Inside Highlights:

- **The Price is Not the Cost: the Case of Housing pgs. 1-3**
- **What Will the IRS Do With the Extra Funding pgs. 3-4**
- **Withholding and "The Tax" Are Not the Same pgs. 4-6**
- **Strategic Errors and Costly Mistakes: IRAs, Roth IRAs and Conversions pgs. 6-8**

"…we want to avoid creating a civilizational risk by having…too much cooperation between governments…..[Neither the rise nor fall of civilizations has] meant the doom of humanity as a whole because there've been all these separate civilizations that were separated by great distances."

— Elon Musk, speaking at the World Government Summit 2023

This is one of the key reasons for the devolution of rights to states, counties, municipalities, and the individual, as imagined by the Founders. The question I have for every central authority telling us how to run our lives is: what if you are wrong? As Elon Musk surmises, one major error could lead to the end of civilization.

Tax and Financial Strategies

Copyright © 2024 by Doug Thorburn, E.A., CFP (818) 360-0985

Issue # 73 Winter 2024

Wealth Creation Strategies

The Costs of Buying a Home Doubled in Four Years. When Will House Prices Collapse?

In 2019 the U.S. median house price was $320,000. By November 2022, that median had climbed to $440,000—a 37.5% increase. In some areas, such as Florida and Tennessee, prices inflated much more. For example, a home valued at $450,000 in 2019 in the small city of Loudon, Tennessee (near Knoxville) soared in value to $785,000 in 2023, a nearly 75% increase. That is far from the most extreme case.

So why do we say, housing costs doubled? Because when monthly payments must be made, changes in the price of money—the interest rate—can completely change our perspective. The price is the advertised price of the home. The cost is the monthly payment, which is a function of both house price and the price of money—interest rates. Home buyers really "buy," so to speak, a monthly payment. To see how much costs have really increased over the last four years, then, we must consider the dramatic increase in the price of money *.

We could analyze this by subtracting a typical down payment from the purchase price to arrive at the amount borrowed (mortgage loan). The interest rate plus a loan amortization table give a monthly cost to purchase. However, subtracting the down payment is arguably misleading. Down payments can be invested at an interest rate slightly lower than the current cost of a mortgage, creating an "opportunity cost" of the initial investment. Down payments also serve to reduce the amount of cash available for inevitable improvements, renovations and furnishings, not to mention out-of-pocket costs like moving and storage. Typically, many borrow to pay for such expenses, on which the price of money (the interest rate) is much higher than the cost of a mortgage (almost always the cheapest money available for home buyers). Therefore, we will compare costs by assuming the entire purchase price is financed.

Primary home loan interest rates bottomed at a tad under 3% in 2020 but averaged about 4% in 2019, the year before prices began to skyrocket. Rates peaked, so far, at a bit higher than 7.5% and hover around 6.25% as of this writing. Who knows where the heck prices are now; since late 2022 some areas have continued to inflate and, in others, they've dropped. Therefore, let's use the 2019 and 2022 home purchase prices above, along with 4% and 6.25% interest rates and compare the total cost of a home.

The monthly payment on a 2019 home priced at $320,000 with a 30-year 4% interest rate loan is $1,529. The monthly payment on a 2022 home priced at $440,000 with a 30-year 6.25% interest rate loan is $2,709, or 77% greater.

Looking at a higher-priced home, the monthly payment on a 2019 home priced at $450,000 with a 30-year 4% interest rate loan is $2,150. The monthly on a 2022 home priced at $785,000 with a 30-year 6.25% interest rate loan is $4,833, or 125% greater!

True costs of ownership, then, have increased considerably more than the nominal median price increase of 37.5% and way more than overall purported inflation, reported by the government at roughly 20% cumulatively from July 2019 through December 2023, which no one believes (among other lies with statistics, "shrinkflation" is not accounted for).

But interest rates will drop! Won't they?

You might think interest rates will continue to drop and indeed they may. The 40-year decline in rates that ended in 2021, during which time rates collapsed from 18% to less than 3%, was not a straight down and smooth decline. Interest rate collapses were commonly punctuated by temporarily spiking rates, before declining again. We expect an overall increase in rates to be no different, but in the opposite direction: increasing rates will likely be (and so far have been) punctuated by temporarily decreasing ones in an overall upward trend. I would be surprised if rates dropped to anywhere near the lows of 2021, which I think were 100-year lows. Of course, I could be wrong.

Say rates decrease to 5%—the likely low end of where they may sit for a while. The monthly payment on a $440,000 30-year loan at 5% is

$2,365—55% more than the $1,529 on the 30-year $320,000 loan at 4%. If overall inflation since mid-2019 was truly 20%, the monthly payment should have increased to ($1,529 x 1.2 =) $1,835, which is wildly different than the reality of home costs today. Using the $1,835 monthly payment at 5% interest rates on a 30-year loan results in an expected home price of $341,000, which requires the nominal home value to drop by 22.5%—from $440,000 to $341,000.

Average debt-to-income ratios for all home buyers are nearing 40%—a ratio last seen prior to the 2006-2012 price collapses. This does not leave much buying power at current prices. Loan officers are reporting $7,000 monthly mortgage payments taken on by middle class homebuyers, who tell lenders they will be able to afford the house, since they will be able to refinance when rates come down. But what if rates do not materially drop from the current 6.25% range? Or, what if they don't drop fast enough and the home buyer is stuck paying 6.25% for years? What if you guess wrongly on how far they will drop because no one can forecast what rates will do and you miss the opportunity to refinance at 5%? At that point, might you bet that rates will come down further and instead you freeze as rates climb back towards 7% and higher?

Without willing sellers, what might precipitate a collapse in prices?

The question, then, is not "should" median prices drop by at least 20%—and more than 40% for the pricier home mentioned above; rather, it is what could precipitate such a collapse. Because sellers are reluctant to lower their selling prices, prices are "sticky" in a downward direction. "My house is worth $1 million, and I won't sell for a penny less!" is a common refrain, even though they bought it for only a half million a decade before. Moreover, we have the greatest "lock-in effect" in history: countless would-be sellers will not (and cannot) give up their 3% and 4% loans on their existing home to buy a home at 6.25%. As a result, there are far fewer willing sellers, seen in the utter dearth of listings. The few willing to sell are often heirs selling a decedent's home or homeowners with large amounts of equity who want to downsize and can pay cash for a lower-priced home.

There is also a crucial class of sellers who must sell—developers. They could spell the beginning of trouble for reluctant existing home sellers because once developers lower their prices to sell their inventory (which they have done in many areas), existing home prices must come down to be competitive.

It's a problem on the purchasing end, too. With both home prices and the cost of money so high, few can afford to buy a home, even their existing home. More than 85% of California families cannot afford to buy a median-priced home in California ($750,000 as of late 2023). Due to the increase in the price of money, the number of available buyers has shrunk to a fraction compared to the available buyers at suppressed, absurdly low interest rates.

Hyper-low rates encouraged investors to buy property(ies). With a 3% return from net rents, they earned 300% more than the piddly 1% rate on T-bills of 2020. Increasing rates have (so far) resulted in a 50% collapse in investor purchases (click here to read the article). Today, why would investors buy real estate yielding 3% net rental income when they can put their cash into savings at 5%? Like anyone else, they ask which is better: a safe, hassle-free 5% CD or the risk and hassle of dealing with home or rental property maintenance and tenant issues only to earn 3%? An investor who is looking for a 5% return on a home currently yielding net income of 3% will wait for the home to yield 5%—requiring a collapse in value of 40% before they buy. If investors start to demand prices for homes that result in a yield of 7% or 8%, as they did for multi-family housing for decades, you can kiss the great home buying bull market goodbye.

Few sellers and even fewer buyers

Sales have already slowed considerably, as they did in 2006-2007 prior to the collapse in prices that occurred largely in 2008-2010. At the end of 2023, *The Orange County Register* reported that home sales in Los Angeles and Orange Counties decreased by 42% over the previous 12-month period.

Dramatic price drops require few buyers and desperate sellers. There are few buyers, but as of yet there are not many desperate sellers. The bubblicious 2000s price peak occurred on the coasts in 2005-2006. Prices levitated for a few years as sales came to a standstill, finally collapsing under the weight of forced selling due to foreclosures in late 2008 through 2010, with a secondary bottom in 2012. Real estate price capitulations take time.

There is another way for a collapse in real estate prices to occur: inflation in everything else except for real estate. If real estate prices stay the same but there is price inflation in other goods and services, the "real" price of property is reduced by the amount of inflation. Because so many who would like to sell will be reluctant to give up their 3% mortgages, a price collapse could take so long that inflation might substitute for a cataclysmic nominal real estate price crash. For example, if general price inflation is 100% over a decade (which requires a tad more than 7% annual inflation) and nominal prices of real estate are the same in ten years, "real" prices collapsed by 50%. In other words, a $400,000 home today that sells for $400,000 ten years later is really worth only $200,000 in inflation-adjusted dollars (its "real" inflation-adjusted price dropped by half) **.

At 6.25% mortgage rates, the median priced home valued at $440,000 in November 2022 would need to plummet in price to $298,000, for the $1,529 original monthly cost to increase to $1,835, 20% higher than the 2019 cost. From current levels, that's a price collapse of 32.2%, taking us below 2019 prices. Due to both general price inflation and what could be at least a temporary drop in interest rates, prices may not plummet to those levels. Still, I suspect price declines in most areas will drop a minimum of half-way to prices last seen in 2019. For example, the median $320,000 home that increased to $440,000 would drop in price to $380,000—a drop that seems understated.

Some areas will do better than others. There is currently a flight from higher-tax and higher-crime states (like California, New York and Illinois) to lower-tax and lower-crime states (Texas, Florida and Tennessee), which may result in lower-tax and crime states' property values holding up better than higher-tax and crime states' values ***. Because so many Americans learned they can work remotely, home values in rural areas may not drop by as much as those in urban areas, especially with the elite's desire to herd us into 15-minute cities ****. This fatal conceit may provide an even greater impetus for the net out-migration from cities. If I were to purchase anything today, I would look at rural areas, including smaller towns and cities and I would drive a hard bargain on the price. And if I were to sell, I would get ahead of the market rather than follow it down in price. But as always, I could be wrong about any or all of this.

* Buyers also factor into their decision making and ability to pay other costs of ownership, including property taxes, utilities, gardening, maintenance and insurance, the costs of which have all increased. While these create too many variables to include in our analysis, they must be considered, especially in areas where such costs have been artificially inflated due to energy and other mandates.

** Take a million-dollar shack, which costs $3,500 per month at 3%. At 7%, it will cost $7,000 per month . If prices of other goods, services and wages in the overall economy double, your $7,000 fixed cost is now affordable—it is now the equivalent of a $3,500 payment from the time before prices doubled. Or, to get the same result with 7% interest rates and zero inflation (not gonna happen) the shack price needs to collapse to $500,000.

*** Obviously, there are other factors at play, such as weather and NIMBYs, which could offset this at least in part. NIMBY's is an acronym for "Not In My Back Yard," which involves existing residents (and, often, businesses) in a neighborhood blocking a new development or occupancy change as "inappropriate" for the area. This serves to decrease supply and increase prices for the existing supply of homes in the area.

**** The 15-minute city aims to reorganize urban space around work, home, community and amenities – the idea is that every need is fulfilled within a 15-minute walk or short bike ride. This is part of the "Great Reset."

Massive Increase in Funding for the IRS Suggests the Likelihood of Increasing Numbers of Audits

Over the past decade, there has been a dearth of IRS audits. The vast majority of IRS scrutiny has been computer-generated notices assessing tax on omitted income discovered from the IRS matching program, comparing W-2s and 1099 income reported on tax returns with records provided by payers.

We expect this to change. The grotesquely misnamed "Inflation Reduction Act," passed in August 2022, increased the IRS yearly budget of $12 billion by $80 billion spread over the next ten years, since reduced to $60 billion. Whether $80 billion or $60 billion, this works out to a minimum 50% annual increase in IRS funding over the previous budget. A large portion is earmarked to increasing IRS enforcement, which translates to more audits.

The question we have is: what is left for the IRS to audit?

A brief history of 1099s

The reporting forms issued by payers that the IRS can match against tax returns have increased exponentially over the past four decades. While brokers have long issued Form 1099-DIVs for dividends, Form 1099-Bs reporting the sales of securities were introduced in 1983. The cost (or "basis") of securities sold was reported to the IRS beginning in 2011. Form 1099-Ss, reporting the gross price of real estate sales, were required in years beginning in 1988. And Form 1099-Ks were launched in 2011. These report payments (sales of goods and services) to merchants by credit card companies and other third-party settlement entities (such as PayPal or Venmo) and allow the IRS to find businesses that are non-existent in IRS records and/or grossly underreport income.

Forms 1099-NEC and 1099-MISC report income for services, rents, royalties, prizes, awards and other types of income provided by non-corporate entities (and medical and legal corporations) to other businesses, rentals and recipients of other types of income. While required for decades, the penalties for failure to issue 1099s were a pittance 40 years ago and, as a result, often were not issued. The penalties for failure to issue 1099s gradually became much more onerous. In addition, since 2011, tax returns have been signed under penalties of perjury stating that all required 1099s have been filed (or that they were required but not filed—an audit trigger). We think both the penalties and the perjury statement have caused taxpayers and tax pros to take their responsibility of issuing 1099s more seriously.

When the income tax was instituted in 1913, payers were required to report all payments of $800 or more to an individual during a calendar year, which is the equivalent of about $25,000 today. This threshold was lowered to $600 and has never been adjusted for inflation, exponentially increasing the number of payments reported.

In effect, by requiring payers to issue increasing numbers of 1099s, Congress has forced payers to take over a significant portion of the IRS's work, which decreases the need for policing the reporting of income.

A brief history of deductions

Entire chunks of deductions (viewed as anything that serves to reduce taxable income, whether as an adjustment to income or itemized deduction) have disappeared over the past few decades. The Tax Reform Act of 1986 eliminated nearly all tax shelters, which freed up a tremendous amount of IRS resources. Employee business expenses as an adjustment to income, without

regard to itemizing personal deductions, were eliminated. These were moved to miscellaneous itemized deductions subject to a 2% of Adjusted Gross Income (AGI) "haircut" beginning in 1987. Medical deductions, which were allowed as itemized deductions to the extent they exceeded 2.5% of AGI, were no longer allowed unless they exceeded 7.5% of AGI. The deduction for all personal interest was eliminated, except for mortgage interest, which is nearly always reported on Form 1098. The maximum deduction for home mortgage interest was reduced to the interest on debt of $1,000,000 or less and, more recently with the 2017 Tax Cuts and Jobs Act, to $750,000, despite skyrocketing house prices. That Act also eliminated the deduction for all "equity" debt, leaving a deduction only for "acquisition" debt (original purchase plus improvements made using that debt). It also doubled the standard deduction, which eviscerated the value of all itemized deductions, but especially what remained of mortgage interest deductions.

The 2017 Act also eliminated all miscellaneous itemized deductions subject to the 2% of AGI "haircut," which includes a plethora of highly auditable deductions such as unreimbursed employee business and investment expenses. The Act also limited the itemized deduction for state and local income and property taxes (the "SALT" deduction) to $10,000, leaving practically nothing in that category for the IRS to question. The increased standard deduction rendered most remaining deductions moot, as the percentage of taxpayers itemizing collapsed from over 30% to less than 10%. With the exception of medical deductions, remaining deductions are easily verifiable. Property taxes are listed in county records; state income taxes are usually reported on Form W-2. Charities are required to issue acknowledgement letters for donations of $250 or more. Mortgage interest paid, reported on Form 1098, has been matched against IRS computers since at least the 1980s.

The exemptions for dependents, which was the equivalent of a special deduction, was turned into a tax credit in 2018. Social Security numbers for dependents have been required since 1986, when several million dependents went "poof!" overnight due to the new requirement.

A brief history of the estate tax

Other returns the IRS can audit for which there are far fewer items to question include estate returns, which take an extraordinary amount of time, expertise and knowledge to both prepare and audit. Every estate return ever filed has been closely scrutinized by IRS auditors and lawyers, even if not subjected to a formal audit. Prior to 1976, roughly 7% of estates owed estate tax. After the Tax Reform Act of 1986, which increased the estate tax exemption, barely .3% owed any such tax. As recently as 2001, nearly 110,000 estate returns were filed yearly. With the enormous increase in the estate tax exemption over the last few years less than 7,000 returns have been filed annually, with only 4,000 returns reporting any tax. According to the Tax Foundation, "To put the number of estate tax returns filed in perspective, the Population Division of the Bureau of the Census estimates that about 2.7 million people died in 2019….an estate tax return will be filed for only about .15% of decedents, and only about .07% will pay any estate tax."

So what *will* the IRS audit?

Before the increased funding, some tax authorities argued, "We are starving the IRS! There is so much work to do with so few resources!" With the staggering decrease in items for the IRS to review and examine, just what is left for them to audit? They already scrutinize the vast majority of large publicly traded firms nearly every year.

With the massive increase in the IRS budget, our best conjecture is the IRS will focus on auditing small- and medium-sized businesses and those owning rental properties. While gross income figures may be readily available to the IRS via 1099s, many businesses and residential income property owners still receive at least some cash, and most expenses are not reported by third parties—two areas the IRS has identified as prime targets in "need" of examination. We expect increased scrutiny (i.e., "audits") of Schedule Cs (sole proprietors), Schedule Es (rental properties), and all forms of small business entities—taxed as partnerships, S Corporations or C corporations, whether LLCs or non-LLCs. This is yet another attack on small businesses which, with much more funding for the IRS, will likely escalate in the coming years.

Withholding is Not "The Tax;" "The Tax" is Not the Withholding

Many clients confuse withholding on their wages and retirement income with their annual tax liability, which we will refer to as "The Tax." We often hear from clients, "I shouldn't owe anything! The tax was already withheld by the employer or retirement plan!" Yet, withholding and "The Tax" are very different.

Withholding is an amount of federal and state income tax withheld by a payer (employer, retirement plan, etc.) intended to cover the tax on that "chunk" of income. "The Tax" is your actual full-year tax as calculated on the tax return, which is based on income, types of income, deductions, types of deductions, and tax credits. "The Tax" is independent of withholding and estimates paid. When filing your return, to determine your refund or balance due, calculate the difference between "The Tax" and all sources of withholding plus estimate payments. If there is a surplus of withholding and payments, you get a refund; if there is a deficit of withholding and payments, you owe.

The amount of withholding does NOT affect "The Tax" in any way. However, most taxpayers want enough withholding to cover their annual tax, so they do not owe additional tax when filing their tax return. The problem is

withholding is a guesstimate that must be made ahead of time. The withholding on a particular "chunk" of income might be zero or 30% or anything in between, but your actual tax may be a very different amount.* You may have zero tax withheld on certain types of income (an IRA withdrawal, investment income, Self-Employment income, net S corporation or partnership income, etc.), yet the marginal tax rate on that "chunk" of income might be upwards of 50%. Or, you might have 20% withheld and the actual tax might be 10%. Other than in the case of taxpayers with one W-2, no other income, dependents, deductions, or credits, withholding rarely matches the actual tax.

Form W-4 (for wages) and Form W-4P (for certain pension payments) are intended to result in withholding that closely approximates "The Tax" when there is only one income source. When there is other income, deductions, or credits, completing these basic withholding forms will not yield withholding that matches the tax on that particular income. Under-withholding is especially common with irregular (lump sum) IRA or other retirement plan withdrawals. Depending on how Form W-4P is completed, some tax may be withheld but the payer has no idea how much *should* be withheld to cover the actual tax on that "chunk" of income. We can all but guarantee the "correct" tax will not be withheld. When planning, we run estimates for clients who inform us in advance they are taking a withdrawal, but all too often we learn of under-withheld income only when we see the 1099s. Then, it is too late.

Let's start with a very basic example. A married joint filer has $25,000 of income for the calendar year. If the income consists of W-2 wages and the sole income earner claims "married" on her Form W-4, federal income tax withholding is zero. Since $0 is "The Tax" for a married filer with that income, nothing is owed or refunded when filing the tax return. If the $25,000 of income consists of yearly IRA withdrawals for a person over age 59 ½, or for any other reason for which the 10% federal early withdrawal penalty does not apply, there is no required withholding and "The Tax" is zero. However, if 10% or ($25,000 x 10% =) $2,500 is withheld, they would receive a refund when filing the return because "The Tax" is zero. And why give the government a tax-free loan? In this new era of 5% interest rates, that temporarily inaccessible money might have earned you $125 or more, or saved you $500 in credit card interest.

On the other hand, if $25,000 income was withdrawn as a lump sum from a non-IRA pre-tax retirement account, there is mandatory withholding of 20%, or ($25,000 x 20% =) $5,000. So long as the recipient of that income is over age 59 ½ and this is the only income in the family, the entire $5,000 will be refunded when filing the return.

Let's look at a more typical situation with more than one type or source of income. A taxpayer over age 59 ½ filing joint has $120,000 of wage income, which generally puts them in the advertised 22% marginal federal tax bracket for 2023 for any additional income up to nearly $220,000. They withdraw $25,000 from an IRA, electing zero withholding. Assuming tax withheld equals the tax on the wage income (and there are no other complicating factors—see next paragraph), federal income tax of 22% of $25,000, or $5,500 will be owed on the IRA withdrawal at year-end.

"The Tax" vs. the marginal tax rate

"The Tax" and withholding are very different from the "marginal tax rate," which is crucial to decision-making. The marginal tax rate is the percentage tax rate on a particular "chunk" of income (or deductions). This rate is essential for planning purposes because it allows you to determine the tax on additional "chunks" of income or tax savings on additional deductions. (There are many strategic methods by which income and deductions can be increased or decreased, which are beyond the scope of this article.)

It should be noted that the federal tax on additional income depends on a seeming infinite number of "phantom" (or hidden) but very real marginal tax brackets, based on the type(s) of income, deductions and credits. The problem is, the real marginal rate is frequently not the "advertised" marginal one, the one the government publishes in tax tables. The advertised rates are currently 0%, 10%, 12%, 22%, 32%, 35% and 37%. However, due to phase-ins of certain income and phase-outs of certain deductions and credits, the phantom but very real tax rate can be much higher than the advertised one. For example, as other income increases the amount of taxable Social Security also increases, which could result in phantom tax rates of 15% and 18.5% for those in the 10% advertised bracket, 22.2% for those in the 12% advertised bracket, and 40.7% for those in the 22% advertised bracket. Allowable rental losses are phased out over a certain income level, which can turn a 22% advertised bracket into a phantom 33% bracket. Some credits are phased out over narrow income ranges. For example, the American Opportunity Tuition Credit (AOTC) phases out over a $10,000 stretch of income ($20,000 for joint filers) and can create phantom rates of up to 72%.** Due to the complexity of tax law, numerous other phantom brackets can make planning a nightmare.

We need the full picture of all income, deductions and credits expected for the *full* year to determine the real tax rate on additional income or deductions. Withdrawals from retirement plans and other such "add-on" income to the usual income must be carefully planned to avoid unpleasant surprises.

It takes only an email, fax or phone call to let us know what you are thinking of doing, so we can help you understand the true cost of taking a particular action—whether to take additional income or create additional deductions—with eyes wide open. Then, we can ensure you have enough withholding or estimates paid to cover "The Tax."

* Different types of income are taxed at different rates and different types of deductions save tax at different rates. For tax credits, we need enough detail to determine whether a taxpayer qualifies for a particular credit and whether the credit is phased out due to exceeding income thresholds.

** The Retirement Savers Credit, Earned Income Tax Credit, Child Tax Credit, Other Dependent Credit, and Dependent Care Credit are also eliminated over relatively narrow stretches of income. The new "Clean" Vehicle and Lifetime Learning Credits are instantly eliminated over certain income thresholds.

Misconceptions, Errors and Mistakes: IRAs, Roth IRAs and Conversions

Which saves more tax in the long run: Roth IRAs or Traditional IRAs?

The long-term tax benefits of Roth IRAs can far exceed traditional IRAs. Since their advent in 1998 I have consistently encouraged clients to make Roth contributions, when eligible. The challenge has been getting clients to look past the short-term cost, no deduction, to the long-term savings, tax-free distributions. For reasons to be discussed in an upcoming article, many more clients should have been contributing to Roth IRAs and Roth 401k's instead of pre-tax retirement accounts—traditional IRAs, 401k's, 403b's and the like.

After-tax funds are contributed to Roth IRAs and those funds grow tax free. If done right *, tax is never paid on Roth IRA withdrawals. On the other hand, traditional IRA contributions are deductible for the year contributed and tax is only deferred until withdrawals are made. The tax paid on withdrawals is often far more than was saved by the deduction.

An example illustrates the enormous tax savings potential of Roth IRAs. Following our advice, a client contributed $46,000 to his Roth IRA over the course of a decade. He asked, "Doug, what should I do with the half million dollars in my Roth?" I said, "You don't have half a million dollars, you must be confused." He responded, "My current statement shows I have $522,480 in my Roth IRA." He must have hit the jackpot in stock selection. "What did you buy?" He responded, "Apple." Every time I recommended that he contribute to his Roth, he bought more Apple. I responded simply, "Brilliant. Now wait until you turn 59 ½ before withdrawing and you'll never owe a dime to the IRS or state."

If these contributions had instead been made to a deductible traditional IRA, the entire half million would be fully taxable when withdrawn.

At a combined 31.3% federal and state marginal tax bracket, our client would have saved about $14,400 by deducting $46,000 in traditional IRA contributions. At the same tax rate, he would pay about $163,500 in tax on the $522,480 in traditional IRA withdrawals—contrary to most people's assumptions, marginal tax rates often remain the same or worsen in full retirement (to be discussed in an upcoming article). By making Roth IRA contributions rather than traditional IRA contributions, he forfeited up-front tax savings of $14,400, but saved $163,500 of tax on withdrawals. He will have saved nearly $150,000 over his lifetime.

Clearly, Roth contributions can save far more taxes in the long run than contributions to a traditional IRA.

The backdoor Roth IRA strategy

Let's say due to income limitations, the same client was ineligible for Roth or deductible traditional IRAs every year and instead made non-deductible traditional IRA contributions. To avoid tax on all growth, he could have immediately converted each contribution to his Roth IRA via the backdoor Roth IRA strategy (which generally assumes little or no funds in other pre-tax IRAs, SEPPs or SIMPLEs). A failure to convert quickly, or never, can create a tax mess.

If he doesn't convert, he will pay tax on withdrawals in excess of the $46,000 in contributions, pro-rata.

Assuming a value of $522,480 at the end of the prior year (the preceding end of year value is used to calculate the taxable vs. non-taxable portion), $46,000 total post-tax contributions divided by $522,480 prior end of year value equals 8.8% of that year's withdrawal would be non-taxable and the other 91.2% would be taxable. Each year forever after requires similar calculations. This tax result and additional unnecessary complications is the reason I urge those using the backdoor Roth strategy to "Convert NOW!"

Should you trust financial institution employees for advice?

The failure to get us involved when dealing with bankers, brokers and insurance agents who suggest that you do something different from what we have advised can prove detrimental to your financial health.

We do our best to match withholding on taxable withdrawals with the expected tax (see related article). Despite being given explicit instructions, withholding is often incorrect due to misguided counsel from financial institution employees. One client had enough withholding on their Social Security "benefits" to cover the tax on a $30,000 IRA withdrawal but, at the urging of the banker, had 10% unnecessarily withheld (even though no withholding is required on IRA distributions). The IRS refunded the $3,000 the following year, without interest of course.

We have seen tax withheld on both Roth IRA withdrawals and Roth conversions, which we generally do not recommend—we want the money in the Roth because those funds grow tax free **. In one instance, $8,000 was withheld on a $40,000 conversion, leaving only $32,000 to grow tax free inside the Roth IRA. While the client could have rolled other funds to the Roth, or even rolled it back to the IRA, they had only 60 days to do so. By the time we discovered the error, it was too

late to fix it.

Both clients in the examples above, one withdrawing $30,000 with enough withholding on their Social Security and the other converting $40,000, told us the financial institution employees recommended withholding tax even though we had instructed our clients otherwise. If a banker, broker or insurance agent tells you to do something that differs from our counsel, please get us involved.

Are 1099-Rs always correct?

A client directly rolled a $50,000 inherited IRA from one bank to another (a non-taxable event); Form 1099-R showed the full $50,000 as a taxable withdrawal.

Another IRA custodian incorrectly coded inherited IRA withdrawals as subject to both tax and the 10% (under age 59 ½) early withdrawal penalty. Inherited IRA withdrawals are never subject to early withdrawal penalties regardless of age (and these clients were over 59 ½, so would not have been subject to penalties regardless).

With our assistance, these errors were corrected, but it was aggravating because the financial institution employees did not seem to know the first thing about rules for retirement plans. Adding to the misery, corrections occasionally do not get properly sent to or recorded by the IRS, resulting in IRS love letters long after we thought we were done correcting the mistake ***.

What are the most common planning errors when dealing with Roth conversions and IRA withdrawals?

The most common—and costly—missed opportunity is the failure to do Roth conversions in years when one's tax rate is low. Expected tax rates in retirement must be forecast and compared with current rates to determine the likely long-term tax savings. Because of the way Social Security is taxed, anyone with a modicum of both Social Security and non-Social Security income will be subjected to a 22.2% marginal bracket. Worse, with inflation-driven boosts in Social Security "benefits," we are increasingly seeing recipients subjected to a 40.7% marginal bracket. You clearly want to take advantage of lower marginal tax rates while you can, especially before starting Social Security.

Converting to the extent you pay a lower tax now than later is a no-brainer. Paying a 12% rate on, say, $30,000, costs $3,600. If your rate will be 22.2% on $30,000 later, you saved more than (22.2% - 12% x $30,000 =) $3,000 in tax [or (40.7% - 12% x $30,000=) $8,610 for those subjected to a 40.7% marginal rate on those same funds later in life]. If the $30,000 grows to $50,000, the tax will be $11,100 at the 22.2% rate ($20,350 for those slammed with a 40.7% rate). You will have saved $7,500 (or as much as $16,750) in tax over the long run. This strategy is too often missed either because of short-sightedness or being unaware that retirees can be subjected to such awful tax rates.

Why? Because they are so well hidden in the way Social Security is added to the taxable base. Tax tables make you think you are in the 10% or 12% marginal bracket, when in fact you in 15%, 18.5% and 22.2% real brackets. A look at a tax table makes you think you are in the 22% bracket when, because your Social Security is still being phased in to the taxable base, you are in a phantom-but-very-real 40.7% marginal bracket, and even higher in some cases due to a phase-out of the medical deduction and the way long-term capital gains and qualifying dividends are taxed.

The second most common missed opportunity is the failure to take small incremental IRA withdrawals over time, which I refer to as the "income smoothing" strategy. This is especially important when planning for large expenditures. For example, if you need a new car in the future (or a home remodel, or a new roof, or...), the tax bill is *generally* lower if you withdraw (or convert) $15,000 per year over four years and save the funds in a non-retirement account (or Roth IRA, letting the funds grow tax-free until you are ready to use them), rather than $60,000 all in one year.

In an extreme example, a retired client with $30,000 in Social Security "benefits" and a $5,000 IRA RMD wanted an additional $60,000 to eventually give to his granddaughter to help with a down payment on her first home. He only had $100,000 left in his IRA, figured he had only four or five years to go and did not need the money. He presciently asked how to minimize the tax on the $60,000 withdrawal. We settled on a four-year plan: rather than withdraw from his IRA, we decided to convert $15,000 per year for four years. The total tax: less than $4,000. Taking the entire $60,000 in one year would have cost nearly $14,000. He realized a $10,000 tax savings. Worse, if he had left the IRA to his granddaughter, we estimated she'd have paid nearly $20,000 of tax on the $60,000. In the meantime, his conversions are expected to earn a completely tax-free $4,500 of interest over the next four years.

You can read more about the "income smoothing" tax savings strategy in pages 1-3 of issue # 53 and pages 1-5 of issue # 44 of *Wealth Creation Strategies* at www.dougthorburn.com/newsbyedition.php.

What strategies can save tax for those who wish to bequeath funds to charities, or to beneficiaries in wildly disparate tax brackets?

The charitably minded often leave money to charities from non-retirement accounts rather than their pre-tax retirement accounts. This is a costly error for non-charity heirs.

Tax is paid by beneficiaries of inherited traditional IRAs and other pre-tax retirement accounts. Because charities pay no tax on retirement funds, any bequests should always be made from traditional IRAs or other pre-tax accounts.

For example, let's say you die with $500,000 in a traditional IRA and $600,000 in other savings/investment accounts. You want to leave $100,000 to charity. If the $100,000 is bequeathed from the non-IRA accounts, the non-charity heirs will pay tax on the entire $500,000 IRA. If the charity receives the money from the IRA, the heirs pay tax on just the remaining $400,000 IRA, likely saving $30,000 (and as much as $50,000) in federal and state income tax.

Another error is the failure to leave traditional and Roth IRAs to heirs based on each heirs' individual tax situation. To take an extreme example, say a couple has two children, one with $500,000 and the other with $50,000 yearly incomes. Which heir should get the traditional, and which the Roth? Although the answer should be obvious—the higher income child gets the Roth, on which no tax will ever be paid, and the lower income the traditional, on which that child will pay tax at low rates—this logical division of assets is oft overlooked. Of course, we would want equalization payments recognizing one child must pay tax, while the other does not, so it can get complicated, requiring careful analysis.

There are infinite variations of these misconceptions, errors and mistakes. The absurd complexity of tax law requires careful planning, which is vital to keep and grow your wealth.

* Generally, do not withdraw until you are 59 ½! Certain other rules pertain to the number of years since you made your first Roth contribution, with similar but even trickier rules applying to conversions.

** On occasion we advise withholding tax on such withdrawals to avoid under-estimated tax penalties to compensate for under-withholding on other taxable income. Such penalties may be worth avoiding at the current 8% per annum penalty rate.

*** The employers are so hyper-focused on meeting government rules under banking regulations, especially those promulgated after the Great Financial Crash of 2008, they spend little or no time educating employees on how to properly guide customers. Although bankers and brokers are not immune, the most egregious errors are often committed by insurers holding retirement fund assets, which was the case here.

Dear Doug: We Need a New Roof. From Which Account Should We Take the Money?

Dear Doug,

Quick question. We need a new roof, which will cost $30,000. From which account should we take the funds? We have traditional IRAs and Roth IRAs that hold plenty of funds. As you know, we are over age 59 ½.

— Helen

Dear Helen,

This may be a "quick" question, but you will see there is no quick and straightforward answer because in tax matters there are many moving parts and options to choose from.

If you take the needed funds from your traditional IRAs, you will pay tax on the entire $30,000 withdrawal (your IRAs are 100% pre-tax). If you withdraw from your Roth IRA, the $30,000 will no longer grow tax-free.

But you own a non-retirement Schwab brokerage account with plenty of assets. The general rule is draw first from taxable non-retirement accounts and begin drawing from retirement accounts only when you run out of non-retirement funds. If you don't have enough cash in that (or any other) account, why not sell some stocks and withdraw the money? This allows you to pay tax at long-term capital gains rates on only the profits and, if you have losses on securities, you can net those against capital gains. Plus, withdrawing from your taxable account reduces future taxable investment income, leaving the IRA to grow tax-deferred and the Roth to grow permanently tax-free. If you were to take these funds from your Roth, you'd leave that much more in your non-retirement account or your pre-tax IRA. The income from the non-retirement account is taxed as it is earned; the pre-tax IRA is fully taxable as you withdraw it.

The exception to the general rule is when you can pay tax at low rates. If you are normally subjected to higher marginal tax rates, you should want to pay tax at lower rates when able to do so. The best way to accomplish this is to withdraw from the taxable account and "use up" your lower bracket(s) when we know your full year income situation by doing a Roth conversion near year-end. This strategy saves tax in the long run.

A common objection to using up the taxable accounts first is, "But then we will have no liquid funds!" Yes, you do. You can withdraw from your IRA and Roth at any time.

Nearly all non-retirement and retirement assets should be viewed as "emergency" funds by those over age 59 ½. The question to ask is how much to withdraw from which account and when so as to minimize long-term tax costs.

Propaganda as a Control Mechanism

"…The post-totalitarian system touches people at every step, but it does so with its ideological gloves on. This is why life in the system is so thoroughly permeated with hypocrisy and lies: government by bureaucracy is called popular government; the working class is enslaved in the name of the working class; the complete degradation of the individual is presented as his ultimate liberation; depriving people of information is called making it available; the use of power to manipulate is called the public control of power, and the arbitrary abuse of power is called observing the legal code; the repression of culture is called its development; the expansion of imperial influence is presented as support for the oppressed; the lack of free expression becomes the highest form of freedom; farcical elections become the highest form of democracy; banning independent thought becomes the most scientific of world views; military occupation becomes fraternal assistance. Because the regime is captive to its own lies, it must falsify everything. It falsifies the past. It falsifies the present, and it falsifies the future. It falsifies statistics. It pretends not to possess an omnipotent and unprincipled police apparatus. It pretends to respect human rights. It pretends to persecute no one. It pretends to fear nothing. It pretends to pretend nothing."

—Václav Havel, *The Power of the Powerless* (1978)