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- Dear Doug: when is "income averaging" beneficial?
- The *real* story of Thanksgiving


# Wealth Creation Strategies

## Tax and Financial Strategies


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# Education, Deductions, Credits and Tax Free Growth

In the October 1993 newsletter in an article titled "Let's Deduct Education," I expressed my belief that a deduction should be allowed for the cost of any type of education. At the time, continuing education (the sort that improves skills in an existing profession) was the only schooling that could be deducted. I wrote, "Currently (taxpayers) may deduct costs of continuing education in trades and professions that quickly become obsolete. Why not allow education deductions in new and upcoming fields, as (we do) for the cost of equipment in a new business?"

We've since come a long way. A variety of educational credits and deductions were hatched beginning in 1998 and have multiplied to a degree then unimaginable. The array of choices, while a wonderful improvement over a system that previously failed to allow deductions for any form of education other than that required for one's current, perhaps stale occupation, is a jumble. Let's make some sense of it, and figure out how to best use the options to our advantage.

First, let's make sure we understand the basics. Education required to improve one's existing job skills, as noted above, has generally been deductible. If self-employed, the costs are deductible on Schedule C, "Profit or Loss from Self-Employment." They are deductible for employees on Schedule A, "Itemized Deductions," to the extent these, other employee business expenses and investment expenses exceed 2% of one's Adjusted Gross Income (AGI). Schedule C deductions are always more advantageous, since they decrease not only income tax but also Self-Employment tax. In addition, they lower AGI, which can decrease taxable Social Security income and increase deductions and credits that are reduced by phase-outs as income moves up. So, as the AGI rises, certain other deductions and credits decrease and as the AGI drops, they increase. Furthermore, educational expenses deductible on Schedule A may not save any income tax because the taxpayer may not have enough total personal deductions to itemize. Even if itemizing, business and investment deductions might not exceed the 2% limitation.

As noted, the improvements in the law are linked to education unrelated to one's current profession. This includes education for young people who are not yet in the work force. Since they aren't working, those who support them—usually, their parents—reap the tax savings. There are three types of benefits: deductions, credits, and tax-free income from investments.

The deductions and credits are all designed to aid low-to-middle income taxpayers. Tax-free income can benefit anyone who pays taxes.

The credits are (and likely will remain) the tax benefit most often used. The "Hope" credit is a dollar for dollar credit against tax for tuition and fees paid for the first two calendar years of college for at least a half-time student in a degree program. The credit is limited to 100% of the first $1,000 paid plus 50% of the next $1,000 ($1,500 maximum credit) per student, for a maximum of two years (even if the half-time student takes four years to complete two years worth of undergraduate work). A phase-out of the credit begins at $82,000 (and is eliminated at $102,000) of AGI (modified) for joint filers and $41,000 (phased out at $51,000) AGI for single persons. (Note that there is no marriage penalty for either this or the other educational benefits described below. Miracles do happen, even in the halls of Congress.)

The "Lifetime Learning" credit is a 20% credit for tuition and fees paid up to $5,000 per year per taxpayer for almost any educational course, degreed or not, including trade schools. The phase-outs are the same as for the Hope credit.

There is a new deduction for tuition and fees for higher education, limited to $3,000 per year. The AGI cut-off is "cliff-like" at $130,000 for joint filers and $65,000 for others. (In other words, if the income is $130,000, a $3,000 deduction is available, while if the income is $130,001 there is no deduction.) Obviously, this deduction will be taken for those who do not qualify for the credits. For those qualifying for either, the mathematics of determining whether one of the credits or this deduction saves more tax is one of the sources of complexity. Unfortunately, we must choose between credits or this

deduction. Needless to say, when preparing your returns we will make the optimal choice.

These various income limitations ($41,000, $82,000 and $130,000) make deductions that help lower the AGI worth more than those that don't, including property taxes, home mortgage interest and charitable gifts. Deductions that reduce the AGI include self-employed business expenses, rental expenses and deductible retirement plan contributions. This further increases the labyrinth of options. These include whether to depreciate or immediately expense business equipment, purchase additional business assets before year-end, suggested levels of contributions to retirement plans and whether to convert income-producing assets into investments that do not yield current taxable income (including deferred annuities, growth stocks and tangible assets such as gold). Some of these choices can be made after the year is over, while others must be planned for well ahead—making planning more challenging than ever.

Just for fun, let's take a look at how crucial these choices can be and what a difference they can make. Take, for example, a single person who earns $51,000 as a legal secretary. She invests $5,000 per year in law school courses that are not deductible (becoming a lawyer is always deemed to be a new profession because lawyers can do things that no one else is legally allowed), but which qualify for the Lifetime Learning Credit. She is allowed to invest as much as $10,000 in her retirement through her employer. She has no deductions other than the standard deduction and personal exemption, which puts her in the 27% federal and 9% California state income tax brackets. What is the net after-tax cost of investing the $10,000?

| | Without retirement contribution | | With retirement contribution | |
|---|---|---|---|---|
| Income | $ | 51,000.00 | $ | 41,000.00 |
| Less Deductions and Personal Exemption | $ | (7,800.00) | $ | (7,800.00) |
| Taxable Income | $ | 43,200.00 | $ | 33,200.00 |
| Federal & CA State Tax | $ | 10,200.00 | $ | 6,600.00 |
| Less Lifetime Learning Credit | $ | - | $ | (1,000.00) |
| Net Tax | $ | 10,200.00 | $ | 5,600.00 |

The amount saved by investing $10,000 is ($10,200 - $5,600 =) $4,600. Her real tax bracket in this income range, then, is 46%, not the advertised 36%. The net cost of investing $10,000 is, therefore, ($10,000 - $4,600 =) $5,400. Any additional contribution from an employer's matching program is gravy.

The same analysis can be made in regards to a self-employed person having the option of depreciating or expensing equipment, or investing in his own retirement plan.

The third type of benefit, tax-free income from investments, is particularly intriguing. There are two main categories: Coverdell Education Savings Accounts (formerly known as Education IRAs) and Qualified Tuition Plans, popularly known as "529 Plans" after the Internal Revenue Code section that authorizes them. To the extent that proceeds are used for college tuition and fees, earnings are not just deferred—they are excluded from tax. The Hope and Lifetime Learning credits are not allowed in any year in which tax-free withdrawals are made from these accounts. However, these very special plans go much further in the types of expenses allowable. The Educational Savings Account (ESA) allows tax-free withdrawals for tuition paid for Kindergarten through grade 12 at any public or private school (including religious), along with computer equipment, educational software, tutoring, uniforms, transportation and internet access. Both allow tax-free withdrawals for books, supplies and equipment. Incredibly, they also allow such withdrawals for room and board at college if at least a half-time student.

A non-deductible contribution of up to $2,000 per beneficiary per year (increased from $500 for years prior to 2002) is allowed for ESAs. For the full contribution allowance, the AGI of married donors is limited to $190,000 (with a phase-out of the allowance at $220,000), while the AGI of non-married donors must be $95,000 or less (phased out at $110,000). Oddly, the donor does not have to be the parent or other person providing support; it can be anyone, including even the child himself or non-relatives, whose income is less than the allowable limits. These rules effectively make the income limits irrelevant. There doesn't even need to be earned income to make contributions.

The 529 Plans are more interesting still, especially for those with money to spare. As much as $269,000 (depending upon the plan) can be invested per child into these special state-arranged accounts. While only $11,000 can be given each year by any one person without gift tax repercussions, the number of people allowed to make such contributions is unlimited. In addition, an election can be made to "pretend" that such contributions were made over as many as five years, increasing the effective limit to $55,000 per donor in the first year and putting a stop to contributions over years two through five. Since the limit is per person, the effective annual maximum is $110,000 per child for married couples or $220,000 for those with two sets of wealthy grandparents, without exceeding gift tax limits.

These tax-wise tools for meeting educational needs have a huge advantage over gifts made to minors under the Uniform Transfer to Minors Acts

(UTMA) of the various states. Under an UTMA, a wayward child owns the account once he turns a certain age. The donor to a 529 plan can redirect funds to another beneficiary or cash out of the account, paying the income tax plus 10% penalty tax. Whether a parent has the ability to remove the child as beneficiary of an ESA depends on its trust agreement. Our advice is to choose one that allows this option. In addition, the beneficiary pays tax on earnings in an UTMA account and avoids tax on earnings in ESAs and 529 plans when amounts withdrawn are used for qualified educational expenses.

There are a number of other considerations in deciding which plan to use and how much to invest. These include the speed at which one wishes to make investments (e.g., $2,000 per year or $10,000 per year), the expected marginal tax bracket of the donor over the years prior to expected withdrawals, and whether the donor has a taxable estate. Additional considerations include desire for flexibility in investment choices, range of such options, likelihood that contributions to such programs will reduce any financial aid, need for creditor protection of plan assets, types of educational expenses anticipated and their amounts.

Those living in states that allow a deduction for contributions to 529 plans or other such advantages may wish to use their own state's plan. However, despite the current costly advertising campaign, California residents are not offered any discernable advantages by using its scheme. I would look at plans offered through the no-load Vanguard Mutual Funds, which is authorized to administer Utah's state plan, as well as American Funds (also known as Capital Research, available through brokers), authorized under Virginia's plan.

The variables are numerous and the choices confusing. However, it's better to be perplexed by the options than to have none at all.

# What Caused the Market Collapse?

Euphoric people are happy people. As Walter Bagehot, financial writer and early editor of 'The Economist' observed, "People are most credulous when they are most happy." Credulous people willingly pay more for assets, such as stocks and property, which in turn leads to greater euphoria. Hence the cyclic euphoria, happiness, credulity and increase in prices, which leads to greater euphoria. Prices eventually become so removed from economic reality that they become unsustainable. Hence, the mania provides the setting—baseless and irrational prices—for their subsequent collapse. As in similar episodes, the exhaustion of the speculative euphoria becomes inevitable.

The pre-mammalian part of the human brain, sometimes referred to as the "reptilian" brain to give a feel for both its evolutionary source as well as the unthinking behaviors for which it can be responsible, is called the "limbic system." This part of the brain compels the instinctual actions and reactions essential for procreation and survival. Impulsive behaviors and herding are the common observable results of meeting these intrinsic needs.

The neo-cortex is the human part of the brain, responsible for reason and logic. It serves to reign in the impulses of the limbic system. The latter, however, is far quicker to act—it must be, since it is responsible for survival. This leads to unthinking behaviors when suddenly endangered; as Robert Prechter puts it in *The Wave Principle of Human Social Behavior and the New Science of Socionomics*, "we run like hell and then reflect on it later." Harvard psychologist Daniel Goleman points out in *Emotional Intelligence*, "the emotion occurs before thought." The same is true for animals seeking food and water. The needs for pain avoidance and pleasure enhancement each serve to create herd-like behavior.

Manias, then, are a result of a mass of individual limbic systems working in unconscious unison. They also feed the aftermath, as the herding reverses on itself, resulting in crowds at the exits.

The same euphoria that fuels the markets is also responsible for the good economic times. The psychology that says, "buy stock," also suggests we "hire that worker," "invest in that equipment," and "start our own businesses." The psychology that tells us to "sell," also whispers "don't hire," "fire," and "don't risk an investment in new machinery." On a mass scale, the psychology is the cause of booms and busts.

All other explanations are mere excuses. The market doesn't react to events; the psychology creates both events and market prices. The psychology that produced a bull market for Presidents, in which an admitted perjurer could remain in the White House, also brought about increasing prices in shares. The psychology that allowed for non-expensing of stock options (along with the massive increase in the offerings of such options) and other accounting chicanery, also fueled the market which, in turn, further stoked the psychology. That options and accounting fraud are now to blame is only a reflection of a change in mass psychology. WorldCom and Enron, along with at most a few dozen other companies involved in similar shenanigans, did not send a market that had already begun a major slump into further tailspin. Investors instead were happy on the way up, making them credulous, which caused them to pay more for shares, thereby feeding their euphoria leading to massively higher prices. Prices began moving down (especially in the NASDAQ, which had already collapsed by two-thirds before most of the scandals even began to come to light), exacerbating the unhappiness that caused the initial wave of selling, making investors less credulous, setting the stage for the

scandals to be seen for what they are. The evidence was there all along; there was just no one willing to believe or act on anything remotely negative.

The psychology also fueled the buy-hold ratings among the brokerage firms. No one wanted to hear a recommendation of "sell," so few (if any) such recommendations were issued. Buy and hold became the mantra; ten years of a market providing only fabulous buying opportunities every time downward market moves neared 10% supported the idea that one should never sell. Anyone who says, "sell," when the crowds are in a manic state gets trampled. Belittling and mocking of those who dared to suggest otherwise became commonplace.

Mass psychology even allowed Federal Reserve chairman Alan Greenspan to avoid taking the one action he now believes he should have in 1996, when he first spoke of "irrational exuberance" and the stock market in the same sentence: boosting margin requirements on securities. The response "to his initial, tentative attempts to pop the bubble," according to 'Barron's' editorial writer Alan Abelson (September 9, 2002), was an "outburst of congressional wrath (especially from lawmakers who owned stock)." As 'The Economist' (September 7, 2002) points out, "bubbles are popular. The public regards high inflation in the prices of goods and services as a bad thing, but rising property and share prices as good things." Not that a decrease in allowable loans against securities would have prevented the bubble: plenty of debt from home equity lines has evaporated in the stock market. In other words, mass psychology will do whatever it must to create the boom and subsequent bust.

The concern now is over how low and long the Great Bear will go. "I'll wait until I break even" is a common thought. The Japanese are still waiting and, after 12 years of disastrous market conditions are down an incredible 75%. The hottest hi-tech stock of the 1920s, Radio Corporation of America (RCA) took 40 years to break even. In his 1995 annual letter to mutual fund shareholders, James Gipson, chairman and president of Clipper Fund, describes the four stages leading to capitulation and bottom. Given the magnitude of the bubble, the psychology may be only in the first half of stage three:

1. My stock is down a little. I'll buy more before it goes back up.
2. It's down even more, what a bargain! I'll spend my last cash reserves.
3. It can't go any lower. I'll hang on until I break even.
4. I can't stand it. Get me out now!

# Markets, Psychology and Real Estate

One of the themes behind Elliott Wave Theory is that mass psychology determines both events and values manifested in prices. The best hints of the underlying psychological mood in free market economies can be found in the values ascribed to firms. In the United States, the most accurate of these measurements may be the appraisals assigned by investors to the largest corporations, such as those in the Dow Jones Industrial Average.

The price action of the Dow, along with the total collapse of some averages (the NASDAQ in particular), is a warning of major economic dislocations in the near future. If these omens are right (and they usually are—the stock market is the single best indicator of future economic activity), there may be little time to get one's financial house in order. While the optimal time for selling shares was, of course, at the stock market peak in early 2000, the case for selling is still compelling if the surmises in the article above are correct. While interest rates could drop further, it couldn't hurt to refinance higher-rate loans against real estate. Consideration should also be given to selling other assets if one has any excuse for doing so. This is true for what seems to be the last beneficiary of inflationary price increases: real estate.

Property owners in most areas of the United States have benefited from massive price increases over the last dozen years. While California real estate was collapsing in the early '90s, practically every other western state was experiencing a bull market. The value of much property in Oregon and Colorado, for example, doubled from 1990 to 1998 or so. California's property prices bottomed between 1994 and 1996, depending on location. Since then, many values have doubled, while in some areas prices have quintupled.

Real estate values, for whatever reason, continue to increase throughout much of the country two and a half years after security prices began a major collapse. This should not be looked upon as the beginning of a new bull market in real estate, certainly not after prices have already fared so well. It should instead be viewed as an opportunity to sell overpriced property.

While this does not mean we should sell our homes, those who have a reason to do so or who don't mind the inconvenience associated with moving might consider the option. Those who keep their homes (myself included) should be prepared for a substantial period of price declines. This is particularly true if interest rates increase in any meaningful way. Affordability is poor already; it would cave in if rates advanced by even 2%. If long-term mortgage rates increased from 6% to 8%, property prices would have to drop by about 25% for affordability to remain at its current shrunken level. The economy would likely be in a free-fall from such an interest rate shock. Since loss of jobs and incomes does not favor an ability to pay, the drop would likely not pause at a mere 25%.

On the other hand, Japanese real estate plummeted by 75% in the face of declining rates. Central bankers, while creating money that becomes fuel for recovery in liquidity crunches, push on a string in the case of solvency crises. If

people and firms are busy paying off debt in the face of interest rates approaching zero in a deflationary setting, prices can fall of their own weight.

Nor does it mean we should all sell our rental properties. However, if one has several such properties there could be both a real and psychological benefit from "hedging one's bets" and selling a portion of holdings.

The biggest stock market mistakes I've ever made included holding when I should have sold. I almost unloaded before the crash of '87; the fact that prices fell 90 points one day about two weeks before the final collapse convinced me I shouldn't sell any. Too bad I didn't at least hedge and dump half, which would have been psychologically easy if I had thought of it. Since people have a psychological aversion to selling everything, especially when prices have already fallen or when the tax consequences could be onerous, the mantra of, "At least hedge and sell half," has been my suggestion for the last couple of years. It is now my counsel in the case of much real estate.

The exceptions lie in areas where we may, if rents continue to be collectible, receive a decent dividend while we wait. The risk is, of course, that a laid-off tenant will thumb his nose at the landlord. If he doesn't remain and trash the house (the source of much financial and psychological devastation among landlords), re-renting at the old price may be impossible in the depth of any serious deflation. However, at a time when money market rates are 2%, a rent "dividend" of 5% or so doesn't look so bad.

However, one cannot just divide the yearly rents by net value after expected selling costs to arrive at the dividend. We need to subtract maintenance, pro-rated costs of eventual replacements, property taxes, insurance and tenant risk. The latter includes vacancies, as well as tenant vandalism. A mortgage complicates the calculation; however, one could run the numbers both without the mortgage and with, using the net equity as the divisor.

If a return of at least 5% (and we could argue as much as 8% or more) on current net equity doesn't look like it's in the bag, serious consideration should be given to selling. Factors that could influence this decision, as well as the rate of return an investor should look for, include tax considerations. The lower the expected capital gains tax the higher the dividend that should be expected; the higher the tax the lower the dividend one might accept. Other factors include psychological ability to deal with unsavory tenants and physical limitations on repairing and maintaining the property. Another essential consideration should be the ramifications of vacancy for an extended period. This is a far greater problem for a person whose employment is at risk in a recession and whose property could quickly create a bankruptcy if the rents stopped rolling in.

Owners of expensive-to-maintain and hold properties with one tenant are subject to greater risk than are those who have several small properties or multi-unit dwellings. Disaster may not loom if a unit or two is empty for a period of time out of a small 4-16 unit complex in a decent area. The concern, however, is that we could be entering a lengthy period of deflation not dissimilar to Japan's of the last 12 years. From the economy that could do no wrong, when in 1990 most people believed the absurd notion that the Japanese would soon own the world, both its stock and property markets have collapsed 75%. Worse yet, they show no signs of recovering anytime soon to anywhere near the all-time peaks.

Americans have overspent and overindulged for too long. We experienced a massive speculative mania in stocks from which we could take decades to recover; the same could be true for real estate in many areas of the country. There will probably be exceptions, but I don't know that I'm lucky enough to find them. The message could be that humility when investing one's hard-earned funds may be the reason the tortoise always seems to beat the hare.

# Letters to Doug

Dear Doug,

You've mentioned the value of "averaging" taxable income so that zero and low tax brackets are not wasted. You seem to be suggesting that although I'll pay more tax now, in the long run I come out ahead. Is my interpretation correct? If true, what strategies can I use to shift my taxable income from next year into this one? As you know, I have my own business. I understand that I may have more ways of shifting income than do those who are not self-employed. I expect a substantial improvement after this year's post 9-11 collapse.

--Long Run Tax Saver/Net Worth Builder

Dear Long Run,

You interpret correctly. The jump from the 15% to 27% rate results in a huge percentage increase in tax, not to mention that an increase from zero to 27% is infinite. Shifting just $20,000 of income from the higher to lower-rate year can save up to $5,400 in federal income tax. In states with graduated rates (such as California), there is usually several hundred dollars in additional net tax benefit.

Income-shifting possibilities are more numerous for you than for a similarly situated employee. You can ask customers for prepayments, perhaps by offering them discounts for early payment. Consider the fact that a dollar today in a 15% bracket is worth $0.85, while a dollar next year at a 27% bracket is worth only $.73, not counting the effect of other taxes such as Self-Employment tax. Send reminder bills before year-end to those who are already in your debt. Remember that income is taxable when received, even if you don't

deposit the funds until next year.

At the same time, ask your suppliers if they wouldn't mind being paid in January. Since they are so often focused on deferring taxes, they'll probably cooperate. You can also defer expenses by delaying purchases. Charging an expense in December even if you don't pay the credit card until next year doesn't help, since the amount is deemed paid when charged. However, if you take delivery from a merchant who extends credit, the fact that you cannot deduct the cost until the bill is paid can be used to your advantage. Try to delay purchases of new equipment. If you purchase this year, we can depreciate it and forego the expense election (which allows us to currently deduct up to $25,000 in non-automobile equipment), but then we lose the option of deducting it all next year. (Once the depreciation period begins, we must continue to depreciate.)

Some non-business deductions can be deferred. If you itemize personal deductions, delay charitable gifts until next year. Don't prepay your January 1 mortgage payment or April 10 property tax. Do not pay your January state-income tax quarterly in December. Invest in Roth IRAs rather than other retirement plans.

You may also consider doing an IRA-to-Roth conversion. These are perfect for those in the zero bracket, since there is no downside whatsoever. You report the IRA as income, which, at a zero tax rate, costs nothing. The Roth to which you convert provides tax-free growth and income years from now. If in the year of conversion your tax rate is the same as the rate you pay in retirement, you come out even so long as you have funds outside the IRA with which to pay the tax. If like many other retirees you're in a higher bracket (often due to the phase-in of Social Security income), you are far better off paying the tax now.

If you decide a conversion is appropriate for you, it must be done this year. Unlike contributions of new money to retirement plans (which can be made next year but deducted on this year's return), you cannot convert next year and say it was for this year. However, let's assume you convert $20,000 and, when preparing your return, we find that your taxable income was higher than expected. You can reverse the conversion or any part of it by October 15th.

There are huge complications in fine-tuning this on your own, so we strongly recommend you call us. The tax brackets are not as cut and dry as they may seem, due to numerous "hidden" brackets including those resulting from the Self-Employment tax, the Earned Income Credit, and the Social Security income phase-in. However, we are delighted that you are thinking about tax planning, despite your adverse financial circumstances. Best of luck for an improvement next year!

# The Real Story of Thanksgiving

Philosophically-speaking, Thanksgiving is my second favorite holiday (our country's birthday is number one). But it is not because of the official story, which has the Pilgrims sailing to America on the Mayflower, learning new farming techniques from the Indians after their first harsh winter (1620-1621), then having nothing but bountiful harvests. This is pure fantasy, as is so much of the history taught in school.

The true story of Thanksgiving is of the triumph of free markets over socialism. Governor William Bradford, in his History of Plymouth Plantation, reported that rather than working, the colonists preferred stealing their food and other necessities. It was only in the harvest of 1623 that attitudes—and crops—improved. This wasn't because the colonists learned in socialist "education camps" that they should care more for their fellow man and work harder. Instead, it was the re-channeling of rational self-interest via the market and property rights that caused the change.

After the dismal harvest of 1622, by which time half the colonists had died of starvation, Bradford began to question their economic organization. This required that "all profits & benefits that are got by trade, traffic, trucking, working, fishing, or any other means" were to become the property of the colony. The colonists took "their meat, drink, apparel, and all provisions out of the common stock." In other words, each colonist was to contribute according to his ability and take according to his need. This is pure Marxian socialism, with predictable results.

Bradford wrote that the most able of young men complained that they were forced to work for other men's wives and children. As numerous inmates of the former Soviet Union reported, the government "pretended to pay us and we pretended to work." Realizing his error, Bradford, in 1623, gave each household a plot of land, which could be worked upon or traded away as the household wished. What a surprise when the new system "made all hands very industrious," marking the end of the famines. After their first bountiful harvest, the Pilgrims celebrated with a day of thanksgiving.

The real meaning behind Thanksgiving is that socialism, running counter to man's nature, always fails, while free markets produce abundance by channeling man's innate self-interest into production and trade. I thank God we live in a country that has, at least in great part, adopted Governor Bradford's system. If the true story of Thanksgiving were told in every home, we just might adopt this wondrously productive and moral system to a far greater extent. We could start with the schools, which leave us in ignorance about such matters, perhaps because the real history may undermine their authority.

**From all of us at ICGS, Inc., Happy Holidays!**