Inside Highlights

- **Updates on contributions to retirement plans and health savings accounts pp. 2**
- **Real estate succumbs to perfect storm pp.2-3**
- **Simplified recordkeeping simplified pp. 2-3**
- ***Real* tax brackets for low income earners pp 4-6**

Two simple questions: 1: How does making health care "universal" reduce costs?
2: Do we really want the same people who run the DMV and post office to run health care?

Tax and Financial Strategies

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Wealth Creation Strategies

Year-End Reminders

1. If you have a choice about whether to take a large deduction or chunk of income prior to year-end, be sure to consult with us regarding your "real" tax bracket BEFORE you act. The series of articles dubbed "What Tax Bracket Am I In?" was deemed important enough for Enrolled Agents to be reprinted in *The California Enrolled Agent* magazine. Among other points, these articles show that taking additional *income* or reducing *deductions* can be profitable. The more obvious and intuitive approach of *reducing* income and *increasing* or accelerating deductions into the current year often increases the multi-year tax burden. If you haven't yet read these articles (Spring 2007 and Summer 2007 issues of *Wealth Creation Strategies* available by request or on the web site, as are all issues published since early 2002), please take the time to read them, as well as part 3 of the series inside this issue.

2. We're not always available between Christmas Eve Day and New Year's Day. Please call us for any year-end planning BEFORE December 24.

3. Record the odometer for business-use vehicles on December 31, or as close to year-end as you think of it (do it today if you think you'll forget!).

4. Forms 1099 and DE-542 (Report of Independent Contractor) must be filed in January. When we prepare 2007 1099s, we assume last year's payees are "ongoing" if California-based, unless you tell us otherwise. Rules for 1099s and DE-542s can be found in page 3-4 of the January-February 2003 issue of *Wealth Creation Strategies*.

5. Inform us as early as possible of available funds for retirement plans (SEPPs, Keogh's, SIMPLEs, traditional IRAs and Roth IRAs), Health Savings Accounts and any additional taxes you may owe. By doing so early, we can better help you optimize retirement and medical funding within the confines of available cash.

6. We will need settlement statements (NOT the 27-inch wad of "other" escrow documents) for any purchases OR refinancing of real estate. For refi's, we'll also need details of how you spent any excess amounts over the old loan amount.

7. As of 2007, all charitable donations of cash must be receipted. If under $250 per occasion, a check will suffice; if over $250, a receipt from the charity is required. Receipts are always helpful regardless.

8. All charitable donations of goods must be for items in "good-used condition" or better. If donations of items total more than $500 for the year, we'll need an itemized listing including original cost and fair market value. The "non-cash charitable contributions worksheet" in our "by mail" package is great for this purpose.

9. Those over 70 ½ must remember to take their RMDs (Required Minimum Distributions) from IRAs and other retirement plans before year-end. Or better yet…

10. As far as we know, this is the last year (of only two) in which charitable donations may be made directly from IRAs (NOT other retirement plans) by those over age 70 ½. Such donations can be in lieu of RMDs and are not counted towards Adjusted Gross Income. It may behoove those whose tax rates are as high as 48% due to taxability of Social Security benefits to take advantage of this provision. The full explanation can be found in the Winter 2006-2007 edition of *Wealth Creation Strategies* ("How Can I Benefit from Charitable Giving if I Don't Itemize Deductions?") and the Summer 2007 issue ("'What Tax Bracket Am I In?' Part 2: A Focus on Social Security Recipients").

An Update on Maximum Contributions to Retirement Plans and Health Savings Accounts

IRA limits

	2007	2008
Up to age 50	$4,000	$5,000
Age 50+	$5,000	$6,000

SIMPLE IRA limits

	2007	2008
Up to age 50	$10,500	$10,500
Age 50+	$13,000	$13,000

401(k), 403(b) & 457 plan limits

	2007	2008
Up to age 50	$15,500	$15,500
Age 50+	$20,500	$20,500

HSA new rules: full deduction regardless of deductible under a qualified paired high deductible health insurance plan

	Single 2007	Single 2008	Family 2007	Family 2008
Deductible contribution limit	$2,850	$2,900	$5,650	$5,800
Additional catch-up contribution *	$800	$900	$800	$900

* Taxpayers age 55 or older, per person

SEPP/Profit Sharing Plan limits

	2007	2008
All ages	$45,000	$46,000

Real Estate Succumbs to a Perfect Storm

Rarely do circumstances and events converge so perfectly to give rise to bubbles such as the late great one in homes and condominiums. Buyers must be willing to overpay for assets and lenders must open the spigots, providing funds with which to bid up prices far beyond economic value. As in any game of musical chairs everything seems fine until the music stops. Like Ponzi schemes, all involved seem to benefit until everyone who was going to buy has done so or, as in this case, lending standards tighten. Those who sell and do not re-purchase do very well indeed, while others resolve to wait for a sinking market to improve.

The confluence of events, circumstances and a failure to enforce laws proscribing fraud that led to one of mankind's great investment manias were as extraordinary as the bubble itself. As readers of these letters knew, I was calling a spade a spade as early as 2004 (Oct-Nov 2004 *Wealth Creation Strategies*, which you'll find on the web site or obtain from us by simply asking), in a two-page article simply entitled "Sell?" I suggested that while we might not be at the end of the rope, we were preparing the noose. Indeed, as I wrote the three 2005 top stories in a row in the summer and fall of 2005, the noose was tightened. My main arguments supporting the idea that prices in many areas would drop 20%-50% included the extraordinary overvaluation of housing vs. incomes and low net yields on debt-free rentals. I also pointed to a tightening of lax lending standards as one possible catalyst for the popping of the bubble ("Froth in the Real Estate Market," July-August 2005 *Wealth Creation Strategies*). I suggested that the financial shenanigans then played by lenders "could make the Savings and Loan crisis of the 1980s look like child's play" ("Real Estate Bubble Part lll," September-October 2005 issue). But not even I fully appreciated the mechanism and disconnect between loan originators and investors, creating moral hazard the likes of which had never been seen.

A definition of "moral hazard" from *Wikipedia*

"*Moral hazard* refers to the prospect that a party insulated from risk (such as through insurance) will be less concerned about the negative consequences of the risk than they otherwise might be; for example, an individual with insurance against automobile theft may be less vigilant about locking the car.

"Financial bail-outs of lending institutions by governments, central banks or other institutions can encourage risky lending in the future…A moral hazard arises if lending institutions believe that they can make risky loans that will pay handsomely if the investment turns out well but they will not have to fully pay for losses if the investment turns out badly.

"Moral hazard can also occur with borrowers." Here, *Wikipedia* drops the ball and fails to mention recent specific hazards: 1. Borrowers could mortgage a house to the hilt, hoping that prices continue to increase, knowing that if price increases fail to materialize, they can hand the keys to the lender. 2. Loan originators sold loans to others. There was no incentive to warn those who purchased such loans that many borrowers were unlikely to comply with the terms of the loans.

As in alcoholism, to which I attributed much of the excess exuberance in the free on-line August 2007 edition of the *Thorburn Addiction Report* (www.addictionreport.com; please take the opportunity to access the archives and sign up for free future issues), fueling the mania required financial tools, techniques and thinking rooted in impaired judgment, deceit, outright stupidity and blatant fraud.

There was an almost complete disconnect between those who originated loans and investors who accepted the risk of non-payment by buying those loans. Debt has always been sold, but never before has so much been packaged into so many types of bonds and purchased by third parties so far removed from the origination process. The bubble, growing beyond what anyone thought possible, required fraud on the part of borrowers, loan brokers and appraisers, deceit by those who rolled mortgages into triple-A rated bonds that should have been rated F-, outright stupidity by rating agencies giving high ratings to bonds that included sub-prime mortgages, and impaired judgment by those who purchased such bonds. It was a perfect storm because if even one of these components had not been present, the mania could not have propelled values to such extremes.

Tenets of the libertarian Austrian school of economics predict that an excess availability of funds ("liquidity") leads to overinvestment ("mal-investment"), which creates a false boom. It also predicts that the excess capacity becomes obvious when everyone who could invest has done so. At this point, spending declines, prices begin to drop and, as lenders belatedly recognize the increased risk, funds become more costly or dry up. This reaction feeds on itself and turns the boom into bust, which if economy-wide creates a recession or depression (keeping in mind that "recession" is when your neighbor loses his job and "depression" is when you lose yours).

This reaction to the malinvestment in housing has created enormous recessionary risks. The 1921 recession was deep, but because government kept its hands off the economy, it was mercifully short and ended within nine months. The 1929 recession turned into depression because government couldn't keep its tentacles out of our lives, in particular jawboning business to keep the price of labor up (if you have unemployed—unsold—apples, you reduce the price until they all sell; government policy naively discouraged reducing the price of labor, which kept unemployed labor from getting purchased). Currently, many politicians are advocating doing what they can to "help" homeowners avoid foreclosure, which will also bail out lenders. Saving borrowers and lenders from their own poor judgment will not only insure that necessary lessons go unheeded (adding to the massive amount of "moral hazard" already in the system), but also turn what may otherwise be a 1921-style recession into an extended period of economic depression.

Simplified Recordkeeping Simplified

It's hard to believe my premiere article on simplifying record keeping was written two decades ago. It was pre-computer age and pre-Quicken, yet the concepts can easily be adapted to computer programs from QuickBooks to Excel. It was written for real estate brokers, yet the principles apply to tracking income and expenses for any business, profession or rental property. While clients are invited to request a copy of the original article (which goes into far greater detail) or await a new version (to be published in a national magazine), here are several quick and easy rules to follow:

1. Write checks or charge everything possible. Minimize cash expenses.
2. Categorize every expense on the check itself and in the checkbook register. That way, you don't have to categorize later by referring to the receipt, which months later may look Greek. You simply total expenses by category from the check copies or register.
3. Use a separate charge card only for business and begin with a zero balance when you start that business or purchase the rental property. Write on the slip what the expense was for—again, categorize it right then and there. Keep the business-use and personal-use cards at opposite ends of your wallet to reduce the risk of using the wrong card. You might even consider using different kinds of cards—for example, I use a Visa for business and a MasterCard for personal expenses.
4. Create three key files for business or rental receipts: (a) receipts that corroborate the checks; (b) receipts and credit card slips that are stapled to and support the statements; and (c) cash receipts, which are kept to a minimum.
5. Tally expenses from the check book register, credit card statement file and cash receipts file.
6. Track expenses by and create a complete set of new files for each year.

We've got plenty of copies of the original article, along with a couple of follow-up pieces on creating files for records. We're always happy to share these timeless articles, which are *not* available on the web site.

"What Tax Bracket Am I In?" Part 3 A Focus on Low Income Earners

In the last two issues, we discussed marginal tax brackets and how they are often not what people think they are. The answer to the question, "What tax bracket am I in?" has been twisted and contorted by a Congress intent on making tax calculations and planning mind-numbing and difficult—at best. The question can only be answered when we know the specific *kind* and *amount* of income or deduction for which we're asking. We previously showed that this is because tax rates vary by their type and enormous changes in rates occur once certain thresholds are reached and broken. Another remarkable change occurs for those qualifying for the low-income **Earned Income Tax Credit (EITC)** and the refundable **Additional Child Tax Credit (ACTC).**

The EITC was created in 1975 to help low-income workers offset the Social Security tax and provide an incentive to work in the day and age of the welfare state. Unfortunately, all government actions create unintended consequences and this is no exception. The EITC arguably creates a disincentive to be too successful or to marry. On the other hand, sometimes the fit hits the shan and those who don't ordinarily qualify might during a period of partial employment or depressed business conditions.

The EITC is refundable, which means that those qualifying get a refund even though no tax has been paid. But rather than phasing in at the same rate of Social Security tax, 7.65% for employees or 15.3% for the self-employed, it phases in at a 34-40% rate, peaking when income reaches $8,050 for parents, whether single or married, with one child and $11,300 for parents with two or more children. This amounts to a negative income tax of 34-40%, way more than enough to offset the Social Security tax (there is no income tax at these levels of earnings). After flattening out (the maximum credit is $2,747 and $4,536 respectively for one and two-or-more children), the credit begins a long decline at incomes of $14,850 for single parents and $16,850 for married parents regardless of the number of children. The phase-out (reduction in EITC) occurs at a rate of 16% of any increase in income for parents with one child and 21% for parents with two or more children, completely phasing out at incomes ranging from $32,000 to $38,348 depending on marital status and number of children. This is the equivalent of an extra 16-21% tax on top of other taxes. (While phase-outs and rates used herein are for 2006, the principles remain the same.)

Let's take a look at the real-world affect this has on a married couple with two children. We will not use employed taxpayers for our example because (1) you won't see the interplay of the EITC and ACTC with Social Security tax and (2) employees have far less control over net working income. Instead, we'll assume the taxpayers are self-employed (one or the other or both with net income) and take the standard deduction (they do not itemize mortgage interest, property taxes and other personal deductions). Note in Table 1 by how much the EITC offsets the Self-Employment (S.E.) tax (Social Security tax for the self-employed) at lower income levels.

Table 1—Real v. Advertised Rates for Married Couple with Children Qualifying the Parents for the Earned Income Tax Credit (EITC) and the Additional Child Tax Credit (ACTC), One or Both Parents Self-Employed

Net Business Income Over	Real Tax Bracket One Qualifying Child	Advertised Tax Bracket *		Real Tax Bracket Two Qualifying Children	Advertised Tax Bracket *	
$0	(18%)	0%	15.3%	**(23.5%)**	0%	15.3%
$8,700	**5.5%**	0%	15.3%	**(23.5%)**	0%	15.3%
$12,200	**5.5%**	0%	15.3%	0%	0%	15.3%
$18,200	24.5%	0%	15.3%	20%	0%	15.3%
$21,700	**38%**	10%	25.3%	20%	0%	15.3%
$25,300	**38%**	10%	25.3%	**42%**	10%	25.3%
$36,600	23.5%	15%	30.3%	**42%**	10%	25.3%
$38,000	28%	15%	30.3%	**42%**	10%	25.3%
$41,300**	28%	15%	30.3%	28%	15%	25.3%

* Left column underneath "Advertised Tax Bracket" income tax only; right column income tax plus S.E. tax.

** These rates are stable to around $90,000, at which point things get convoluted due to reaching the maximum earnings subject to S.E. tax and, soon after, beginning the phase-out of the child tax credit.

A married couple with two qualifying children and income under $12,200 loses $235 for every $1,000 that net income drops from that level (see bold **23.5%** under "Real Tax Bracket Two Qualifying Children"). Therefore, increasing one's business expenses works against the taxpayer. And the one-child couple with income between $8,700 and $18,200 saves only $55 for every $1,000 in additional business expenses. Incredibly, at these income ranges decreasing the bottom line either costs or saves too little, while increasing net income adds to the tax refund or costs almost nothing in additional tax.

Oftentimes the business owner can defer expenses from or accelerate income to the current year if he expects to be in a low or negative tax bracket. Elections to expense business tools, equipment and furnishings can be foregone in such years, instead taking the slowest depreciation allowed. Also, many self-employed taxpayers experience low incomes when starting new businesses. Until a business is operational, expenses may be considered "start-up" costs, which must be amortized over 15 years (unless an election is made to immediately deduct up to $5,000 of such expenses). The date a business becomes operational may be subject to interpretation, allowing some flexibility in limiting otherwise allowable deductions and deferring the benefits of such deductions to future years, when they may save taxes at a far higher rate.

Note too that taxes can be saved at a surprisingly high rate (**38%**) by accelerating deductions if net business income is between the "hump" amounts of $21,700 and $36,600 for a couple with one qualifying child and **42%** for couples with two children and income between $25,300 and $41,300 (refer to Table 1). This creates some non-intuitive planning opportunities. Crazy though it may seem, deductions against income are worth so much less over the top end of these ranges (where additional income is taxed at far lower effective rates of 23.5% to 28%--see Table 1, $36,600 and over for parents with one child and $41,300 and over for those with two children), it may pay to *increase* net income one year disproportionately compared with a prior or subsequent year.

Usually, taxpayers are far better off "smoothing" income—what we might call an informal sort of "income averaging," as opposed to the formal version that disappeared two decades ago. For example, a single taxpayer with zero income in one year and $100,000 income in another pays roughly $6,000 more federal income tax than the same person with $50,000 income in each year (approximately $20,000 on $100,000 vs. $7,000 for each of two years on $50,000 per year). However, the result of such income averaging for a married couple with two qualifying children can work in their favor—or, due to the "humps" referred to above, against them. Table 2 gives an example at the low end ($24,000 income over two years) in which averaging the income between two years saves a bundle and several examples in more moderate income ranges ($60,000 to $90,000 over two years) in which our intuition—which tells us to "smooth" that income—fails.

Table 2—Savings or (Cost) of "Income Averaging" at Various Net Income Levels for a Married Couple with Two EITC Qualifying Children

	Year 1	Year 2	Total 2-Year Tax	Year 1 and Year 2	Total 2-Year Tax	**Savings (or cost) by "Averaging"**
Income	$0	$24,000		$12,000		
Tax	$0	($1,695)	($1,695)	($2,834)	($5,668)	$3,793
Income	$20,000	$40,000		$30,000		
Tax	($2,491)	$4,713	$2,222	$411	$822	($1,400)
Income	$25,000	$50,000		$37,500		
Tax	($1,503)	$7,696	$6,193	$3,645	$7,290	($1,097)
Income	$30,000	$60,000		$45,000		
Tax	$411	$10,504	$10,915	$6,292	$12,584	($1,669)

Because of the interplay of the EITC, ACTC and other factors, taxpayers are often subject to tax rates on different types of income and deductions they'd never dream possible. Note that the real tax rate on long-term capital gains in Table 3 is more than 500% of the advertised tax rate.

Table 3—Tax Cost or Savings on an Additional $1,000 of Income or Deduction for a Married Couple with Two EITC Qualifying Children at $24,000 of Income

Income or (Deduction)	Tax Increase or Decrease	**Real Tax Bracket**	**Advertised Tax Bracket**
S.E. income	$420	42%	25%
Wages	$310	31%	10%
Long-term cap gains *	$260	**26%**	**5**%
(Capital loss)	($100)	(10%)	(10%)
(IRA, 401k, SEPP) **	($159)	(15.9%)	(10%)
(IRA etc. 2nd $1,000)	$0	0%	10%
(Other spouse's business deductions that create a net loss)	($289)	(28.9%)	(10%)

* But if total investment income—capital gains, interest, dividends and royalty income—exceeds $2,800, the EITC completely disappears, which can create a theoretical real tax bracket as high as 453,600% on that $2,801st dollar. A refund of $2,872 turns into a balance due of $1,664, for a net tax increase on that last additional dollar of income totaling $4,536. See how crazy this is?

** To extent eligible.

Table 1 showed real tax rates on low-income married couples for EITC and ACTC qualifying children. Table 4 reports real rates on low-income heads of household with EITC/ACTC qualifying children.

Table 4—Real v. Advertised Rates for Self-Employed Unmarried Head of Household with Qualifying Children for the EITC and the ACTC

Net Business Income Over	**Real Tax Bracket One Qualifying Child**	**Advertised Tax Bracket ***		**Real Tax Bracket Two Qualifying Children**	**Advertised Tax Bracket ***	
$0	(18%)	0%	15.3%	**(23.5%)**	0%	15.3%
$8,700	**7.6%**	0%	15.3%	**(23.5%)**	0%	15.3%
$12,200	**7.6%**	0%	15.3%	0%	0%	15.3%
$15,200	**1.5%**	0%	15.3%	0%	0%	15.3%
$16,000	16%	10%	25.3%	20%	0%	15.3%
$17,800	**38%**	10%	25.3%	20%	0%	25.3%
$18,800	**38%**	10%	25.3%	**33.7%**	10%	25.3%
$26,800	**42.7%**	10%	25.3%	**33.7%**	10%	25.3%
$30,250	**42.7%**	15%	30.3%	**47%**	15%	30.3%
$34,500	28%	15%	30.3%	**47%**	15%	30.3%
$39,900	28%	15%	30.3%	28%	15%	30.3%
$59,400	38%	25%	40.3%	28%	15%	30.3%
$63,000**	38%	25%	40.3%	38%	25%	40.3%

* Left column income tax only; right column income tax plus S.E. tax.

** These rates are stable to around $81,000, at which point things get convoluted due to beginning the phase-out of the child tax credit and, while the credit is still in phase-out mode, reaching the maximum earnings subject to S.E. tax.

And the marriage tax penalty is still in full bloom for some. What happens if two unmarried heads of household, each with one qualifying child and identical incomes get married?

Table 5—The Cost of Doing the Right Thing by Getting Married

Net Business Income for Each	Head of Household Tax	Tax (Refund) Two Heads of Household	They Marry and the Tax (Refund) is	Cost of Getting Married	% Increase in Tax by Doing the Right Thing
$10,000	($1,374)	($2,748)	($2,491)	$257	9%
$16,000	($1,051)	($2,102)	$1,268	$3,370	Infinate
$20,000	$83	**$166**	**$4,713**	**$3,700**	**2,839%**
$25,000	$1,998	$3,996	$7,696	$3,700	93%
$30,000	$4,061	$8,122	$10,504	$2,382	29%
$35,000	$6,124	$12,248	$13,312	$1,064	9%

Enrolled Agents know better than most what a mess Congress has made of the tax system. In this vein, we often think of the fact that hardly anyone knows what the law really means. This series of articles has shown the dramatic differences between advertised tax rates and real ones. In an effort to increase "fairness" and "equity," what should be simple arithmetic has morphed into a convoluted form of higher mathematics. The unfortunate implication is that the law of unintended consequences seems to turn attempts at greater fairness into complicated morasses. Simplification may not seem quite as equitable, but there's a price to be paid either way.