Inside Highlights

- **Say no! to deductions for underwear** p. 2
- **Pop! goes the real estate bubble** p. 2,6
- **Avoiding social security tax** p. 4-6

"Most financial debacles result from good ideas carried to excess."

—Warren Buffett

Tax and Financial Strategies

Copyright ©2006 by Doug Thorburn, E.A., CFP (818) 360-0985 *Issue #26 Summer-Fall 2006*

Wealth Creation Strategies

What Did Dinner Really Cost?

A 50-year-young client recently admitted to me that she disdains cooking and eats out almost every night. Although earning $75,000 per year, she invests nothing for retirement. When I asked what she typically spends on dinner, the response was a sheepish $25 to $40, not including tax and tip. I suggested we take a closer look at the real cost of such spending, with a long-term view in mind. As you read on, consider replacing "dinner" with clothing, gifts, sports, vacations, toys, furnishings or anything else on which *you* spend after-tax dollars.

The dinner spending doesn't seem that extravagant for her income, until we change the lens through which we view it. If we figure dinner averages $32.50 plus tax and tip, or $40.50 five nights per week, the yearly cost is $10,500, or 14% of her gross income. However, dinner isn't deductible, so she needs to earn substantially more to have that much in usable after-tax funds. Since she's in a roughly 40% marginal tax bracket when we take into account federal and state income, Social Security and SDI taxes, she needs to earn $17,500 to net $10,500. ($10,500 divided by the inverse of her tax bracket, .60, equals $17,500; proof: $17,500 x .40 = $7,000 tax; $17,500 minus $7,000 = $10,500.) It's starting to look rather expensive, but remember, she doesn't like cooking.

Now let's take a look at what it really costs. Money represents earnings from time and expertise (wages and self-employment income), innovation (royalties and patents) or a reward for deferring one's spending by instead investing (interest, dividends, rents and capital gains). Since her income is recompense for time spent working, we need to look at how much time she needs to spend to earn $17,500.

There are a number of ways to calculate the true cost. $17,500 divided by the yearly income of $75,000 is 23.3%; therefore, she's spending almost a quarter of her work time to earn enough to eat dinner out in the style to which she's accustomed. Looked at another way, she earns about $37 per hour. To net the cost of dinner, she needs to gross $67.50, which requires about one hour and 50 minutes of work time. She's not even saving this much time behind the stove!

The worst part is that she's not investing in her 401(k), presumably to afford dining out regularly. She could invest the entire $17,500 each year (the maximum allowable contribution is $16,000 plus an additional $5,000 "catch-up" contribution for those aged 50 and over). The *really* interesting part is what *this* is costing her.

All spending reduces saving and investing. The $17,500 could be invested and spent, say, 20 years from now. Obviously, someone or some entity—usually a bank, lessee or company—has to pay you interest, rents, dividends or expected capital growth to get you to forgo current spending. You expect a return on that $17,500 or it's simply not going to be saved and invested.

What's that $17,500 worth in 20 years at 4% per annum? If inflation averages 4%, it's worth the same as it is today. So let's say it earns 4% after inflation, which historically is a conservative rate of return given a properly diversified portfolio. Conservatively, it grows to $38,340 in real dollars. That's what one year's worth of dining out costs in terms of future benefits 20 years from now.

What does 20 years worth of dinners cost? Using this analysis it totals over $580,000, inflation-adjusted. I asked if she was beginning to consider the possibility that the cost of dinner is extravagant and she agreed that perhaps it was. But how was she going to eat?

I pointed out that a 401k contribution of $17,500 was going to cost far less out of pocket. Since she'd save current federal and state income tax of about $5,500 at her marginal tax bracket (but not Social Security or Medicare tax), the net cost would be less than $12,000. She agreed she might figure out a way to limit yearly dinner expenditures to $5,500.

Now replace dinner with whatever you spend after-tax dollars on. Calculate the true cost by asking, what do I have to earn in order to spend this much? Then convert that figure to hours worked and to foregone future assets. You just might reconsider the spending.

Real Estate Chills

This issue's masthead quote by the Sage of Omaha and second wealthiest man alive, Warren Buffett, is a fitting one for what may be the beginning of a marked decline in valuations of real estate of most types and in many areas of the country. Having written four major articles on the subject over the last two years, which say pretty much all that needs to be said (beginning with the understatedly-titled piece "Sell?" in the Oct-Nov 2004 issue of *Wealth Creation Strategies*), comments during the course of the deflation will be limited. However, there are two points that bear mentioning near what could be the beginning of a catastrophic cooling.

First, Buffett's quote is an appropriate one as we rethink a public policy that allows people to purchase property with little or nothing down, securitizes mortgages in a way that increases the odds of fraud in mortgage applications, allows borrowers to qualify for Adjustable Rate Mortgages at low introductory rates and encourages urban planning with land-use restrictions that create artificial constraints on the supply of land for housing (a subject on which Randall O'Toole wrote a brilliant expose in the February 2006 issue of *Liberty Magazine*). All these have done is drive up the price at which the market "clears," meaning that such policies, while pretending to help buyers, really help only sellers.

Second, as the decline takes hold, the number of desperate sellers will increase, making them more susceptible to fraud. One form, now migrating from the Internet, is a real estate version of the "Nigerian 419" scam, which is a variation of an old con perfected by Oscar Merrill Hartzell in which the mark with the last name of Drake is convinced that the newly discovered Sir Francis Drake treasure is his—so long as he's willing to front some of the money to pay legal and other expenses proving lineage (and who wouldn't for millions of dollars?). In a recent case reported in *The Los Angeles Times*, a forthright real estate agent admits she negotiated with an overseas buyer who wanted to pay the entire purchase price via an online check requiring no signature. The agent knew enough to put it through escrow and wait for the check to clear, but the buyer then told her he'd send the money with his lawyer, who would come to California to review the property and sign the contracts. The flag went up when he told her the lawyer was from Nigeria, but dropped some after speaking with the smooth-talking Nigerian a half dozen times or so as he planned for the trip.

Then the buyer asked the seller to send $2,500 to the lawyer to cover his costs.

She refused, but the buyer was willing to compromise. They finally agreed that he'd come up with $2,000, the lawyer $350 and the seller $150. A week later, the lawyer told her that gunmen had robbed him and he needed $350. Realizing she'd been had, she cancelled and reported the crime to the FBI's Internet-crime complaint center, which receives 20,000 such complaints a month.

An apparently smart agent lost only $150 to someone in a country where the average monthly wage is less than that. If only that were all that will be lost as the numbers of "for sale by owners" and those represented by less-than-competent or outright dishonest real estate agents increase during the coming years.

Congress Says No! to Deductions for Donations of Undergarments

Congress, in its most recent act of wisdom, has decreed that John Q. Taxpayer shall no longer be permitted a deduction for any clothing or household item that has "minimal monetary value, such as used socks and used undergarments." Nor will deductions be allowed henceforth for such items in less than "good used condition or better." "Household items" include furnishings, electronics, appliances, linens and the like. Artwork, including antiques, along with jewelry, gems and collectibles are excluded. A deduction will be allowed for something in less than good condition if the amount claimed is more than $500 and a qualified appraisal of the property is included with the tax return. While we don't yet know what "qualified appraisal" means, we might question whether the cost of obtaining such an appraisal will be worth the effort and potential tax savings. The word "good," like the phrase "reasonable man" in so much of what passes for law, was left undefined.

As is so often true when Congress is in session, there are numerous questions (such as, "Just what are they smoking?") and holes. Donations of used items in "good" condition or better are left untouched. However, due to the fact that many tax examiners will tend to guess that such donations are likely of property in less than "good used" condition, taking photographs of donations is a better idea than ever. Having a garage sale and donating what didn't sell could be used as compelling evidence that the items were in less than "good" condition.

In addition to the provision above, Congress closed a loophole that allowed contemporaneous recorded notes of donations to serve as evidence for deductions of cash. Now, the donor must maintain a bank record such as check or electronic payment, or written communication from the donee, show-

ing the name of the donee organization, date of the contribution and amount contributed. There doesn't appear to be any minimum level under which such records are not required. **They've basically outlawed deductions for donations of cash without receipts.**

Congress also acted to close an interesting loophole that affects few of us directly, but affected the sensitivities of many. There was recently a public outcry over safari hunters claiming deductions for the appreciated value of taxidermy donated to charitable organizations. The value was arguably not only the price of preparation, stuffing and mounting, but also the cost of a safari, resulting in a de facto deduction for such safaris. The resulting legislation restricts the donation to the cost of preparation, stuffing and mounting, with transportation specifically excluded.

Congress Attacks Teens

You know that Congress was getting hard up when they began to tax children's investment income at the parents' tax bracket back in 1987. Showing signs of increasing desperation, they've just expanded their reach into the pocketbooks of your kids.

While it won't affect many of you because of high thresholds, the cutoff age for taxing such income at the parents' rate was increased effective this year to 18, up from 14. The "kiddie tax," as it's called, is designed to stop "wealthy" parents from shifting significant investment income to their children in order to benefit from the child's lower tax rate. Once the threshold is exceeded ($1,700 of investment income this year and adjusted for inflation in future years), the income is subject to the parents' higher rates. It's a complexity nightmare, particularly when there is work-related income. That generally wasn't an issue when the cutoff age was 14. Obviously, it will become a more common issue.

Investment income includes interest, dividends and, most importantly, capital gains. Such gains can be far more significant than interest and dividends, and greatly increases the odds of the "kiddie tax" hitting home. If the parents are divorced, the tax is based on the custodial parent's marginal tax rate. For children of unmarried parents who live together, the tax is at the marginal rate of the parent who has the greater income. It's messy in terms of complexity and there can be privacy issues involved. One senior director at a large accounting firm quipped, "Forget the additional tax. The real expense is that this kid may have to hire a [tax professional]."

Dodging the tax can be easy if the children have not already been given gobs of money. Funds can be invested in a 529 college plan, which accumulates income tax-free (or tax-deferred if not ultimately used for college). Funds can also be invested in tax-free municipal bonds or growth-oriented assets that hopefully appreciate and pay little or no dividends. Or, parents can simply keep funds in their own accounts. It's going to be taxed at the higher rate anyway, and it's a great way to keep full control over funds that could otherwise be squandered once the child reaches legal age.

When Are Contributions to a 401(k) a Bad Idea?

We love 401(k)'s. In the right situation, they save tax at a 25% federal rate or greater and 5% or more for those in many states, including up to 9.3% for typical Californians. By reducing adjusted gross income for those with children under age 17, 401(k)'s serve to increase the Child Tax Credit, which can result in an additional 5% tax cut. The same reduction can increase other credits and deductions, as well as decrease the amount of Social Security income subject to tax, often resulting in hundreds of dollars of additional tax savings. We love 401(k)'s.

However, we should refrain from loving them too much. If you switch companies, you become ineligible for such plans until employed for a year or two. Once eligibility returns, jumping right back in may not always be the best decision. In some instances, more taxes might be saved by waiting until January 1 of the following year.

While this seems to fly in the face of intuition and logic, money is frequently lost by assuming that reason can be applied to one's tax situation. The trouble in this case is the interplay of IRAs and qualified plans. If you're not in a qualified retirement plan for any part of a year, your spouse is, and your combined adjusted gross income is under $150,000, you're eligible to contribute up to $4,000 ($5,000 for those 50 and over beginning in 2006) into a traditional IRA.

What if you join the new company's 401(k) in November and invest 15% of your $4,000 monthly income? You'll get to shelter all of $1,200 for the year. When the tax savings for this (about $400 for a Californian in the 34% combined federal-state bracket) and the savings from a $4,000 IRA (about $1,360) are compared, it's obvious you should have waited until January 1. **Under new rules that allow employers to automatically enroll qualified employees beginning in 2007, you may have to be careful to opt out of such automatic enrollment.**

It gets more complicated if the employer "matches" part of your contribution. Say your eligibility for the 401(k) begins in July, which would result in an investment of $3,600. If the employer

matches 50% of your contribution up to 6%, you'd have "free" money of ($4,000 x 6 months x .06 x .50 =) $720. You were obviously better off joining the company plan in July because you ended up wealthier, even though it sheltered less income.

A related situation involves part-timers earning from as little as a few hundred to several thousand (and arguably more, depending on personal preferences) dollars a year whose spouses earn between $80,000 and $150,000. While a traditional IRA contribution might otherwise be appropriate, part-timers working for government entities may be participants in a retirement plan whether they want it or not, precluding traditional IRA contributions even if the employer's contribution is only a few pennies. Since net income after the real tax is so little (remember, the withholding tax is not the real tax, which is calculated based on the combined income) and the traditional IRA deduction is forfeited, quitting (perhaps working as a volunteer) may be sensible. The same can be said for those working for certain private employers with SEPPs (Simplified Employee Pension Plans) or SIMPLEs (Savings Incentive Match Plans for Employees), which must make contributions for the benefit of part-time workers after only two years of employment.

This may seem overly complicated. It is. But you need to know enough to know when to call us with questions. That's why we're here year-round.

How Can You Avoid Underestimated Tax Penalties?

Taxes must be paid incrementally through the year in order to avoid underpayment of estimated tax penalties. Since the penalty is calculated as an annual interest rate from the date the tax should have been paid, it helps to understand the basics.

The current rate on underpayments (which changes from time to time based on other rates) is 8% per annum. Since the current return on short term savings is 2-3% and around 5% in longer-term CDs, net worth shrinks by not keeping up with estimates. This is exacerbated by the fact that earnings are taxable and the penalties are never deductible.

Here's the general rule for penalty avoidance if tax is expected to increase: Pay the equivalent of the prior year tax in four equal quarterly installments and, no matter how much you owe at year-end, there's no penalty. Withholding is treated as paid incrementally throughout the year, even if all paid in December (although rules may prohibit this if there should have been withholding earlier in the year).

This can be confusing for those who owe a substantial sum one year and avoided penalties, yet for whom estimates must be paid the following year.

Let's say your tax in '04 was $5,000, followed by $18,000 in '05. If you paid $5,000 via withholding or timely-paid quarterlies during '05, you owed the difference, $13,000, without penalties. Yet, required quarterlies for '06 are $4,500 per quarter, or $18,000 for the year. This is because we have to base the '06 estimates on the '05 tax of $18,000. If you pay that amount, you'll avoid penalties regardless of how much additional tax is due.

There are other complications and opportunities. Those whose Adjusted Gross Income exceeds $150,000 must base estimates on 110% of the prior year tax. Required payments can be based on when income is actually earned, an "annualized income" approach, the savings from which can be substantial. Shifting from employment to self-employment can get complicated because the required payment is a function of all taxes owed the prior year, including self-employment tax but not withheld Social Security tax. In addition, an adage from real life, "better late than never," applies to taxes: penalties stop running when an estimate is paid, even if late. And finally, in one glaring exception and out of respect for the fact that new retirees may be unaware of their change in tax liability, penalties can be abated in the first year of retirement.

How Can You Avoid Social Security Tax?

When I wrote my first piece on Social Security tax avoidance some 25 years ago, the maximum wage base on which the tax was imposed was $29,700 at a flat rate of 10.7% (employer and employee rate combined), yielding a maximum tax of $3,178. Inflation would have taken the maximum wage base to $67,695 and the maximum tax to $7,243. Instead, the tax rate was ratcheted up during the 1980s to 12.4% and the maximum wage base has been pumped up at a far greater rate than inflation. The wage base for 2006 is $94,200, yielding a tax as high as $11,681. The Medicare tax, which up until 1990 was capped with Social Security, is now paid on unlimited employment and self-employment income at a combined (employee-employer) rate of 2.9%. The total 15.3% Social Security/Medicare tax rate results in a total tax far greater than income tax for many workers. And, as the govern-

ment has forced more people into the program over the years, the tax has gotten far more difficult to avoid. At least Charles Ponzi didn't have the power of government behind him. As a result, he was out of business and behind bars within a year of beginning what became known as a "Ponzi Scheme," which is no different in principle.

Why would someone want to avoid paying the tax, when so many want to retain the Social Security system? Because many view Social Security taxes as an "investment" on which the rate of return is pathetic. The chart below is reprinted from "The Greatest Ponzi Scheme Ever," *Wealth Creation Strategies* July-August 2002 (available on the Internet at www.DougThorburn .com). As pointed out, a game in which investors receive "profits" out of the pockets of subsequent investors can continue for only so long before the scheme collapses. Social Security is the same kind of game, since taxes collected are not invested, there is no "trust" fund and the proceeds are immediately paid to retirees.

Ages* that workers must reach in order to fully recover their Social Security tax plus interest at 3%

Year of Retirement	Minimum Earner ($10, 712**)	Average Earner ($31,685**)	Maximum Earner ($76,200**)
1940	65	65	65
1960	66	66	66
1980	67	68	68
2000	77	82	89
2010	79	87	99
2020	81	90	113
2030	80	91	121

* Assuming retirement at age 65. This too is fraudulent, since normal retirement age slowly increases to 66 years for those born from 1943-1954 and 67 years for those born after 1959. Therefore, the true results are worse than the chart portrays.
** In 2000 dollars

Because of the fact that only wages and income from self-employment are subject to Social Security and Medicare taxes, there are some perfectly legal ways to avoid these taxes. There is also one gaping "gray area," which is being challenged by the IRS wherever possible and could be changed by Congress at any moment. Here are a few tax avoidance ideas.

1. We would think that there is tax equivalency between an employee earning $50,000 who must pay $10,000 in business expenses and one who earns $40,000, for whom the employer pays all expenses. We would think logically, something contrary to the ways of Congress. While Social Security and Medicare tax must be paid on all wages, there is no credit for such tax when deducting business expenses. (It gets even worse because, among other potential costs, the taxpayer loses the income tax benefits of the deductions (1) to the extent he wouldn't otherwise be itemizing, (2) due to limitations on itemized deductions including the 2% threshold, and (3) to the extent the AMT affects him.) It's surprising how many employers still require employees to pay business expenses, particularly in view of the fact that the employer saves employment taxes. Solution: employer reduces wages paid to the extent the employee seeks reimbursement for employee business expenses. If an overall cap is desired, my friend and tax attorney Mel Kreger offers a variation: set a low base salary, leaving plenty of room for reimbursed expenses but limiting them, giving a bonus to the extent of unused expenses. If the overall cap is $50,000, salary can be set at $40,000 with a $10,000 allowance for expenses. If expenses for the year total only $4,000, according to the formula, the employer agrees to pay a year-end bonus of $6,000.

2. Many employees, particularly in the film and TV industries, work for many employers, making idea number one impractical (which employer will reimburse the expenses?). These employees have, in increasing numbers and for various reasons, incorporated and elected to be taxed as an S corporation. Net income after all business expenses including wages is taxed to the S corporation owner(s), but is not subject to Social Security/Medicare tax. This is the area mentioned above that is coming under IRS scrutiny and is not something to try on your own. Expert advice is a must and, even still, must be viewed skeptically. We simply don't know what the IRS or Congress will do.

3. Incorporate and avoid SE tax on contributions to certain pensions. If net income is $80,000 and you intend to invest $15,000 in a pension, the SE tax is roughly $12,000. If you incorporate, your corporation pays you a salary of $60,000 and pays about $9,000 in combined employer-employee Social Security tax. You legally avoid Social Security tax on the $20,000 because $15,000 is earmarked for your pension and half of the $9,000 is the employer's share of Social Security. Alright, there's $500 left over, but the government's not going to mess with you over such an insignificant amount. You saved roughly $3,000. Since there are other costs and benefits to consider, don't do this on your own.

4. Spread out income, doing everything possible to avoid business losses.

Profits are subject to Social Security/Medicare tax, while losses do nothing to decrease it. A recent example involved a client who had net income of $10,000 one year and a loss of $10,000 the next. Self-Employment tax of about $1,500 was paid on the $10,000, with no offset the following year. If the net income instead had been zero each year, the tax would have been avoided in both years. While this isn't always possible, many business owners have some control over expenditures and timing of income, and we have some control over how quickly or slowly equipment is depreciated.

5. Contractors and others who are handy are in a unique position to convert labor that is ordinarily subject to Social Security/Medicare tax into increased wealth that not only avoids those taxes, but also income tax. To the extent your own sweat increases the value of your home all taxes are avoided up to the exclusion amounts when you sell. If your work increases the value of rental property, tax on the increased value is avoided until the property is sold. If sold, taxes are paid at lower capital gains rates rather than ordinary income plus Social Security rates. Retaining rental property into retirement and the great beyond permanently eliminates such tax.

6. Gradually replace work-related income with rental income. Obviously, this requires capital, which often must be slowly grown over decades. However, several clients have invested wisely over the last two or three decades and are now able to survive on just their rental income. A housing collapse could make implementing this strategy challenging, but those who are willing to pick up the pieces five or ten years from now could do very well.

Debunking the Myths of House Prices

It's astounding that many otherwise intelligent people say things like, "Look at how much construction activity there is. I have to buy now!" when considering an investment in real estate. A variation of this idea can be found in the May 21, 2006 issue of *Parade* magazine, which got part of it right when explaining, "Prices are steepest where demand is high and supply is limited by geography, government regulation and other factors—which explains why San Francisco and New York City stay expensive year after year and why fast growing Atlanta remains affordable." But they continued. "Nearly 61,000 building permits for single-family homes were issued in that Georgia metropolis last year. *Yet* median prices rose by a reasonable 6.6%" (emphasis added). How misleading.

Economic un-truths can become pervasive because of seemingly insignificant words. Take the word "yet." Used here, "yet" implies that with so many houses under construction prices should have increased by far more than a "reasonable 6.6%." Yet (choosing the word more carefully), the proper word is, "therefore." There is plenty of new construction and, *therefore*, prices have been restrained. Sigh. If only homeless and "affordable housing" advocates would understand this simple economic truism and drill it home the next time no-growth advocates attempt to block the construction of more housing.

I would also question the observation that San Francisco and New York City "stay" expensive year after year. I've written elsewhere that the disparity between the coasts and hinterland, where home prices are as little as one-tenth of those in the more expensive coastal cities, is unsustainable in the information age. The word "stay," while not necessarily perpetuating a myth, is a term that implies prices in those areas cannot drop 30% or even 10%, something over which reasonable people may disagree. It is one whose future accuracy as a descriptor will be known only in the fullness of time.

Principled Voting 2006

The October-November 2004 top story, "Using Principles in Deciding How to Cast Your Vote," (the entire article is at www.DougThorburn.com) included five principles that can serve as a guide for anyone who believes that the purpose of government should not extend beyond protection of its citizens from thugs, both foreign and domestic. I pointed out that all spending eventually results in tax increases and, " Ballot initiatives are often used to increase the supply of proper government functions….The question that cries out is, why aren't existing tax dollars, which in California are twice per capita what they were just twenty years ago, allocated to support these essential government functions?" The upcoming ballot includes over $40 billion in such ballot initiatives, along with additional taxes on unpopular people (smokers), an unpopular industry (oil, which always amazes me considering 90% of the world's oil reserves are in countries with government-owned oil monopolies) and on corporations, upping what is already the highest corporate tax rate in the country.

The votes in the upcoming election consistent with these and other principles cited in the article are: Yes on Propositions 1A and 90; no on bond-issue Propositions1B, 1C,1D, 1E and 84; and no on tax-increasing Propositions 86, 87, 88 and 89.