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- **Additional depreciation for some**
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- **Letting inflation do the work of Congress**
- **Letters to Doug: does collective social mood determine events?**

Wealth Creation Strategies

Tax and Financial Strategies

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Who Pays Income Tax?

Politicians often appeal to class hatred and envy for votes. Nowhere is this more apparent than when proposing new taxes on "the rich" or in the call to reduce taxes for everyone except them. The problem is that not only do they already pay an inordinately large portion of the nation's income tax, but also that "the rich" were often "the poor" of yesterday.

The following chart shows that those with high incomes already pay a share of tax far greater than their use of the legitimate powers of government: national defense and protection against domestic thugs. The following figures are estimates for 2001.

Income Category	Share of Population	Share of Income Tax
Less than $20,000	30.40%	-1.6% *
$20,000 to 39,999	24.10%	3.70%
$40,000 to $74,999	24.60%	15%
$75,000 to $99,999	9.10%	11.80%
$100,000 to $199,999	9%	23.60%
$200,000 and over	2.70%	47.50%

* Negative, due to cash payments to Earned Income Credit recipients.

In other words,

Income Category	Share of Population	Share of Income Tax
Less than $40,000	54.50%	2.10%
$100,000 and over	11.70%	71.10%

And in other words,

Income Category	# of Taxpayers	Share of Income Tax
Less than $40,000	70,632,000	2.10%
$100,000 and over	15,163,000	71.10%

In addition, with actual rankings from 2000,

Income Category	Share of Population	Share of Income Tax
Over $27,000	Top 50%	96%
Over $55,000	Top 25%	84%
Over $92,000	Top 10%	67%
Over $128,000	Top 5%	56%

Before suggesting that Atlas should shrug, consider the fact that the upper and lower income earners are in a constant state of flux. Most in the bottom 20% change classes within ten years. Among those whose incomes are in the bottom 20% of all Americans in one year, 80-90% are in a higher quintile ten years later. About 40% end up in the top two quintiles and 15% in the top quintile. This would not have occurred in the former Soviet Union, nor is it likely to occur today in Iraq, Cuba or North Korea.

Weight-Loss Programs May be Deductible

The IRS now views obesity as a disease, and none-too-soon. Recently, one-third of school-age children were identified as having obesity. Consider what this suggests for the rest of us.

The IRS ruling, issued in mid-2002, is surprising in its scope. While treatment for "general" health is not deductible, treating a disease or congenital defect is. If obesity is diagnosed, the cost of its treatment is now deductible. Remedies may include the initial fees of weight-loss programs plus additional costs for meetings, and the expenses of a health club or personal trainer, if prescribed.

However, even though deductible, there may be little or no savings. For a tax benefit, one must ordinarily itemize deductions. Overall medical expenses need to exceed 7.5% of Adjusted Gross Income. On the other hand, because a new disease creates greater costs, more taxpayers will incur overall medical expenses that exceed these thresholds. In addition, Medical Savings Accounts, employer reimbursable health care plans, and "Cafeteria Plans," also known as "Section 125 plans", can be used to pay for prescribed obesity treatments. Participants in these plans don't need to itemize and, significantly, costs need not exceed any particular level to be deductible.

Reduced-calorie food sold under the weight-loss program's brand name may not qualify as "treatment." Another IRS Ruling determined that the cost of special food is deductible only if:

1. the food is not part of the taxpayer's normal nutritional needs,
2. the need for the food is substantiated by a physician, and
3. it alleviates or treats an illness.

While food prescribed by a physician in treating obesity meets the latter two stipulations, it probably won't meet the first. However, prescribed supplements and vitamins may qualify.

In ruling that weight loss programs are deductible, the IRS is proving that it can be a gentler and kinder monolith. Not that we should cozy up in front of a toasty fire, but this extends the logic of its prior rulings that allow deductions for treating alcohol and other psychoactive drug addiction, as well as for smoking. Tobacco users can deduct smoking-cessation programs and prescription drugs used to alleviate nicotine withdrawal, because an inability to stop smoking is now considered a disease.

Note that the person must be diagnosed as having a disease. Expenses incurred by a taxpayer wishing to improve his appearance, general health, or sense of well being do not qualify.

New 30% Depreciation Allowance for Business and Rental Property Owners

A new law permits a 30% first-year deduction in addition to normal depreciation for qualifying new (i.e., not pre-owned) assets. Congress passed this rule in March 2002 as a reaction to the economic slowdown and the September 11, 2001 atrocities. It is due to expire September 10, 2004. While one should not invest capital only for its tax-savings advantages, some rational business and rental property proprietors may wish to add to their assets before the expiration date, rather than after.

For many, the additional allowance is meaningless. The rules of Internal Revenue Code Section 179 already allow an immediate deduction for up to $25,000 per year in tool and equipment purchases. However, yearly expenditures larger than this may obviously result in a benefit under the new law. Purchases of new cars and light trucks also yield a benefit, but are subject to a limit of $4,800 per business vehicle (in addition to normal, slow depreciation) regardless of total cost. *On the other hand, if this special deduction is taken, the standard mileage rate can never be used.* Over the long run, the loss of this option can cost far more than actual depreciation might save. The same argument can be made regarding heavier vehicles eligible for faster depreciation, the Section 179 deduction and the new 30% allowance without the $4,800 limit. We have found that the benefits of such deductions can be easily exceeded by taxes incurred on the sale of such autos and trucks (weighing over 6,000 pounds).

Because of the fact that assets purchased in operating income properties are ineligible for Section 179, the new allowance may benefit many property owners. While buildings and attached fixtures with a normal depreciation period of over 20 years do not qualify, two kinds of assets often purchased in conjunction with the operation of rentals may: land improvements (with a depreciable life of 15 to 20 years) and furnishings (five to seven-year life). The former includes landscaping, fencing and driveways, while the latter consists of such items as carpeting, window treatments, furniture, decorations and appliances. Certain leasehold improvements also qualify (ask us what's included before spending your hard-earned capital on such items).

Two caveats should be kept in mind. Recall that since 1987 the allowable rental loss deduction is limited to $25,000. It is phased out for those with AGI exceeding $100,000 and eliminated when this income reaches $150,000. The additional deductions do not provide a current benefit for a rental unit owner subject to these passive loss limits. In addition, those in 15% and lower brackets should exercise caution when taking advantage of such special deductions. As regular readers of this newsletter are aware, we prefer to defer deductions if possible when in lower brackets. In many cases, preserving deductions may yield savings later that could greatly exceed the benefit of any earnings on tax dollars saved now.

Real Tax Brackets: Not the Advertised Ones

The idea of "marginal" tax rates is very confusing and yet, for purposes of tax planning, essential to understand. Income is taxed in what might be viewed as "chunks." When a person moves into a higher bracket, only the incremental amount or "chunk" of income is subject to tax at the higher rate; prior chunks are taxed at their lower rates. Conversely, deductions shelter tax at the greater rate only to the extent one is in the higher bracket. If only $1,000 of income is taxed at 27%, increasing deductions by up to $1,000 saves $270. Any additional deductions reduce tax at lower (15% and below) rates.

This is extremely relevant when planning for more income and/or pondering additional deductions. It determines the penalty for working harder (or smarter), as well as the tax saved by purchasing a home, shifting assets into tax deferred accounts such as retirement plans and deferred annuities, or purchasing tax-advantaged investments such as rental property. This would be a fairly straightforward calculation if there was only one tax with just the advertised rates. Unfortunately, there are a multitude of taxes, including federal, state, Social Security, Medicare, state disability and penalties on early withdrawals from retirement plans. These subject different kinds of income to different tax rates and benefit diverse deductions at various rates. For example, take an additional $1,000 in income on what is otherwise the same tax return for a person in the nominal 15% tax bracket. This can result in a tax of $80 on capital gains, $150 on interest or dividends, $227 on employment, $250 on a premature withdrawal from an IRA or other pension, or almost $300 on self-employment, nearly four times greater than that on the most tax-favored income.

Adding to the complexity, there are numerous unadvertised tax rates due to phase-ins of otherwise non-taxable income and phase-outs of deductions and credits. The real tax rate at identical levels of taxable income for taxpayers with different situations varies dramatically. A few of these bear special mention, particularly those relevant to making decisions on whether to continue working and/or contribute to retirement plans.

The most common covert tax rate that adversely affects our clients is one that subjects those with Social Security income to the 85% phase-in rule. When Adjusted Gross Income (AGI) exceeds $34,000 for single persons and $44,000 for joint filers, $85 of Social Security is taxed for every $100 of additional income until 85% is taxed. I became aware of the gravity of this situation a number of years ago, when a client was smacked with an additional tax of $3,500 on an income of just $5,000 from a new side business. Every other item of income and deduction was virtually identical to that of the prior year. At first, even I was confounded. I became appalled as I realized that the 27% marginal rate was really (27 x 1.85 =) 50% due to the phase-in of Social Security at his particular income level. Since the additional income was from self-employment, the 15.3% Self-Employment tax (Social Security tax for the self-employed) applied. An 8% state income tax rate added insult to injury. After factoring in the deduction for one-half the Self-Employment tax (thank goodness for small favors), the effective rate was about 70% on the incremental income.

Since few clients that receive Social Security income have side businesses, this effective tax rate is unusual. However, for those who continue to work as employees (and many do, even if only part time), the real tax rate can be over 65% (50% federal, 8% state, 7.65% employee's share of Social Security tax) over the range of income subject to the 85% phase-in rules. Other retirees have pensions, interest, dividends, or rental income that may subject at least a portion of their Social Security income to a combined 58% federal and state tax rate. For those whose income extends into this bracket, but not beyond, deferring or sheltering a thousand dollars of pension or investment income may save $580 of tax.

Most clients who receive Social Security are in the advertised 15% bracket but subject to the 50% phase-in rules, resulting in a real 22.5% federal tax rate. At this income level, most are liable for a 4 to 8% state income tax, along with 7.65% Social Security tax (or 15.3% Self-Employment tax) on work-related income. Therefore, the marginal rate for which even moderate income earners are liable ranges from 22.65% (15% federal plus 7.65% Social Security for workers in states having no income tax) to a confiscatory 45.8% (22.5% plus 15.3% plus 8%) on additional employment income.

Another abominable consequence of the Social Security income phase-in can result from the occasional sale of stocks, real estate or other capital assets. The long-term (over one year) federal capital gains tax is advertised at 8-10% for those in the lower (15%) bracket and 18-20% for higher-income earners. The rate, however, increases to 15% for lower-bracket earners hit by the 50% phase-in, to an abusive 37% for those in higher brackets affected by the 85% phase-in. Then add a 2% to 8% state tax. It's disconcerting to explain to a client subjected to this stealth bracket that the tax on a $10,000 capital gain may be $4,500 when it should only be $2,000 based on the advertised rate of 20%. It's also difficult to plan for, since small variations in income can dramatically alter the final result.

Another common "higher tax bracket than advertised" is found in credit phase-outs. The magnitude of these covert brackets can be seen in greater-than-expected savings from additional investments in retirement plans (including 401Ks, IRAs and self-employed plans). The nominal rate for married couples earning $80,000-$100,000 is 27% federal and 9.3% state (assuming California tax rates). However, this is the range of income over which the child tax credit (a credit for having children

under age 17) is phased out. While we would expect to save 36.3% on retirement plan investments, the savings can be as high as 43% when Adjusted Gross Income lies within this range. The additional 6.7% savings is due mostly to the phase-in of the credit, plus a small kicker from increasing itemized deductions (employee business expenses subject to the 2% AGI limitation and medical expenses subject to the 7.5% limit) as AGI decreases. Therefore, some taxpayers in this income range pay only $570 out-of-pocket for every $1,000 invested in a deductible retirement plan. By itself this is a compelling reason to invest in such plans. It becomes a "no-brainer" to the extent that the employer partially matches a 401-K contribution. (The benefit of an 80% matching contribution from the employer is huge. Each $1,000 yields a real investment of $1,800, for an out-of-pocket cost of as little as $570. The first-year rate of return can, therefore, be as high as 320% ($1,800 divided by $570). Bear in mind, the contribution need not be invested in stocks.

The Earned Income Credit phase-in and phase-out can also be significant in calculating savings from deductible retirement plan contributions. The nominal bracket is 10-15%, but the real tax savings can be about 25% on a $2,000 contribution due to bizarre calculations over the credit phase-in for those with children, as AGI decreases from about $30,000 to $14,000. Care must be exercised, however. In at least one case, an investment of $2,000 by one spouse saved $490, while an additional $2,000 contribution by the other would have saved nothing. This was due to the fact that the tax had been reduced to zero by the first contribution, while the odd calculations referred to above allowed no additional Earned Income Credit. Beginning in 2002, such complications are greatly exacerbated for workers eligible for the new low-income retirement "savers credit."

Now that the cap on earnings for those aged 65 to 70 has been eliminated, more people continue to work while receiving Social Security income. Contributions to retirement plans are allowed up to age 70 1/2 (and in some cases even later). These investments serve to reduce the amount of Social Security subject to tax. Conversely, an increased income reduces the allowable contributions to IRAs for participants of employer-sponsored plans. Combining an increasing amount of Social Security income subject to tax with a reduction in the allowable IRA contribution can result in a tax rate as high as 93% on additional self-employment income. (The breakdown is 71% federal income, state income and Self-Employment tax rate, along with a 22% reduction in savings resulting from a lower allowable IRA contribution).

There are a few choices that can be made when preparing returns to increase or decrease Adjusted Gross Income, including making retirement plan contributions and depreciation elections (including expensing equipment, or not doing so for those in low marginal tax brackets). Helping you make these choices is a very important part of our work. Planning ahead for the numerous covert rates built into the tax code is difficult. However, it should be attempted by those with the flexibility of increasing or decreasing expenses in businesses and/or rental properties, purchasing deferred annuities, increasing retirement plan contributions, or altering other items of income and expense that affect the all-important AGI.

No Indexing = Higher Hidden Taxes

There are a number of limits, deductions and credits in the tax code that are not regularly adjusted for inflation. This lack of indexing has resulted in substantially higher taxes for those affected. To the benefit of politicians spending your money, hardly anyone has noticed.

One such area can be found in the taxation of Social Security benefits. While we may not support a retirement system based on coercion in which accumulated funds cannot be bequeathed, it is hard to fault the fact that half of Social Security benefits received may be subjected to tax. After all, the half paid and deducted by employers is not included in the employee's income. The trouble is, half of Social Security is phased into taxpayers' Adjusted Gross Income (AGI) once "Other Income plus half of Social Security" (O.I. + .5 SS) hits $25,000, or $32,000 if married filing joint. These thresholds have been in place since 1984, a period during which inflation has exceeded 77%. Slipping in hidden tax increases by maintaining this threshold could be considered a perversion of government power.

Far more objectionable is the provision (added in 1994) that imposes tax on as much as 85% of Social Security. This is phased in once "Other Income plus 85% of Social Security" (O.I. + .85 SS) exceeds $34,000, or $44,000 if married. Since workers pay tax on their half of Social Security, the additional 35% has already been taxed once. (To better grasp this, take a look at your pay stub. You'll notice that your half of Social Security tax is not deducted from income subject to income tax. In other words, you pay income tax on your gross and Social Security tax on that same gross. The same idea holds for the self-employed.)

We might think that once the latter threshold has been exceeded, the additional 35% is gradually phased in at that rate. In other words, we've already added 50%, having increased your income by 50 cents for every dollar earned from sources other than Social Security; now let's tax the other 35% by adding 35 cents for every additional dollar of income. Instead, every $1,000 of other income results in an additional $1,850 subject to tax until 85% of Social Security has been taxed. Many retirees who think they're in a 27% marginal tax bracket are really paying tax at a (27% x 1.85=) 49.95% rate. This does not include state income tax and Social Security tax they're paying if still work-

ing.

If these provisions had been indexed, Social Security recipients would not begin to pay tax on half the Social Security income until O.I. + .5 SS totaled $44,422 ($56,861 if married). Eighty-five per cent of their Social Security income would not begin to be subject to tax until O.I. + .85 SS exceeded $60,415 ($78,183 for married couples).

A Tax Increase By Any Other Name				
	Soc Sec Subject to Tax Begins at:		If Adjusted for Inflation:	
Phase-In/Taxed Since	Single	Married	Single	Married
50% /1984	$25,000	$32,000	$44,422	$56,861
85% /1994	$34,000	$44,000	$60,415	$78,183

Anther sneaky tax increase is found in the phase-out of allowable rental real estate losses. The 1986 tax act limited such losses to $25,000 beginning in 1987. This has never been indexed for inflation; if it had been, the maximum loss allowed would now be $40,344. Nor has the income range over which rental losses are phased out been indexed. If it had been, this range, locked at $100,000 to $150,000 for the last fifteen years, would be $161,378 to $242,067.

Back-door tax increases can also be found in the phase-outs for Roth IRAs (and deductible IRAs if only one spouse is in a retirement plan at work). The ranges have been fixed at $95,000 to $110,000 for singles and $150,000 to $160,000 for married couples since 1998. Even in this period of relatively low inflation, the phase-out ranges should now begin at $104,853 for singles and $165,558 for couples. While after 27 years, Congress has finally seen fit to increase the $2,000 allowable IRA contribution to $3,000 ($5,000 in another few years), inflation adjustments would have allowed almost $3,000 by 1980, over $4,000 in 1984 and $7,179 for 2002.

The dependent care tax credit provides a ravenous government with more supplemental under-the-table tax increases. The credit was first allowed in 1975 for childcare expenses of up to $2,000/$4,000 (one child/two children). This was increased to a credit on up to $2,400/$4,800 in 1982. At long last, the expenditures on which the credit is allowed (or taxable wages decreased under a dependent care benefit arrangement through participating employers) is being increased in 2002 to $3,000/$6,000. If it had been indexed, dependent care costs allowed would now be $7,179 for one child and $14,358 for two.

The net capital loss deduction exposes yet another instance of non-indexing. This has been set at $3,000 since 1978. In 2002, inflation adjustments should allow net losses of $8,759, but don't.

Letting Inflation Do the Work of Congress			
Tax Rule	Non-Inflation Limits	Inflation Adjusted Limits	Fixed Since
Rental Loss Allowance	$25,000	$40,344	1987
Rental Loss Phase-Out	$100,000-$150,000	$161,378-$242,067	1987
Roth Phase-Out Single	$95,000-$110,000	$104,853-$121,409	1998
Roth Phase-Out Married	$150,000-$160,000	$165,558-$176,595	1998
IRA Contribution Limit	$3,000	$7,179	1975*
One/Two Dependent Care	$3,000 and $6,000	$7,179 and $14,358	1975*
Capital Loss Deduction	$3,000	$8,759	1978

* Non-inflation limit was just increased. See text for clarification.

Note that all of these nasty quirks in the law can result in higher taxes for two single people who decide to marry. The first has the perverse result of punishing the elderly. If each person has income (O.I. + .5 SS) of just under the $25,000 threshold amount, none of their Social Security is taxed. Marrying may subject 50% of the Social Security to tax. In addition, a portion of the Social Security income often becomes subject to the 85% phase-in rules.

The second, rental real estate losses, is draconian even though rare in its most extreme form. Two single people, each with an income of $100,000 and allowable rental real estate losses of $25,000, are allowed no such deductions if they marry. This alone can account for a federal marriage tax penalty of up to $15,000 (with many thousands more in a state having an income tax—$4,500 in California, for example). We have a number of clients with incomes of $75,000 to $100,000 each, experiencing real estate losses ranging from $5,000 to $15,000. Just this one penalty results in $2,000 to $6,000 in additional taxes every year for these clients who marry.

Such penalties also punish married couples who would otherwise invest in Roth IRAs. As single people they could each invest up to $3,000 at incomes of $75,000 to $95,000 each, phased-out at $110,000. If married, the allowable contribution is zero once their combined incomes reach $160,000. Worse still, if only one spouse has a pension through his employer, the other is not allowed to invest in a traditional IRA once the income reaches this level. This is particularly irksome in cases where one spouse has income of, say, $65,000 and the other $95,000, or some similar combination totaling close to or just over

$160,000. If single, they would both be eligible for Roth IRAs or, if not participating in an employer provided retirement plan, traditional IRAs. By marrying, they lose the ability to invest up to $6,000 into Roth IRAs or a combination Roth and traditional IRA.

One of the most perverse areas of the law is the penalty for those filing as head of household (single people with related dependents), who decide to get married. There are enormous penalties (as a percentage of income) embedded in the tax rates, standard deduction and earned income credit. In addition, if two people each with two children get married, the total expenditures on which a dependent care credit is allowed drops from $12,000 ($6,000 each) to $6,000.

In an age when we have finally learned that stocks can drop in value, the non inflation-adjusted limit for capital losses is a particularly galling insult to married people with capital losses. They can deduct up to $3,000 each if single, yet only $3,000 total if married.

The idea of indexing these and other tax code limits and thresholds was not included in recent tax law changes. Nor was eliminating the marriage penalties in some of the areas hit hardest by lack of inflation adjustments. I doubt that there's any hidden meaning or conspiracy behind the fact that so much of what is not indexed for inflation is also limited by marrying. But it is interesting.

The High Cost of Marriage

Tax Rule	Single Limits	Two Singles	Married	Maximum Tax Penalty*
Rental Loss Allowance	$25,000	$50,000	$25,000	$7,500
Rental Loss Phase-Out	$100-$150k	$200-300k	$100-150k	$15,000
IRA Phase-Out	$95 -$110k	$190-$220k	$150-160k	$900
Dependent Care	$3/$6,000	$6/$12,000	$3/6,000	$2,300
Capital Loss Deduction	$3,000	$6,000	$3,000	$1,150

* Not including state income tax penalty; numbers are approximate. Penalty for the IRA phase-out is only the immediate cost and does not include the increasing value of tax deferral for the traditional IRA and tax-free growth for a Roth IRA. Dependent care penalty is calculated as if taxpayers are both eligible for salary reduction dependent care benefits through their employers.

Letters to Doug

Dear Doug,

I found your essay on the reason for the market collapse (Nov-Dec 2002) of great interest. You have previously identified yourself as a believer in the "Austrian" school of economics. As such, you should be aware that the proximate cause of the collapse is credit expansion by our central bank, the Federal Reserve. You didn't mention this, instead grounding your belief in Elliott Wave.

Yet, years of easy, cheap money from the constant lowering of interest rates below what the market would have determined caused this cyclic mess. While you mentioned Chairman Greenspan, you failed to discuss his role, despite his having been an associate of Ms. Rand and a student of the greatest economist of all time, Ludwig Von Mises of the Austrian school. Please clarify your thoughts on this all-important matter.

--Fred, of the Seven Seas (friend of Ragnar Danneskjold)

Dear Fred,

I completely agree with you that credit expansion leads to credit busts. However, Greenspan couldn't have allowed the bubble were it not for the psychology of the masses (based in Jungian psychology) behind it. In other words, psychology determines the events. The event that this unconscious mindset somehow decided upon was the greatest asset to inflation ever.

We are thinking along similar lines. Elliott Wave (and its most brilliant proponent Robert Prechter, Jr.) simply go deeper. Only it can explain how a man of Greenspan's intelligence and underlying economic beliefs could have allowed such a bubble to occur. It was, quite simply, its time, based on a herd mentality having its roots in the limbic system, or the pre-mammalian part of the brain.

Greenspan "knows" he could have pricked the bubble by increasing stock-buying margin requirements. However, not even this would have stopped it. The social mood determines events and not vice versa.

I'm also aware of the role that tax policy played in the bubble. Stock options were doled out like candy because of a foolish $1 million maximum on deductible, non-incentive based executive compensation, enacted in 1993, not coincidentally near the inception of the mania. To get around this cap, large corporations offered stock options (not subject to this limit) to upper management. The higher the stock price, the greater the compensation. The result was an incentive to manipulate stock prices in the short run, to help insure that such managers would more quickly receive a market-based rate of pay. The alternative was to lose them to the NBA, NFL, WWF or local minor-league baseball teams where there is no maximum allowable deduction for compensation. Stock prices may have increased far beyond where they would have without the proliferation of stock options. However, the social mood set the stage for electing representatives who feed on envy, which in turn enacted idiotic tax policy.