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“When the government is too intrusive, people lose their spirit. Act for the people’s benefit. Trust them; leave them alone... [When the ruler leaves people alone] the people of themselves become prosperous.”

— Lao Tzu, *Tao Te Ching*, 6th Century B.C. (founder of Taoism)

“Lao Tzu adhered to the principle of nonintervention (wu wei) and discovered the principle of spontaneous order more than 2,000 years before Adam Smith... [This] is a lesson both Beijing and Washington need to learn.”

— James A. Dorn, Senior Fellow, *The Cato Institute* (WSJ letters, May 31, 2013)

Tax and Financial Strategies

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Wealth Creation Strategies

The Ultimate “How To” on Simple Record Keeping For Personal, Business and Rental Records

We’re privy to all manner of record keeping for tax purposes. Some clients do a terrific job; others, well, leave a bit to be desired. On a number of occasions, we’ve described simple solutions. Yet, it still proves vexing for many—and worse, from our best estimates talking with a number of you it can take five times longer (or more) than it should. By following these simple guidelines, you may be able to do the same job in a fifth of the time it currently takes.

We figured a one-two-three approach might help those still vexed.

1. If you have a business, large employee business expenses or rental property, use separate credit cards and checking accounts for each (but see # 2, below). Pay for business expenses from the business card/account and personal expenses from the personal card/account.

a. Think before writing that check: is the expense business/rental or personal? Pull out the right checkbook and *then* write that check!

b. Think before charging and pull out the right charge card! Use one type of card for business and a different for personal—say a Visa for one and MasterCard for the other—and put them at opposite sides of your wallet. Since I started doing this I’ve reduced errors by 75% (yes, even I goof!).

c. If you use an American Express Costco or similar membership credit card, you can pay one yearly fee and still have separate personal and business cards. Again, these could go on opposite sides of the wallet. An alternative is to put the card you use less frequently behind the card used more often, especially if you often use both cards during one shopping trip.

d. If you write a check out of the wrong account or charge an expense on the wrong credit card, reimburse the appropriate account ASAP—don’t wait for the end of the year to correct the error.

2. An additional checking account may increase your monthly bank fees. If you do not operate as a corporation, partnership or LLC, though not ideal, you *can* use one account for personal and business purposes. It should be emphasized, however, this is not ideal. It may well be worth the additional monthly fee which, while under (intrusive) Dodd-Frank banking rules you can no longer negotiate, you might be able to figure out a work-around with your banker.

3. Regardless of whether you have separate accounts, be sure to categorize the expense(s) appropriately on both the check and in your register. Use at least two lines per transaction: one to record the name and amount,

the second for the category. If a credit card was used, record the category on the credit card slip or receipt. Do this when you write the check or charge the purchase—it’s hard to remember the correct category for some expenses even a week later!

a. This makes “doing the books” super easy because you reduce the thinking involved when you get around to recording transactions months later.

b. Where there are purchases for multiple categories, as often occurs at Costco, Target and Wal-Mart, spend a few minutes when you get home to record the amounts spent by category in whole dollars at the top of the receipt. Remember to include the tax and don’t worry about absolute precision. On a recent Costco excursion, my wife and I purchased pool supplies for \$77, pet supplies for \$25, nutritional and fitness supplies for \$20 and groceries for \$47. The shorthand at the top of the receipt reads pool \$77, pet \$25, nutr \$20 and groc \$47. Try figuring out even a week later that “3” tablets” was chlorine tabs (so: “pool”), “margherita” was a pizza (“groc”), “chicken jrky” was for the dogs (“pet”), “ h a w a i i a n k c u p ” a n d “sfbfrench80c” are two kinds of coffee (“groc”), “tn lutein140” is a

vitamin supplement (“nutr”) and “Clantro Lime” was frozen packaged chicken (“groc”)!)

4. Except for minor items, minimize cash expenses. If you have a gambling budget or, because of atrociously high foreign currency conversion fees you use cash when travelling overseas, categorize cash withdrawals using approximations. For example, if you withdraw \$2,400 cash per year, you might rough out the \$2,400 as (see below for category-subcategory explanations) \$600 “recreation: gambling,” \$1200 “vacation,” \$400 “dining” (for those inexpensive Del Taco Thursday night specials) and \$200 “groceries.”

5. **CRUCIAL:** do your books at least once every four months. This means, simply, file the receipts in the appropriate file and then enter your income and expenses by category either on paper or into a computer program.

a. You can do this daily, weekly or monthly, but pulling the files, starting the computer program and getting into the “mode” (which can serve to reduce errors) takes time. On the other hand, doing it only once a year nearly guarantees you’ll spend many additional hours trying to figure out what to do and how to do it. You’ll find your own optimum, but every three to four months works for me and I don’t touch the files or the program during Tax Season.

b. The files you create are a function of the types of expenses you have. These should be maintained even if you have no business or rental properties. Why bother? First, for budgeting purposes you need to know what you spend your money on. Second, in case of casualty, what you owned can be reconstructed for insurance or tax deduction purposes (of course, only if the files are kept in a fire/flood/wind-proof container or cabinet, or uploaded to the cloud!) Create a fresh set of files yearly, labeled by year and category. You can store the list of file folder names in a Word file, from which you print onto color-coded labels.

(Search “Avery 5204 template” for a downloadable Word template.) Here’s a list of the sort of files you should have:

i. Receipts that corroborate personal checks. You should have additional such files for any businesses and rental properties. Generally, you “can” toss these after five years, but be careful: don’t toss items for which you may want proof of purchase in case of casualty or long-term warranties. Some might ask, why keep personal receipts? If you’re not self-employed and you don’t have employee business-type expenses, you can probably quickly dump a lot of these. However, if you are self-employed or incur employee business expenses, it may be a good idea to keep these records for five years. I’ve had audits in which grocery purchases were questioned—real estate agents’ open houses, office coffee and sodas, etc.—and I used personal grocery records to prove that my client had personal expenses too. Likewise, proof of pleasure trips, personal entertainment, home phone use, etc. may be useful.

ii. A separate permanent file should be kept for receipts for home improvements. You can also place receipts that should be kept “longer-term” in another file.

iii. An additional file for receipts that corroborate checks for any regular expense for which receipts can make a file too thick. Telephone bills come to mind, even if they’ve thinned over the last decade. Business-use phone bills can usually be tossed after five years.

iv. A file for receipts supporting credit card expenses, along with the credit card slips and statements; again, you will have additional files for any

business and rental property credit cards. You can generally toss these after five years (although I like to keep the statements forever), but create another file for receipts for long-term improvements or items that have long-term warranties, which generally should be kept permanently or at least semi-permanently.

v. A file for receipts for any important personal cash expenses and, if applicable, business and rental cash expenses. Again, try to keep cash purchases to a minimum.

vi. One file for each checking account for statements and copies of checks, appropriately labeled personal, business or rental. These are usually thin enough to keep forever. **CRUCIAL:** while our bank no longer sends copies of personal account checks and they make copies available for only the most recent few years, every few months I download and print checks paid for personal deductions such as charitable gifts and property taxes for our home.

vii. One file for each investment account. Although brokers are now required to provide gain and loss records, you might want to keep your own permanent records in case something goes wrong. After the year is over, a year-end statement summarizing the year’s transactions should be sufficient.

viii. One file for each retirement account; you can combine those with minor activity. The summary year-end statement should be good enough.

ix. A file for your medical records and, if applicable, HSA or HRA account(s).

c. Sometimes, page 1 of your credit card statement summarizes your balance due, minimum payment

and credit line, but shows no expenses. In this case, staple page 1 behind the page that lists your expenses. If expenses continue onto the backside, photocopy that page and staple it behind the top page. This is rare enough for me to draw a big red arrow on the top page to remind me of expenses that need recording on the next page. If expenses show on the bottom of page 1 and continue to page 2, fold page 1 so that only the expenses are showing and staple to the next page if you can do so and not cover page 2 expenses. Attach the credit card receipts to the back of the statement so that you don't cover any expenses. Check off the expenses on the statement for which you have such "back-up." Circle the expenses that have no check-mark and make sure they are valid purchases—maybe the expense isn't yours! (I once found two \$400 flights to Kansas City, MO, where I've never been.)

d. While for very simple situations paper and pencil can be used, most people are better off using software. We generally recommend Quicken: it's simple, easy to learn and inexpensive. QuickBooks is overkill for personal use and, even, for 98% of our clients' business and rental properties. (If you insist on using QuickBooks, spend the necessary time to learn how to use it. Check your local junior college—many offer single-semester courses on the program. Kristin did an intensive semester-long night class at Pierce College a few years ago for about \$100.)

i. **CRUCIAL:** Learn to use the program, especially how to set up and link separate accounts within the computer file. Properly link credit card accounts to bank accounts so that credit card expenses are properly categorized when charged and the payment is treated only as a subtraction from your checking account.

6. We generally do NOT recommend

downloading your accounting information from your checking account or credit card. It's too easy to get lazy. Most people download and think they're done. Sorry—not by a longshot. Your bank, credit card and software have no idea what categories of items you purchased at Costco until you tell it (via "splitting" the entry, creating multiple categories for a particular named payee). While the download may think you purchased fuel at a Mobile station, the expense could be "auto: repairs and maintenance" or even "drinks and snacks," rather than "auto: fuel." In addition, it has no idea which car the charge corresponds to: business or personal or, even, *which* personal car. Once you've set things up properly, you will find making these entries take much less time than you might think, especially because all your receipts have already been categorized per step 3. Therefore, I also never download "updates" from Quicken—they nearly always relate to web-based banking.

7. Speaking of categories, be consistent and don't use similar names for the same category. Don't use "office expense," "office supplies," "supplies: office," and "office: supplies" to categorize office supplies. Pick one. My preference is "supplies: office," because I also have a "supplies: tools" and the expenses can easily overlap. **Don't use Quicken's categories; create your own.** Once you enter a few months of expenses, you'll have created most of your categories. You can then print a list. If the auto-fill doesn't automatically finish filling it in, you're probably using the wrong category name.

8. Still speaking of categories, subcategories are essential to see where your money goes. It's crucial, however, to put categories and subcategories in the right order. A bit of serious thinking and planning will assist you in setting it up in a way that provides useful information—and if you end up with useless information, you'll waste a lot of time fixing the problem. For example, if you have both home repairs and office repairs, which category-subcategory should you use—"repairs:

office" and "repairs: home," or "office: repairs" and "home: repairs"?

a. I have Quicken installed on my home computer, on which both personal and rental expenses and income are recorded. I use "home repairs" with numerous subcategories, including garden, painting, plumbing, etc. I have a separate category for "home improvements" with, again, numerous subcategories such as "pool," "garden" and "remodel." I even have subcategories of subcategories, such as "home improvements: remodel: bath" and "home improvements: remodel: bedroom," so I know how much each room's remodel really cost.

b. I have a separate Quicken file used exclusively for my business. I use "repairs" with subcategories such as "office" for real estate repairs and further subcategorize garden, plumbing, electrical, pest control, etc.—so, for example, you'll find "repairs: office: plumbing" and "repairs: office: garden" on my business Quicken printout. Because I like to know what we spend repairing and maintaining computers and, separately, copiers/printers, you would see "repairs: computers" and, separately, "repairs: copier/printer." How you adapt this is a function of the quantity and quality of information you want or need.

c. On the other hand, car repairs do not belong under "repairs;" like car insurance, they should be sub-categorized under "auto." So, "auto: repairs," "auto: insurance," "auto: fuel," etc. And if you want or need to track multiple vehicles you might have "auto: LexusSUV: repairs" and "auto: G-35: repairs," or "auto: Betsy: repairs" and "auto: Lola: repairs" if you name your cars.

9. **CRUCIAL:** Always round to the nearest whole dollar. This saves a tremendous amount of time. If your average expense is \$100.00, you will shave two-fifths off the time in making entries by this alone! In addition, you'll decrease the number of errors by

40%—and finding errors can be time consuming. Yes, you will be off from your actual bank balance by a few dollars a year, but small rounding errors are a miniscule price to pay for the time savings and reduction in material errors.

10. Since you've already categorized everything in your checkbook register(s) and/or credit card statement(s)/receipts, recording the transactions is a breeze. Because Quicken "memorizes" the category by payee, you don't even have to re-enter categories except for payees for whom more than one category of expenses applies (for example, Costco), and for deposits to record the type of income (self-employment, net wages, gifts, transfers, etc.). Other than this, the recording process should be brainless and simple.

11. **CRUCIAL:** After recording each page from your checkbook register, hold the register up to the computer monitor and check your entries for accuracy. You will find errors. Fix them! After recording the entries on each page of your credit card state-

ment, hold the statement up to the monitor and compare entries. You will find errors. Fix them!

12. Compare your Quicken balance to your checkbook balance. Good for you if you're only a few dollars off—that would be a rounding error! If you're off by more than a few dollars, you failed to correct one or more errors. Now you have your work cut out for you.

13. Reconcile the latest checking account to your checkbook register/Quicken balance. If off by more than a few dollars, you'll have to go backwards and find the error made in recording the check or your bank made in reading a check. You've got your work cut out for you, but don't feel alone: even I was off recently by \$400. (I messed up on recording a check in my register, which found its way into Quicken.)

Because of my business and our rental properties, I create about 30 file folders and make about 1,200 entries into our two Quicken files (one for

business and the other combining personal and rentals) per year. Many of the entries are complex: Costco purchases are split among at least eight personal categories (Leslie's isn't our only "pool stuff" provider, Swanson's isn't our only "nutrition and fitness" provider and Macy's isn't our only "clothing" supplier) and deposits are split among several rental properties as well as other types of "income." I even split the DWP bills between power, water, sewer and trash (yes, it gets a bit silly, but there's an ulterior motive: having the power info separated could come in handy for an article I may write on solar panels, and it informed me of the surreptitious 500% increase in trash collection costs over the last eight years—thank you L.A. City Council!). Yet, the entire process takes at most 24 hours per year—and that's for everything! I've talked to clients with one-quarter the number of entries who take three times as long. By following this outline, they are beginning to trim their bookkeeping time substantially. You can too!

A Few Thoughts on "Income Inequality"

Inequality as a Driving Force in Increasing Living Standards

Free markets reward those who best provide what others want or need. Equalizing incomes allows the equalizer, not the marketplace via consumerings like you and me, to determine the value of goods and services. When producers receive less benefit after-tax for providing goods and services others value, incentives to work and produce decline. With a decreased financial drive to research, develop, innovate and produce goods and services, the ultimate outcome of equalizing incomes will be lower living standards for everyone.

Numerous government policies serve to make incomes more equal and decrease incentives for the low-income to improve their lot. Take, for example, the earned income tax credit, refundable child tax credit, Social Security tax and Medicare tax. As income increases beyond very modest thresholds, a nearly 50% marginal tax rate kicks in*. Subsidies created by the "health care" act

increase these rates to well over 100% for many. At these rates, many shrug their shoulders and ask, why work harder, earn more and produce more goods or services that others value?

Other government restrictions prevent many from getting jobs in the first place. Adolescents and unskilled adults can't get their hands on the rungs if they aren't yet worth \$9 per hour, not to mention \$15. Occupational licensing prohibits many ready-and-able workers from entering their occupation of choice because of required high entry fees or education and tests that have little or nothing to do with the goods or services they provide.** These regulations are counteractive in discouraging or preventing the poor and untrained from becoming suppliers of things others value. Because financial success, productivity and helping others all serve to build dignity and self-esteem, a particularly perverse outcome is a reduction in dignity and self-

esteem.

Who is better at identifying those worthy of help and assistance: a large, intrusive government with few checks or balances and little accountability, or private, competing providers, which must satisfy those who pay them? Should such crucial decisions be made by politicians and bureaucrats, who rarely if ever are thrown out of business for making bad decisions, or by a marketplace of customer-taxpayers? Taxpayers could direct their donations to organizations they think best suited for the incredibly complex job of helping the down-and-out, receiving tax credits in exchange.

In addition, "help" for able-bodied adults of sound mind could be limited to a lifetime maximum (for example, five years) of assistance and government tax credits. Individuals would decide when to use their assistance, further incentivizing them to become more productive. Increasing

productivity causes self-esteem, wealth and wealth of those for whom they work to increase, leading to higher standards of living for all.

Another issue when considering the coerced equalizing of income is the idea that “scalability” in occupations and professions, as defined by Nassim Taleb in *The Black Swan*, increases with technology. Essentially, scalability occurs where there is no effective cap on the number of patients, clients or other recipients of an individual’s work or productivity. Our profession as Enrolled Agents is *not* scalable; we can charge only one client at a time. My alter-ego profession as a writer, however, *is* scalable. The same time is taken to write an article or a book for one as for one million. The printing press increased exponentially the scalability of the profession of writers. Radio, television, computers, smart phones and other technologies have increased the number of occupations that are scalable.

Compare the Elizabethan actor’s

earnings while entertaining a few hundred, with those of a movie star, earning more by orders of magnitude because technology allows her to entertain millions. Consider Ty Cobb wowing a few thousand in a baseball stadium earning as much as \$1.14 million in today’s dollars at his peak with Alex Rodriguez, viewed by tens of millions on television, where ad dollars help to determine A-Rod’s value, earning more than \$30 million yearly. Similarly, today’s CEOs earn far more running companies and being responsible for hundreds of thousands of employees than their small-shop owners of the 19th or even 21st century.

Non-scalable professions tend towards income equality while scalable professions can result in massive income inequality. The incomes of dentists, consultants and Enrolled Agents are far more equal than those of baseball players, actors, entrepreneurs and CEOs. While nearly anyone who puts in a bit of hard work can become any of the former, very few potential base-

ball players working equally hard ever get to the minor leagues, much less the majors. The income disparity between the lowest and highest paid is astronomical. This is true in all professional sports, films, TV, radio, management and technology companies.

How has this “income inequality”—resulting from technology-induced “scalability”—affected the “poor”? Refrigerators, dishwashers, televisions and countless other appliances and conveniences of modern life are more common in poor homes today than in homes at the median income as recently as 1980, not to mention the fact that the “poor” today live lives of unimaginable luxury compared to Kings and Queens of the 16th century or even the wealthiest capitalists of the 19th century. Consider the collapse in hours of work at median wage levels required to purchase common household appliances in 1959, 1973 and 2013:

Retail Prices and the Time Cost of Household Appliances: 1959 vs. 1973 vs. 2013

| Household Appliance | 1959 | | 1973 | | 2013 | |
|---------------------|----------------|-----------------------------|----------------|-----------------------------|----------------|------------------------------|
| | Retail Price | Hours of Work @ \$2.09/hour | Retail Price | Hours of Work @ \$3.95/hour | Retail Price | Hours of Work @ \$19.30/hour |
| Washing Machine | \$210 | 100.5 | \$285 | 72.2 | \$450 | 23.3 |
| Clothes Dryer (gas) | \$170 | 81.3 | \$185 | 46.8 | \$450 | 23.3 |
| Dishwasher | \$190 | 90.9 | \$310 | 78.5 | \$400 | 20.7 |
| Refrigerator | \$350 | 167.5 | \$370 | 93.7 | \$432 | 22.4 |
| Freezer | \$320 | 153.1 | \$240 | 60.8 | \$330 | 17.1 |
| Stove (gas) | \$190 | 90.9 | \$290 | 73.4 | \$550 | 28.5 |
| Coffee pot | \$23 | 11.0 | \$37 | 9.4 | \$70 | 3.6 |
| Blender | \$22 | 10.5 | \$40 | 10.1 | \$40 | 2.1 |
| Toaster | \$14 | 6.7 | \$25 | 6.3 | \$37 | 1.9 |
| Vacuum Cleaner | \$95 | 45.5 | \$90 | 22.8 | \$130 | 6.7 |
| Color TV | \$ 267 | 127.8 | \$400 | 101.3 | \$400 | 20.7 |
| TOTALS | \$1,851 | 885.6 | \$2,272 | 575.2 | \$3,289 | 170.4 |

Adapted from <http://www.aei-ideas.org/2014/01/data-reveal-that-the-average-working-american-is-better-off-today-than-in-the-1950s-and-wage-stagnation-is-a-myth/>

Not only does the retail price fail to reflect inflation (a dollar in 1959 is worth about \$10 today—that \$350 fridge would cost \$3,500 in today’s dollars); it doesn’t even begin to address extraordinary quality and efficiency

improvements made possible by free markets and incentives. Nor does it reflect computers, cell phones and smart phones that were unavailable or nearly so at any price just 35 years ago, all owned today by the “poor.” In a

truly free society, hard work, innovation and ability improves the lot of the “poor” in both spiritual and material wealth, while also improving everyone’s lives. Ask yourself whether a “handout” can accomplish the same

thing.

* For example, income tax is zero and Self-Employment Tax is \$5,087 on \$36,000 net business income; for a single parent with two children, this is offset by a \$2,014 Earned Income Tax Credit and a \$714 refundable Child Tax Credit, resulting in a net tax of \$2,359. If net income increases by \$5,000 to \$41,000, the income tax is *still* zero, SE tax increases to \$5,793 and the EITC and CTC offsets decline to \$1,035 and \$16, resulting in a net tax owed of \$4,742. $\$4,742 - \$2,359 = \$2,383$, which divided

by the \$5,000 increase in income is 47.66%, the real marginal tax rate on that \$5,000 “chunk” of income. While this rate applies to a relatively small amount, 35-40% real marginal tax rates apply to a vast swath of income in this instance (from about \$20,000 to \$36,000; oddly, the real marginal rate on the income from \$10,000 to \$20,000 is only 11%, and below that level it’s a *negative* 35%).

** For example, most states require a year to two years and \$5,000-\$20,000 for hair styling or cosmetology school for would-be African hair

braiders whose specialty isn’t even addressed in class. The Institute for Justice in its study <https://www.ij.org/licensetowork> provides an excellent synopsis on the issue of irrational, unnecessary and arbitrary occupational licensing. I have no problem with licensing—but it should be voluntary and provided by private, competing organizations, which will tend to make the education and testing much more relevant than the rote memorization of irrelevant garbage one must learn to pass SEC, real estate sales and insurance exams, all of which I have personal experience with.

Roth 401ks and Roth IRAs: Very Different Animals

The question, “Should I contribute to a Roth 401k instead of a traditional 401k?” has become increasingly common, as more employers offer this option. First allowed in 2006 as an alternative to standard pre-tax 401ks, Roth 401ks (along with their Roth 403b and Roth 457 counterparts, for non-profit and government employees respectively), allow employees to contribute after-tax dollars to a retirement account. Earnings grow tax free and can be withdrawn tax free if certain rules are followed, as with Roth IRAs. A related question is, “Should I roll (convert) a traditional 401k over to a Roth 401k?” (allowable since the beginning of 2013). With exceptions, the short answer to both questions is generally “no,” at least without careful analysis and planning.

Unfortunately, Roth 401ks (the rules for which apply to both Roth 403bs and Roth 457s) lack many of the most flexible and best attributes of Roth IRAs. Differences include:

1. Traditional-to-Roth 401k conversions cannot be “undone” (recharacterized) the following year; you’re stuck paying whatever the tax is as if you withdrew the funds (but, as with Roth conversions, penalty free). Therefore, Roth 401ks aren’t as helpful as Roth IRAs in effecting the “income averaging” strategy discussed in numerous pieces in prior issues of *Wealth Creation Strategies* (including articles in issues # 53, 44 and 21), which allows us to fine tune the amounts converted to “use up” only the (lower) tax brackets you choose.
2. Required Minimum Distributions (RMDs), which are never required

from Roth IRAs during the owner’s life, are required for Roth 401ks beginning the later of age 70 ½ or, if the plan’s terms allow, the year after the calendar year of retirement. While this can be avoided by rolling over a Roth 401k to a Roth IRA before age 70 ½, how many taxpayers will miss this opportunity due to ignorance or inertia?

3. There are no exceptions to the penalties for early withdrawals of profits from a Roth 401k, as there are for Roth IRA earnings, to pay tuition, certain medical expenses and up to \$10,000 of the down payment for first-time home buyers.

4. Roth 401k contributions can be attributed only to the year in which the contributions are made, while contributions can be made to Roth IRAs for the previous year until April 15 of the following year. This flexibility allows better planning opportunities than Roth 401ks afford. For many clients, we don’t know the optimal relative contributions they should make to their IRAs and Roth IRAs until their tax return preparation is nearly complete. For example, we may find only after the year is over that a \$500 contribution to a traditional IRA may be all that is necessary to trigger the 50% Low Income Savers’ Retirement Credit, in which case the balance of the credit-maximizing \$2,000 contribution should be made to a Roth IRA. Another example: if we find that a \$2,350 contribution to a traditional IRA saves tax at a phantom 30% rate and additional contributions save only 15%, we would choose to contribute the balance allowed (up to \$5,500 or \$6,500 for those 50 and over) to a Roth IRA. Determin-

ing these optimal amounts with the precision required for Roth 401ks before the year is over is difficult at best. Making similarly optimal contributions to a traditional vs. Roth 401k can be an exercise in futility. While we can improve the odds of success by back-ending the contributions—making them all in the last few months of the year, when we may have an idea of what the year “looks” like—this isn’t a realistic approach for most people and, if we err, we can’t change 401k allocations after contributions have been made.

5. Perhaps worst of all, early withdrawals from Roth 401ks are considered, for tax purposes, to be taken pro-rata from both contributions and profits. For example, if you’ve contributed \$10,000 to a Roth 401k, it has grown to \$12,000 and you withdraw \$10,000, tenths, or \$8,333 is considered a tax-free return of capital, while two-tenths, or \$1,667 is subject to both tax and penalty. A \$10,000 withdrawal from a Roth IRA to which you’ve contributed \$10,000 is 100% tax-free, regardless of the current value of the Roth IRA. This (and # 3 above) makes the Roth IRA much more attractive than the Roth 401k for use as an emergency fund or saving for kids’ college education (along with numerous other creative uses mentioned in “I Can’t do my Roth IRA Because....” in issue # 25 of *WCS*).

6. A positive difference is that Roth 401ks, like traditional 401ks, may be the recipient of matching contributions by the employer. Since this is “free” money to the employee, 401k contributions should nearly always be made up

to the point at which the company stops matching. Be aware, however, that company matches are made with pre-tax dollars, which complicates planning for the optimal allocation of employee contributions.

7. Another positive difference is that Roth 401k contributions can be made

at any income level, while full Roth IRA contributions can be made only by those with incomes under \$114,000 for single filers and \$181,000 for married couples, subject to complete phase-outs of allowable contributions at incomes of \$129,000 (single) and \$191,000 (joint). However, at these high income levels we rarely suggest

foregoing current tax deductions traditional 401k contributions provide.

The Roth 401k is clearly not a Roth IRA. Be sure to speak to us *before* contributing to a Roth 401k or converting a traditional 401k to a Roth 401k.

Comparison of Roth IRAs and Roth 401ks

| Item # above | Attribute | Roth IRA | Roth 401k |
|--------------|-------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------|---------------------------------------------------------------------|
| N/A | Can convert from what retirement account(s)? | IRA, SEPP or SIMPLE | 401k |
| 1 | Can “undo” (recharacterize) the following year? | Yes | No!!! |
| 2 | RMDs required while owner alive? | No | Yes!!! (but see text) |
| 3 | Penalty exceptions for limited pre-age 59 1/2 withdrawals of profits for first-time home buyers, tuition payments and certain medical expenses? | Yes | No!!! |
| 4 | Contribution window (dates)? | By April 15 of the following year, maximizing planning opportunities | By December 31 of the current year, limiting planning opportunities |
| 5 | Distributions considered first from contributions, then from earnings? | Yes | No!!! They are proportional to total contributions and earnings |
| 6 | Company/Employer matches contributions? | No | Often, but with pre-tax “traditional” 401k-like \$\$\$ |
| 7 | Income level at which contributions phased out | \$114,000 - \$129,000 (\$181,000 - \$191,000 Joint) | None |
| N/A | Distributions tax-free if certain rulers adhered to? | Yes! | Yes! |

Bankers Are At It Again!

Once again, some bankers have diserved you, our clients, in multiple situations. A few were told, as in tax seasons prior, you were “too old” to make Roth IRA contributions. To the extent you have wages or self-employment income, subject to the maximum yearly limit (\$6,500 for those 50 and over) you are *never* too mature. Several were told they should not do Roth conversions because, the banker or broker asked, “Why pay tax now when you can pay it later?” and, in at least one instance, the broker didn’t understand the urgency and failed to complete the conversion in 2013. You should have seen the steam coming out of my ears, especially when that individual, otherwise forever and always having income taxed at 25% and higher, could have

paid tax in only one year—2013—at zero, 10% and 15% on the amount we intended to convert. Another was told, as seems to occur every year, she couldn’t do a Roth conversion for some oddball reason that doesn’t matter, because *anyone* can do a conversion regardless of age, income or assets.

The worst, however, was a doozy. A banker allowed a client to do an indirect IRA rollover, twice, within 30 days, both within the same branch—from one division of the bank to another. (As far as we can tell, the banker didn’t feel like doing direct rollovers that day.) Because you can do only one indirect rollover (in which they give you a check rather than directly transfer the funds to another financial institution) in any 12-month period, the

amount the client intended to roll over tax-free became fully taxable. It was especially awful because if our hapless client had spread out the withdrawal over ten years (“income smoothing”) the tax would have been about 60% less than what they ended up paying. And if they had done direct rollovers—IRA custodian to IRA custodian—the tax would have been completely avoided. The coup de grâce was they could have engaged in a series of Roth conversions over a ten-year period, paid 60% less tax and avoided tax on all future earnings on the converted funds. Because the prohibition of multiple rollovers is subject to rules requiring strict compliance (no exceptions allowed), the only recourse the client has is legal action against the bank (and

good luck with that!).

If there is *any* question by the banker or broker about what you are doing or what he or she is telling you, call us before doing anything. If they are contradicting something we have told you (or that you believe), call us

from the banker or broker's office. Occasionally, we have found our client used the wrong term in describing what they intended to do; more often, the banker or broker doesn't understand the law, hasn't been properly trained, or a combination of the two. Either

way, we can fix the problem then and there by correcting your terminology or the banker/broker's thinking. And I promise not to yell at the banker or broker.

Avoid Indirect IRA Rollovers

Tax can be avoided if an IRA custodian sends you funds from your non-inherited IRA and, while you do whatever you want with those funds, the sum is deposited into another IRA within 60 days. This can be done only once every 12 months. In the story above, our client indirectly rolled the same IRA funds multiple times within a 12-month period. This clearly violates the tax-free rollover rules. If instead, funds are transferred directly from one IRA custodian to another, tax is avoided regardless of frequency. It was long believed, however, that *different* IRAs could be safely indirectly rolled, so long as this was done with the *same* funds no more than once in any 12-month period and the funds from any one rollover were rolled into another IRA within 60 days. No more.

In a shocking case, *Bobrow v. Commissioner*, tax attorney Alvan Bobrow, arguing *pro se* before the U.S. Tax Court, lost. Bobrow had made sequential indirect rollovers from three different IRAs that effectively gave him the use of \$65,000 for six consecutive months. The court ruled that the last two were fully taxable and subject to early withdrawal penalties. Granted, he flouted the rules, but the ruling contradicted the IRS's own guidance on the subject. For years the IRS, via Publication 590, informed taxpayers that IRA owners could do one indirect rollover *per* IRA account every 12 months. Theoretically, someone could have done six sequential 60-day rollovers per 12 months from six different IRAs if they wanted use of those funds for the entire year.

We have long suggested that indirect rollovers be avoided. Several clients have received IRS computer-generated love-letters questioning such rollovers. While we've even had a few clients get such letters for direct (custodian-to-custodian) IRA rollovers ("transfers"), which are easy to respond to, indirect rollovers require assiduous proof of being completed within 60 days and, now, proof that there were no other such rollovers within 12 months before or after from or to *any* of their IRAs. The whole question is best avoided by simply not doing indirect rollovers—ever. Save yourself time and worry and request direct rollovers when you switch IRA custodians.

The Attorney General Becomes Victim to Tax Return Identity Theft

U.S. Attorney General Eric Holder recently was victim of fraudsters filing tax returns using his name and Social Security number, along with fake income and withholding numbers designed to create a tax refund sent to the fraudsters' address. The problem of tax return ID theft has obviously hit the big time when even the nation's top law enforcement officer is subjected to this crime.

The IRS's incompetence in stemming such fraud is breathtaking. In *WCS* issue # 51, we mentioned that 2,137 refunds were sent to one address, which should have raised questions before the refunds were sent. As is all-too-common, government has proven incompetent at performing functions in which it "should" be engaging (not to mention the nearly countless functions

it doesn't belong doing but which it attempts to do anyway). There are at least two simple and effective ways it could put a huge dent in such ID theft.

In a letter to the editor of *The Wall Street Journal* (March 2, 2014), Lawrence Gering of Walhalla, SC, suggested that when you change your address—whether on your tax return or via IRS Form 8822 "Change of Address" between tax return filings—the IRS should immediately notify you with a letter sent to your old address, just like financial institutions do. I would add that refunds for those changing addresses only when the tax return is filed could be sent the same sort of letter and the refund could be delayed by, say, two to four weeks—long enough for the individual to react to such a letter and stop the issuance of

a fraudulent refund.

I would suggest that anyone using new direct deposit information also be notified with a letter. To stem delays in refunds, Form 8822 could include a section for direct deposit information.

Our own Kristin Ericson, EA, suggests that your Adjusted Gross Income from a prior year return could be used as a PIN # to e-file current tax returns. She points out it would be difficult at best for someone with malintent to gain access to your prior year return and fraudulently e-file a current year return even if they have your name and Social Security number. I would suggest combining the two ideas would make life very difficult for would-be scammers. We'll call it the Gering-Ericson (or Ericson-Gering, as she insists) tax return life-lock.