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"Expanding the scale and scope of government largess means that more and more of our best entrepreneurs, managers and workers will spend their time and talent chasing hand-outs...not the marketplace needs and wants of consumers."
--Micahel J. Boskin, Wall Street Journal

Tax and Financial Strategies
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WEALTH CREATION STRATEGIES

The Wealth of Individuals Part 4

Part 1 of this series explained the importance of debt avoidance, stable growth, relative stability in one's personal life and beginning a savings and investing program earlier rather than later. Part 2 discussed the ultimate source of wealth: the protection of property, which fosters the incentive to build savings used to invest in capital equipment, the essential component in creating a standard of living magnitudes greater than in societies lacking this protection. Part 3 expanded on an idea alluded to in Part 1: that increases and decreases in wealth seem to occur in spurts, and there are times when capital preservation is so important it's ok to earn little or nothing on your capital. In this installment, we'll shed some light on risk management and reveal a method of assessing one's tolerance to risk, with the goal of increasing the odds of participating in upward spurts and avoiding downward ones.

Step back from the picture

The first step in risk management is to look at the big picture. All-too-many err by focusing on just one part of their portfolio. A recent example occurred when I (enthusiastically) told a client, who'd invested $4,000 in his first Roth IRA the previous year, he could invest $5,000 in his 2008 Roth.

He became visibly agitated and almost breathlessly said, "I'm never doing that again."

I couldn't resist and innocently asked, "Do tell, why not?" Responding that he'd lost half his $4,000, I looked him square in the face and said, "First off, you didn't have to invest in stocks or stock mutual funds. Secondly," and of course knowing the answer to the question as would any good attorney, I asked, "By the way, how much money do you have in the bank?"

"About $100,000."

"So," I responded in as serious a tone as I could, "you lost 2% and you'll never again invest in either Roth IRAs or stocks."

I sat silently and watched his expression move from anger to a somewhat quizzical look and, gradually, to understanding. He uttered a long "ooohhhhhh."

It dawned on me he's probably not the only person focusing on just one component of his or her portfolio. Yet, viewing the big picture is essential for sound asset allocation and a precondition for proper risk management.

Let's take a look at your portfolio. Add up the current value (forget about what they were worth before the cataclysm!) of your taxable accounts, including savings, checking, CDs, brokerage accounts, etc., along with your retirement accounts, including IRAs, 401k's, 403b's, pensions, the cash value of annuities, etc. Let's say the total comes to $100,000. Now add up the stock and stock-equivalent (i.e., stock mutual funds) portion held in each account. Count variable annuities as stock equivalents (as some have recently found to their dismay, that is what they are). If you're not sure how to categorize an investment, include it with the stock equivalents, particularly if it fluctuates in value by more than a few percent (these could include high-yield bonds). Let's say the total adds up to $60,000. Now check your math: cash and cash equivalents (CDs, savings accounts, U.S. government bonds, fixed income annuities, etc.) should total $40,000. Next, divide the value of the stock equivalents by the total. The result, in this case 60%, is your "at-risk" position (the percentage of your portfolio that could tank with the economy).

Granted, this is rather simplified, but simple is sometimes better. Be aware that you could count the present value of a stream of future Social Security benefits and other pensions that disappear at death, as well as future inheritances; it's a judgment call. A lump sum expected from an estate that is currently in probate should probably be included, while an inheritance from someone who hasn't yet died should probably be excluded.

Questions of tolerance

The next step is to ask yourself a series of questions designed to assess your risk tolerance. The goal is to help you find a position from which you will be unlikely to panic regardless of the

direction stocks move. Ideally, your answers should vary at different price points in the market, which requires that you have an opinion as to how under- or overvalued the market is. They should also vary based on your age and short-term cash needs. Also, bear in mind that when dealing with emotions there are no right or wrong answers.

1. Will I panic and sell everything if stocks collapse by 50%? If the answer is yes, or "maybe," adjust your at-risk position downward until you answer no.

2. Would I be willing to increase my exposure (i.e., buy more) if stocks collapse by 50%? If the answer is no, sell at-risk assets until the answer turns positive.

3. If stocks move up strongly from current levels, will I "chase" the market and buy them at higher prices? If the answer is yes, begin buying now and stop only when the answer turns negative.

4. If stocks move up substantially, will I take some off the table (sell)? If the answer is no, adjust your exposure upwards until the answer is yes.

I mentioned in the winter edition of *Wealth Creation Strategies* (mailed mid-January) that I was about 40% net invested at that time, at about 8500 on the Dow (I had invested at lower levels). I ascribed roughly equal odds to a sizeable move up or down from that point. I argued to myself that even in 1929-1932 the market as measured by the Dow, while ultimately collapsing almost 90%, experienced six 20-50% rallies. I countered that we hadn't yet completed a full Elliott Wave (www.elliotwave.com) structure to the downside and, in order to get to levels of valuation last seen in 1982 (not 1932, but 1982), the Dow would have to be marked down to 4500.

So I asked myself the above questions. To question 1, if I lost 20% (50% of 40% invested), I figured I wouldn't panic and sell everything. In response to question 2, I told myself the price of a $100 pair of sneakers (selling for $200 in the market's heyday) was back to reality and if they went on sale for $25-50, sure, I'd use that 60% cash hoard to buy more. Pondering question 3, I'd be thrilled to make 10-15% overall at 40% invested, so I didn't think I would chase stocks. Question 4 was easy: I'd been uninvested at Dow 14,000 and 12,000 and even 10,000, so sure I'd be selling on the way up and be out somewhere around Dow 10,000-10,500.

Reality bites

Of course, we never know what we'll do when reality sets in, but those were the actions I thought I'd take depending on where the market went. I concluded that the roughly 40% position in stocks and stock equivalents was *right for me at that time* and at that price-point. When the Dow dropped to the 7000 area in March and a sustainable rally appeared likely, I increased my exposure to about 65-70%. That said, longer-term I'm extremely bearish and still intend to begin selling incrementally at levels not too far above current ones. However, I always keep in mind that if I do not remain humble, the market will humble me. I hope to have the fortitude to suck it up and admit to being wrong—and appropriately sell, but not necessarily at half the price—if the market begins to tumble from current levels. Sometimes taking losses is better than the alternative.

In a series of articles in 2005 I wrote that the real estate mania would likely go down as the greatest bubble in the history of mankind. I added, "Bubbles end badly." This is what I meant. If I'd written that the events of the last year might occur, everyone would have figured I'd gone off the deep end. Forgive me for stepping on a few toes, but unfortunately the cronies in Washington, D.C. are doing everything they can to replicate the errors of the Great Depression. So, while the ferocious rally could continue I think we face far worse, particularly if the government continues on its current economically destructive path.

So, if you're thinking, "Even if the Dow moves to 9500, I'll still be down overall by 40% (or some such number); I can't sell!" think again. The past is a "sunk" cost and is irrelevant to future decision-making. The only relevant question on which to base decisions is what will the market do tomorrow? Since we can never be sure, hedge. We can be 10% (or zero) invested when prices are dear and 90% invested when they can't give the stuff away. Forget about breaking even. As suggested in "The Wealth of Individuals: Part 3," there are times to focus on preservation of capital. I believe now is one of those times.

The Paradox of Mutual Funds: You Bought for $10,000 and Sold for $23,000. You've got a $7,000 Loss. Huh?

Many investors feel stuck in their taxable (non-retirement) stock mutual funds due to a belief they have large taxable gains. "How can I sell? I paid only $10,000 almost 15 years ago and, even after the catastophic decline in values, it's still worth $23,000. I don't want to pay the tax on a $13,000 gain!"

For now, we'll ignore the fact that Mr. Market could easily take far more than Mr. Taxman, which may be considerably less than you think under current law. We'll focus instead on whether or not there's even a taxable gain. The paradox is while there are gains there may be deductible losses!

The incongruity makes sense once we understand that stock mutual funds contain stocks that pay dividends and those stocks are bought and sold by the fund managers while you own the fund over extended periods. When stocks "inside" the mutual fund earn dividends or are sold at net gains, tax law requires that the profits be distributed to the fund shareholders, who must report their share of income

on their individual tax returns.

We can dispense with those rare stock mutual fund shareholders who take their dividends and gains in cash. Almost all such shareholders "reinvest" these in more shares, which increase your cost ("cost basis") for income tax purposes.

Think about it this way: you buy $10,000 of mutual fund X mid-year. Later that year it pays out dividends and capital gain distributions (when there were such gains) of $1,000. You pay the tax on the $1,000 even though you haven't yet sold the fund. Your cost basis in the fund is now $11,000, even though your position may still be worth $10,000 (or for that matter, less).

Before I lose those of you to whom this doesn't apply, I want to emphasize one point that's relevant even to the relatively uninitiated: when purchasing a fund late in the year, but before dividends and capital gains earned by the fund during the year are paid to shareholders, you may be hit with tax on gains realized by the fund long before you owned it. Say you place that $10,000 order on November 30 and the fund distributes gains on December 1. You will be socked with the tax on gains you weren't even a part of. The good news is you make it up when you later sell the fund, which you could even do immediately (although in most cases, that would be silly). Another way around this problem is to wait until the distribution occurs before buying the fund (the distribution date is announced by the fund many weeks in advance).

Through the looking-glass

When dividends and capital gain distributions are reinvested for years, things get interesting—and even surprising. To show just how surprising, we'll take a real example from 2008.

Our client took large gains in other stocks that she'd owned for decades and would have loved to have moved entirely to cash. The only stock she had left to sell was a mutual fund she'd purchased in 1991 for $10,000 which, even after the collapse of '08, was still worth $50,000 (its peak value was $80,000). Not wanting to add further to her tax burden, she decided to keep this one last position.

I suggested we take a look at it anyway and asked for the year-end statements covering the 18 years she'd owned it. She asked, "Why do you need those? I paid $10,000 for it. That should tell you I've got a $40,000 profit." I agreed the profit was $40,000, but the taxable gain might be a fraction of that—and there might even be a deductible loss. She slowly grasped the idea that she'd been paying taxes on the distributed gains over the years. But wasn't that reflected on the current statements?

This is where a bookkeeping nightmare can become a reality. Mutual funds may report cost basis on current statements, but only if you've owned the fund since they began tracking such basis (usually from the mid '90s). If you held the fund inside a brokerage account, your broker may have been tracking the basis (again, generally only from the mid '90s). However, if you switched brokerage accounts along the way you're out of luck, since the new broker doesn't have a clue about transactions in a prior account.

Allow a brief digression. A different client moved an account containing several mutual funds she'd held for at least a decade. Several weeks later she sold those funds—almost $200,000 worth. At first she thought it didn't matter, since she purchased other shares. Sorry, but there are no tax-deferred exchanges with stocks as there are in real estate. She assumed the cost basis was in the statements because it was always there before. Yes, because she hadn't changed brokers from the time she first purchased the funds—until now. Oops! Worse, she had bought and sold shares of those funds along the way—which, as you will see, *greatly* complicates matters. The new broker didn't have the records from the old broker and the old broker wasn't about to cooperate without a sizeable payment for its trouble. So please, don't buy stocks and mutual funds without understanding at least something about them and do not transfer them from one broker to another without first getting a complete history of your cost basis in every stock and mutual fund held.

Back to our client with the $50,000 mutual fund that she'd purchased for $10,000. She held it outside a brokerage account from 1991 through 2000. Holding funds this way can make tallying the gradually increasing cost basis (from those reinvested dividends and capital gain distributions) relatively easy. There are four potential sources providing the dollar amount of reinvestments: 1. the 1099; 2. the year-end mutual fund statement; 3. the interest and dividend income form (Schedule B) of the tax return, which reflects reinvestments under the name of the fund; and 4. my computer, if I've prepare the return all of those years. This can become more difficult if the fund has changed names, if Schedule B wasn't filed every year (it's only required when total interest and dividends exceed a certain amount, currently $1,500), or if there is more than one fund (capital gain distributions from several funds become one number on the tax return, individually indistinguishable). Fortunately, I had the records on my computer for all of those years except one, which we were able to reconstruct from other sources.

Unfortunately, things got more complicated beginning in 2001, when she put the mutual fund certificates into her brokerage account. Because the dividends become a single number on the 1099 and, consequently, tax return (in other words, the dividends from the fund were combined with dividends from a dozen other stocks), the only source for the required detail was the year-end statement, which breaks down dividends and capital gain distributions by stock and fund. Fortunately, she was able to piece together all of the year-end brokerage statements, where I found the full-year reinvestments.

The Reconstructed Cost of a Mutual Fund Worth $50,000

	Dividends*	Long-Term Capital Gain Distributions	**Total Cost Basis**
Original investment			$10,000
1991	$100	$500	$10,600
1992	$50	$450	$11,100
1993	$100	$900	$12,100
1994-2000	$6,900	$19,000	$38,000
2001	$1,000	$2,000	$41,000
2002	$200	$800	$42,000
2003-2007	$4,500	$24,000	**$70,500**

* Tax law requires that "dividends" include not only ordinary dividends, but also interest income and gains the fund has earned from sales of stock held less than one year, making the term a misnomer. This accounts for some sizeable "dividends."

Whoa! Am I telling you she paid $10,000 for something that's worth $50,000 and she has an unrecognized (meaning: she hasn't yet sold it) loss of $20,500? Yup!

The bad news is she paid tax on the $60,500 in dividends and capital gain distributions over the years, which is more than the current value. The good news is she already paid the tax on that income and her "cost basis" increased to $70,500. She can sell the fund and, to the extent of capital gains plus $3,000, deduct a $20,500 "loss." And any loss she can't use this year gets carried forward, where it can offset capital gains plus $3,000 each year until all of the loss has been deducted.

It's not quite complexity theory, but…

These complications apply as well to stocks in which you participate in a "dividend reinvestment plan," where dividends are reinvested in additional shares. Because there are no capital gain distributions, the cost basis rarely increases by anything close to that of stock mutual funds. However, the bookkeeping is cumbersome and such plans are best suited for retirement accounts, where we don't have to be concerned with the sometimes complicated process of determining the cost of particular stocks or funds.

Now let's briefly mention a computational challenge alluded to above. If shares were sold during the period of ownership, or only a partial sale was made, we need the number of shares bought or sold in each transaction. Again, this isn't an issue for those who've held the shares at the same brokerage during the entire period of ownership, since the broker can provide the cost basis. Since every chunk of shares purchased has its own cost basis, those who've moved a mutual fund from one broker to another face a laborious calculation. Sellers of funds also have a decision to make regarding the method of determining the cost basis: using the "FIFO" or first-in first-out method (the first shares purchased are the first ones sold) or one of two "average cost methods," which you don't want to read about in a family publication. Whichever method you choose at the time of the first sale must be used for all subsequent sales of that mutual fund.

Take a look at the chart above. If our investor sold just $15,000 of her $50,000 and she elects to use the FIFO method, we have no idea what the cost of that $15,000 is unless we have a history of mutual fund purchases and sales *including* the number of shares bought or sold. If she uses one of the average cost methods, we can easily calculate the cost of the first sale, but after that—as soon as there are more investments regardless of method, including reinvestments—it gets *far* more complicated.

It may not seem like it would be worth the time and fees to determine the cost basis of a mutual fund that's been owned for a decade or longer. However, if you've got a fund worth $23,000 that cost only $10,000 initially, you may be surprised to learn that the cost basis, including all reinvestments, might be $30,000. That $7,000 loss can save a typical Californian $1,500 to $2,380—and get you out of the way of Mr. Market, in case he again turns his wrath on investors.

Inherited Stocks and Real Estate Can be Mined for Tax Losses

When stocks and other investments such as real estate are inherited, the "cost" for tax purposes, known as basis, is the value on the date of death. It's as if you purchased the asset with a check written for the full value on that date. Except for spouses who owned the investment jointly (in which case the cost is half the original amount paid plus half the value on date of death), the old purchase papers can be trashed by the heirs. The price paid by the decedent is irrelevant.

This change in basis is often called a "stepped-up basis." It can also be "stepped-down." If the original cost was greater than the value as of date of death the cost to the heirs is the lower figure.

If a mutual fund is inherited, as in the article above, cost basis includes reinvested dividends and capital gain distributions paid after date of death. Let's look at an example.

A spouse died in July 2007, when the stock market peaked. The couple owned two stocks as community property via a living trust, which allows a 100% stepped-up basis. (Remember, if the couple owned the assets as joint tenants, the step-up applies only to the decedent's half.)

There were 1000 shares of Microsoft, worth $30,000 and a chunk of Vanguard Magellan fund, worth $50,000. Magellan paid distributions totaling $4,000 in December 2007 and $2,000 in December 2008, which were reinvested in additional shares. Today, the Microsoft shares (from which dividends were taken in cash) are worth $20,000 and the Magellan position is worth $30,000. Unrecognized capital losses total $36,000.

Big Losses in Inherited Stock

Stock or Fund	Value on Date of Death	Additional Investments	Total Cost Basis	Current Value	Potential (Loss)
Microsoft	$30,000	$0	$30,000	$20,000	($10,000)
Magellan	$50,000	$6,000	$56,000	$30,000	($26,000)

Anyone who inherited stocks, stock mutual funds or real estate in the last few years, especially if the decedent died before October, 2008, may have sizeable losses. These losses can be deducted only when recognized, which requires that the asset be sold. Now is the time to begin thinking about taking those losses, especially by those concerned that the rally may not have staying power.

A Contribution History is Essential When Taking Early Withdrawals From or Losses on Roth IRAs

Roth IRAs are tax-free if you follow the rules. However, those under the age of 59 ½ taking withdrawals must pay tax and penalty on *profits*. Those over age 59 ½ taking withdrawals must pay tax on *profits* if the first contribution to a Roth was made within the last five years (warning: determining the "last five years" is tricky). To calculate the taxable gain, *we need to know how much you contributed and, if over 59 ½, when.*

A loss on a Roth IRA can be deducted if all funds in all of one's Roth's are withdrawn (i.e., there can be *nothing* left). To determine if there's a deductible loss, *we need to know how much you contributed.*

An opportunity, even if not quite golden

The bad news is many investors have losses in their Roth IRAs. The good news is they can take treat this as an opportunity. However, due to limits on deducting such losses and having to start over in accumulating what could be a tax-free goldmine, planning for such a loss must be done with care. Roth losses are considered miscellaneous itemized deductions subject to the 2% rule. Therefore, before they yield a dime in tax savings, the total of these deductions plus others such as employee business and investment-related expenses must exceed 2% of Adjusted Gross Income (AGI). Further, total allowable itemized deductions must exceed the standard deduction before any of them do you any good. In addition, deductions subject to the 2% rule, including losses on Roth IRAs, don't save any tax once the Alternative Minimum Tax (AMT) is triggered. Recognizing losses is a strategy that could make sense in one year but not in another, depending on all of the above factors.

Depleting a large Roth of its funds may not be the wisest long-term investment decision, since the larger the investment the greater potential there is for substantial tax-free gains. On the other hand, if the Roth is relatively small in value and you currently qualify for new contributions, you may be able to quickly rebuild it after saving a sizeable chunk in taxes. If you've got, say, $10,000 in a Roth IRA for which $15,000 in investments were made over the years, your $5,000 loss could save as much as $1,800 in tax. If eligible, you can quickly reinvest the $10,000 in $5,000 increments ($6,000 if age 50 or over).

Those taking early withdrawals must create a contribution history (call it a "basis schedule"), as do those intending to take a loss on a Roth. Here's an example of a Roth owner who could benefit from going back through years of old records:

Taking a Loss on a Roth IRA Can Make Sense

Year	Roth Contribution	Total Basis	Value at End of Following Year*	Gain or (Loss)
1998	$2,000	$2,000	$2,040	$40
2001	$2,000	$4,000	$3,160	($840)
2003	$3,000	$7,000	$6,200	($800)
2004	$3,500	$10,500	$14,700	$4,200
2005	$4,000	$14,500	$22,900	$8,400
2006	$4,000	$18,500	$28,250	$9,750
2007	$4,000	$22,500	$14,500	($8,000)
2008	$5,000	$27,500	$18,500	($9,000)

* This assumes the investment was made for the preceding year, which is the norm for most investors. For example, the value in the 2007 row is that of December 31, 2008 and the value in the 2008 row is the mid-2009 value. This column and the Gain (Loss) column are informational only. For planning, we need the contribution made each year, along with current value.

The downside is, if the Roth is terminated, the investor must start over. However, at $5,000 or $6,000 per year the $18,500 withdrawn can be quickly redeployed. $10,000 to $12,000 can be reinvested almost immediately if the spouse also qualifies. This can be a terrific strategy for someone who does not otherwise have the funds to contribute to a Roth IRA.

Here's another example where this strategy makes sense.

Taking a Loss in a Roth and Reinvesting in a Roth

His Roth	Roth Contribution	Total Basis	Current Value	Possible Deductible (Loss)
2005	$3,000	$3,000		
2006	$4,000	$7,000	$1,500	($5,500)
Her Roth				
2005	$4,000	$4,000	$1,000	($3,000)

The couple itemizes and their miscellaneous itemized deductions not counting the loss on the Roth IRAs exceed 2% of AGI. They are in the 34% federal/state tax bracket and not subject to the AMT. I advised that they take their $8,500 loss by withdrawing everything from both Roth IRAs. *Since the IRS could consider new contributions within 60 days a Roth rollover, I suggested they wait 61 days to contribute to 2009's Roth IRAs.* They started over and recovered some of their losses in the form of tax savings by doing so. Oh, and I suggested they place their funds in more conservative investments so they don't have this "opportunity" again.

FoRGeD, or Some Pigs are More Equal than Others

Mnemonic devices can be a very helpful way to memorize important information. I needed to memorize the names of several recent tax scofflaws and came up with FoRGeD as way to remember the names Frank, Rangel, Geithner and Daschle.

Three of these four public servants are among the top government employees to have recently admitted to large "errors" on their tax returns, but only after they were found out. Mr. Frank is included partly because I needed him for the mnemonic and partly because he's one of the biggest spenders of your money and mine (and was probably the loudest defender of Fannie Mae before she fell from grace). Rangel failed to report $75,000 in rental income on a villa he owns in the Dominican Republic over a five-year period. Geithner forgot to pay Self-Employment tax of over $43,000 on income earned from the International Monetary Fund in 2001 through 2004. Incredibly, the IMF not only sent him repeated notices reminding him of his tax obligation, but even gave him the money with which to pay the tax. Although he paid over $17,000 of the tax pursuant to an audit for 2003 and 2004, he didn't pay it on the earlier years until he was nominated for Treasury Secretary—a position from which, ironically, he oversees the IRS. Daschle, who was nominated for Secretary of the Department of Health and Human Services, failed to pay more than $100,000 in taxes on the use of a car and driver which was supplied in 2005 through 2007 as part of a consulting job. He also failed to include over $83,000 in consulting income earned in 2007 and "inadvertently" overstated his charitable contributions by almost $15,000 over the three-year period ending in 2007.

As many observers have pointed out, the rest of us would have been hit not only with penalties on such gross understatements of tax, but might also have been investigated for fraud.

This light treatment of what many are calling out and out fraud may set back IRS enforcement by a generation. Already IRS agents are reporting that taxpayers are using these very public figures, all of whom should have known better, as excuses for abating penalties for understating their taxes.

I will ask for the FoRGeD exception the next time a client is hit with a penalty. Of course, since my name isn't Frank, Rangel, Geithner or Daschle, it may not go over very well.

Coming Attractions

- **New tax law—Should you take advantage of credits for first-time homebuyers, energy saving devices and more?**
- **Should I refinance?**
- **Finally! Non-deductibility of mortgage interest explained**
- **A review of books and websites on the Great Depression and Greater Recession**