements forever)	While brokers now track this, they are not required to track costs of securities purchased prior to 2011 (and you may need statements after to be able to make optimal "cost basis elections")
Investments: retirement account statements, including IRAs, Roth IRAs, SEPPs, 401ks, Keoghs, etc.	Year-end summary statements: forever	Mid-year statements can be tossed after you receive the year-end statement
Investments: savings account statements and the like	Four years; year-end summary statements: forever	Statements like these can be helpful to prove income in audits
Business or rental checking statements with copies of checks	Forever, or at least until four years after business or rental is sold or terminated	They take so little space!
Business receipts that back up checks, consumables	Four years	
Business receipts for depreciable items, including vehicles	Four years after the item is sold	Supporting receipts showing odometer readings of vehicles should be kept in this folder
Business credit card statements and receipts	Receipts, four years; statements, forever	Be sure to keep receipts for depreciable items separate (see above!)

*Past the extended due date of the return for the year in question.

The Draconian State Part 1: Foreign Bank Accounts—and More—Must Be Reported On Personal Income Tax Returns

Under threat of enormous penalties, your personal tax return must now include information regarding certain "specified" foreign financial assets you own in excess of an "applicable reporting threshold."

The "specified" assets include:

1. Any financial account maintained by a foreign financial institution, including savings accounts, stocks, mutual funds, hedge funds, etc.
   a. Incredibly, such "financial accounts" include foreign pensions (including those with Canadian RRSPs, which is their version of our 401k) and foreign deferred compensation plans
2. "Other" financial assets not held in an account maintained by a financial institution such as:
   a. Stock or other securities issued by any foreign entity
   b. Any interest in a foreign entity, including corporation or partnership
   c. Any debt owed to you by a foreign person
   d. Any interest in a foreign trust or estate
   e. Any of several complex "swap" or similar arrangements with a foreign counterparty
   f. Any option or other derivative instrument related to these if entered into with a foreign counterparty
3. Some foreign-based real estate, especially including any held in a foreign-based trust *
4. Foreign prepaid credit cards ("Prepaid Electronic Toll Card," or "PETC") with a value of just $10,000 or more.

The "applicable reporting threshold," aside from item 4 above, is generally $50,000 on the last day of the year ($100,000 for joint filers) and $75,000 anytime during the year ($150,000 for joint filers). It applies to the total value of all assets described above (and perhaps some I haven't yet divined in the rules and regulations).

Such interests must be reported even if there is no income, and no gains, losses or distributions relating to these assets. If such interests go unreported, you are subject to penalties of $10,000 to $50,000, plus 40% of any tax underpayment resulting from a transaction involving an unreported "specified" asset. The penalties for willful failure are much worse. Further, the statute of limitations for the tax year may remain open for your entire tax return until three years after the date you finally file a complete and accurate disclosure.

I can't begin to describe how disgusted I am over the Draconian penalties the U.S. government is imposing on otherwise law-abiding citizens. However, as Inspector Javert (think: Charles Laughton in "Les Miserables") said, "The law is the law." **

* A friend, another Enrolled Agent, points out this is an information gathering form and the penalties are, as she puts it, "horrendous" for any non-disclosures. Therefore, she says if in doubt disclose.

** This latest and greatest law was apparently Congress's response to the UBS fiasco, in which UBS admitted they helped people evade U.S. taxes. Yet these new rules and penalties are in addition to rules, regulations and disproportionately excessive penalties that were already on the books requiring disclosure of foreign bank accounts.

Broker Elections For Stock and Mutual Fund Sales: What A Mess

Under new rules for 2012, when you sell only a part of a particular stock or mutual fund in a non-retirement (taxable) account, you are required to make a "cost basis election." Such an election requires you to "select" the particular shares you are selling. Brokers will pressure you now to make a choice of method for determining which shares you will sell in future months and years. Don't make that choice now; we can do that later. If you feel compelled to do so anyway, we recommend you select the "specific identification" method. You can change your method later for each fund on which a sale has not been made (once you've made a sale of any one stock or fund, you cannot change your method afterwards). Keep in mind this "broker" election applies only to stocks purchased since 1/1/11 and mutual funds purchased since 1/1/12. We must still decide which method to use on partial sales of shares purchased prior to those dates. Call or email us before selling.

The real mess will be the late-filed 1099s you will receive from brokers in late February, along with corrected ones in March and probably even April. In addition, instead of all sales reported on Schedule D as we've known it for decades, we will be required to first complete another form, with up to three of these forms "feeding" into Schedule D: one for transactions reported by brokers on forms 1099-B on which cost basis is reported; a second for transactions reported by brokers on forms 1099-B on which cost basis is not reported; and a third for transactions not reported on forms 1099-B (sales of personal property such as vehicles used in a business and sales of land for under $100,000, for example).