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"The multitudes remain plunged in ignorance of the simplest economic facts, and their leaders, seeking their votes, [do] not dare to undeceive them."

—Winston Churchill

Tax and Financial Strategies

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Wealth Creation Strategies

The "Meathead" Tax: Universal Pre-School At What Price?

In his younger days, actor-director Rob Reiner played Archie Bunker's politically-minded son-in-law "Meathead" on "All in the Family." Reiner has since become politically active in real life, generally promoting the idea that increasing the size and scope of government solves problems. He recently helped lead a crusade to get the state government to buy the Ahmanson Ranch west of the San Fernando Valley, further squeezing the supply of new housing and exacerbating the housing affordability crisis in the Los Angeles area. His latest brainchild is an Initiative on the June 6, 2006 ballot, Proposition 82. It would subject single taxpayers earning over $400,000 and married couples earning over $800,000 to a 1.7% additional tax, to be used for universal pre-school for four-year-olds. The initiative will miss hitting me and all but a few clients by wide margins. The trouble is, like most other government programs, the Law of Unintended Consequences—in this case, the Laffer Curve—insures we will all be indirectly affected.

The Curve is named after economist Arthur Laffer, who reportedly drew the concept on a cocktail napkin in the late '70s. The idea, which shows to a point that as tax rates fall government revenues increase, helped instigate President Reagan's lower-tax revolution. (Few recall, but the pre-Reagan era included tax rates as high as 70%.) A classic instance of the Curve at work is the Bush-led 2002 reduction in tax rates. Most observers figured the wealthy would reap a windfall when maximum taxes on dividends and capital gains were reduced from rates as high as 35% and 20% respectively to 15% (5% for those in the lowest brackets). Instead, collections from these taxes increased in the following two years by 35% and 80% respectively. Why? Because behavior changes as tax rates change. Corporations saw that investors would be willing to take more income in the form of dividends at these lower rates and proceeded to raise pay-outs. High-income and low-income earners alike were less reticent to realize large profits by selling securities and real estate on which there were substantial gains. Reducing tax rates turned out to be an economically sound way to fleece everyone, particularly the wealthy.

Contrary to expectations, the reverse will likely hold true. If tax rates are again increased on dividends and capital gains, collections from those sources will probably shrink. Now compare the power of the Internal Revenue Service, from whose clutches few U.S. citizens escape, with that of individual state taxing authorities. U.S. residents rarely move out of the country and give up U.S. citizenship in order to reduce their U.S. tax (a complicated process requiring, among other things, ten years of non-residency). However, they often move from one state to another. Aside from family and job considerations, they may do so because their state's taxes or regulations become overbearing. We're already seeing a net outflow from California due to its poor regulatory climate, high housing prices and high taxes. The cost of renting a U-Haul trailer to move from Los Angeles to Las Vegas is about five times the cost of renting the same trailer for a move in the opposite direction, indicating a substantial out-migration by those with material assets. (We found similar ratios for Boise and Atlanta.) The outflow—and, conversely, lack of inflow—may become pronounced, particularly among the wealthiest.

Additionally, the wealthiest Californians already pay a lopsided proportion of the income tax. This could get worse, except for one problem: they might leave. Los Angeles radio station KFI 640-am talk show host John Ziegler (7-10pm week nights) inspired me to ask a simple question: for the state to just break even on this new tax, how many high-income earners will have to submit to increased plunder for every one who decides he or she won't take it anymore? The answer is disturbing. When a high-income taxpayer leaves California, the state doesn't lose just the 1.7% additional tax; it also loses the entire 9.3% regular tax plus 1% mental health tax surcharge voted into existence in the last election. Since the additional tax on each million-dollar earner will amount to $10,200, increasing his or her total tax to approximately $100,000, for every millionaire who leaves almost ten must remain. The additional tax collected on a person earning $10 million will amount to $163,000. If that super-rich taxpayer decides to bail out, the state loses the entire $1.18 million he pays. The ratio of such taxpayers willing to stay vs. those deciding to leave must exceed 7.2 just to break even. Why *should* they stay—and why should they even come to California? Are the benefits worth anywhere near the tax paid? What would you do if you earned $10 million or even $1 million yearly?

Another way of looking at the choices available to anyone paying income tax is a variation on a classic story. Ten old friends decided to dine each month and spent $1,000 at their inaugural feast. Afterwards, they voted to divvy up the bill in accordance with their earnings. The bill totaled $40 for the five lowest income earners combined. The sixth lowest paid $20. The fourth from the top paid $50, the third highest income earner $90 and the second $130. The highest income earner among friends paid $670. The other diners were shocked when the top earner didn't appear for the following month's dinner. The third month, only the lowest six income earners showed up. They decided fast-food was all they could afford.

Each diner's bill mirrors that given to U.S. taxpayers by the federal government. The lowest 60% of income earners pay 6% of all taxes. The top 20% pay 80%. Californians have an even more top-heavy system. The upper 20% of income earners pay almost 86% of the state's income tax and the top 1% pay nearly 39%. The lowest 60% pay less than 4%. The state's nominally maximum marginal tax rate of 10.3% is already the 2nd highest in the country. Now we're asked to subject the most productive Californians to a tax increase of 16.5% (1.7% on top of the 10.3% highest rate; 1.7%/10.3% = 16.5%). I have a hunch they won't put up with it.

Amount of California income tax paid by various income earners by quintile in 2003:

Income earners	Lowest 20%	2nd quintile	3rd quintile	4th quintile	Top 20%	Top 10%	Top 5%	Top 1%
$ of tax paid per $100	10 cents	60 cents	$3	$10.50	$85.80	$73.20	$61.00	$38.80

While rational changes in behavior that high-income earners can make to avoid being taken to the cleaners are limited, there are some that can make a lot of sense. Here are a few of the more obvious ones:

1. Make John Galt proud: declare your independence and leave the state. Moving can be good tax planning.
2. Invest in double-tax-free municipal bonds and growth stocks that pay no dividends.
3. Exchange overvalued into undervalued real estate in a no- or low-income tax state. Then move there.
4. Work less hard.
5. Delay selling stocks with large gains until you leave the state.
6. Take compensation in the form of stock options. Leave the state before exercising the options and selling the stock.
7. Plow as much as possible into retirement plans and withdraw from those plans only after a move to a lower-tax environment.
8. If you're planning to retire, incorporate your business, including the assets (but not real estate). Leave the state. Then sell the stock of your business. Explanation: The state cannot tax the profit on the sale of an intangible such as stock. If real property is involved, exchange it for property outside the state.

There's another aspect to this foolhardy Initiative that deserves scrutiny. **Does pre-school really increase the odds of beneficial future outcomes?** —or are the statistics bandied about faulty? Here are some truths behind the "First 5 for California Ads" that ran last year at taxpayers' expense, proclaiming that every $1 spent on pre-school generates up to $4 in societal benefits:

1. Since 66% of California four-year-olds are already attending pre-school at their own expense, *if* the Initiative reaches its goal of 70% enrollment, just 22,000 new four-year-olds will enroll. Because the new tax aims to raise $2.4 billion, th**e additional cost per preschooler will be $109,000.**
2. The alluring ads cited a Rand study of a Chicago program that served the 1500 most disadvantaged kids in Chicago. The program served three- to nine-year-olds far beyond the 3 hours per day that the Initiative will fund for one year of a child's life. It included private tutoring up to the 3rd grade and six years of a child-parent program designed to increase parental involvement. The ads suggested the results could be extrapolated to a half million California four-year-olds. As the *Los Angeles Times* put it, "The Chicago experiment…says little about what a half-day of preschool would accomplish for California kids."
3. Only 20% of California children are considered "high-risk," while 20% are at medium risk and 55% have little or no risk of serious problems later in life. A study of kids at low-risk reported zero benefit from pre-school enrollment. Vouchers for the high-risk kids would run a fraction of the proposed cost.
4. The Initiative requires that

*There are many states that have no state income tax or a far lower one. Here's the **additional tax for the privilege of living in California** vs. a selection of popular destination states at various income levels assuming Prop. 82 passes:

Taxable Income	$100,000	$500,000	$1 million	$10 million
NV, FL, WA, TN, TX, WY, AL, NH	**$6,700 additional tax**	**$44,000 additional tax**	**$100,000 additional tax**	**$1,180,000 additional tax**
CO	**$2,200 additional tax**	**$21,100 additional tax**	**$54,000 additional tax**	**$717,000 additional tax**
AZ	**$2,900 additional tax**	**$20,000 additional tax**	**$51,000 additional tax**	**$677,000 additional tax**
GA	**$3,400 additional tax**	**$16,800 additional tax**	**$42,800 additional tax**	**$583,000 additional tax**

teachers have a Bachelor of Arts degree and a teaching credential. Do preschool teachers really require as much education as high school math teachers? At least one study shows zero difference in long-term outcomes among preschoolers taught by teachers having BAs vs. those without.

5. 80% of the existing pre-school work force has neither a BA nor teaching credential. A small army of new teachers will need these. In typical government one-size-fits-all thinking, the Initiative requires that pre-school teachers be paid the same salary as other public school teachers. Do we really need to pay teachers of four-year-olds as much as those teaching16-year-olds?

6. The two states that implemented universal preschool in the 1990s, Georgia and Oklahoma, score below the national average in fourth-grade reading and in the bottom 10 states in improving fourth-grade reading scores from 1992 to 2005.

7. Because it's a Constitutional Initiative, regardless of how poorly the program works (and, with the Law of Unintended Consequences, it could be one of the great failures in modern government), it will be very difficult to change or eliminate. One would be hard-pressed to find many failed government programs abolished even among those non-constitutionally mandated.

8. To paraphrase a *Wall Street Journal* piece written by Martin Feldstein, it's ironic that cell phone service is widely available at low cost because it was originally regarded as a luxury and, therefore, left to the market, while quality education is hard to obtain because it is regarded as a necessity and, therefore, managed by government. K-12 has already failed. Why subject four-year-olds to such failure? An oft-aired ad touting the virtues of credit unions informs us that they provide much-needed competition for banks. Now apply the same idea to private schools which, weak competitors though they may be, provide such competition for government ones. Greater competition forces every provider to perform better than they otherwise would. Vouchers, which would inject a far greater dose of competition into the system, would go further in improving long-term outcomes for children than any other policy initiative.

9. If for no other reason, the Initiative deserves to be pummeled because taxpayer dollars were spent to lobby for more taxpayer dollars. Until recently, Rob Reiner served on the board of the First 5 California Children and Families Commission, which oversees tobacco trust fund expenditures. The commission paid $230 million for advertising and public relations to firms that helped Reiner create the First 5 Commission and $206,000 to political consultants who won the work without having to bid for it and who now work for the Proposition 82 campaign. Even if such activities do not violate the law, they violate the spirit of what a free country is all about. Taxpayer dollars should never be spent on propaganda to promote increased taxes or in any way sway election results.

We need to send Reiner and the politicians supporting this wrong-headed Initiative a message. Failing to do so could ruin the financial health of the state. And if we really want to turn California around, take a message from Laffer: ask your representatives to reduce maximum ordinary tax rates to 7% and those on long-term capital gains to half that. My bet is the bulge in revenues will astound everyone except those few of us who understand that the Laffer Curve is more than just a drawing on a napkin.

"I Can't Contribute to My Roth IRA Because…"

Early this tax season, I realized that many clients for whom investing in Roth IRAs made great sense had failed to take advantage of the opportunity. I'd ask, "So, you're going to sock away $4,000 ($4,500 for those 50 and over) into your Roth IRA again, right?" and hear a meek *"I haven't been doing Roth's."* "Why not?" *"Because I thought I might need the money."* I'd ask, "So? Withdraw it." The response was invariably, *"But then I'd get hit with tax and penalties!"* When I explained that tax and penalties applied only to earnings and that contributions can be withdrawn at any time tax- and penalty-free, I'd hear an *"Oh. I didn't know that."* I realized that some of the key concepts behind Roth IRAs, which allow tax-free growth of already-taxed savings, have not sunk in.

A simple way of looking at Roth IRAs

If I had a million dollars earning $50,000 per year and was allowed to transfer the entire million into a Roth, I'd do it in a heartbeat. *"But what if you need the money?"* Fine, I'd take out what I need. *"But what about tax and penalties on the withdrawal?"* There is no tax or penalty on a withdrawal of my after-tax contributions. I can withdraw up to the $1 million tax-free; it's the $50,000 in yearly *earnings* that I have to let ride until I'm 59 ½ if I'm to take those out tax-free. Now, shrink the numbers: I can withdraw my $4,000 in yearly contributions at any time.

By investing in Roth's, you're converting funds that earn taxable interest, dividends and capital gains into funds that earn permanently tax-free income. This is a no-brainer for almost everyone who is eligible.

There were all sorts of reasons offered by clients for failing to invest in Roth IRAs. Here are some I heard this tax season, along with my response.

I can't invest in a Roth IRA because…

"I might need the money and don't want to get hit with tax and penalties!"
Then take it out. Since you've already been taxed on the funds invested, you can withdraw your contributions at any time without tax or penalty. You need to let the *earnings* ride until you are 59 ½ (or for five years if your first contributions weren't made until after age 55 ½) or permanently disabled. If you are in desperate need of funds before age 59 ½, deplete savings first, then Roth contributions, then Roth earnings and other retirement accounts. On the other hand, a truly desperate need for funds suggests a dramatic drop in income—in which case a taxable withdrawal from a pre-tax account may be appropriate.

"What if I need the money in an emergency?"
Same response. If your $4,000 has grown to just $4,100 or some other small incremental gain, I'd probably take out the whole thing and pay the tax/penalty on the $100. With small gains, it may not be worth the yearly fees to let the earnings ride. At least you gave yourself the opportunity and, who knows, you might figure out another way to pay for the emergency.

"I'm saving for my children's college education."
Great—invest in the Roth. Let's say the kids are ages 7 and 4, you're married and you are able to put away $8,000 a year for your childrens' future. If you invest in an Educational Savings Account (ESA), you're limited to $2,000 per year per child. If the children do not go to college or you don't spend all the money in the ESA on education, the earnings must be withdrawn by the time the youngest child is 30 and tax must be paid on those earnings. If instead you invest in Roth IRAs, by the time the oldest child is in college you'll have ($4,000 times two of you times 11 years =) $88,000 of your funds invested, not counting earnings. The principal alone will buy a quality education at most colleges and universities. You need to follow the rules only for tax-free treatment of the *earnings*, which would total $31,000 figuring growth at 5% per annum.

"We're saving for a home."
Great! A Roth is a terrific holding tank for such a goal. You'll need a down payment of, say, $40,000 or more (after the crash—ha-ha). You each sock away $4,000 a year for five years, waiting for house prices to slide. You'll each have $20,000, plus (at 5% per annum growth rates) an additional $6,400 in earnings. When you find your starter dream home, withdraw what you need and let the rest ride, along with the earnings. Mission accomplished—and you've still got something left for later.

"I don't have the money to invest."
You have $20,000 in a savings account. Transfer the money to a Roth in allowable increments. The $800 in interest you earn on those funds on which you pay $200 tax each year will gradually become non-taxable. The yearly tax saved may not seem like much, but over decades will add to sizeable sums.

"We're already contributing the maximum allowed amounts to 401k's. That's enough for our retirement accounts."
It may be. But if you have $100,000 in savings accounts (or even $20,000), why not take advantage of the opportunity to shift the assets from taxable accounts into non-taxable ones while you are allowed?

"I use money from my savings to live on to supplement my salary."
The response to this objection depends upon the amount in savings and the negative draw from it. I understand the futility if your earnings are $30,000 and you have only $20,000 in savings from

which you are withdrawing $1,000 per month just to live. However, if you've got $50,000 in savings, I'd invest in the Roth, hoping that my earnings will increase or living expenses decrease before I spend it all.

"I have too small an amount to bother with and the yearly fees are too high relative to the amount I can invest. I'll start next year."
If you plan on making future contributions, start now. First, it's a good idea to create the habit; the sooner, the better. Second, if older than 55 ½, you can get the five-year holding requirement running now. The earnings can then be withdrawn in your early 60s if needed. Once the first investment is five years old, all the investments—even those invested less than five years ago—can be withdrawn after age 59 ½.

"Interest rates are too low to invest in a Roth."
They were for several years, but now they're not. That's the point: you never know when rates will creep back up. If you'd been investing the allowable amounts in Roth IRAs for the last four years, $13,000 would be sitting there growing tax-free rather than in your taxable account growing more slowly due to taxes. While it was hardly worth the trouble at 1%, the 5% return you're earning now makes those prior year contributions very worthwhile.

"I'm losing money in the Roth I've already done! I don't want to invest more only to lose more!"
You made the wrong investment. Choose a better one that doesn't lose money. Would you have had a different result if identical funds had been invested in the same place outside the Roth? No.

"At least the losses outside the Roth are deductible!"
Although admittedly more difficult, you might be able to deduct a loss inside a Roth as well. But you aren't hoping for losses. Try to avoid them whether funds are invested inside or outside a Roth.

"I don't earn enough. Maybe next year."
If you don't have available funds, I understand. If you do, you're missing an opportunity that may not be available in future years. Once adjusted gross income exceeds $95,000 ($150,000 for married couples), the allowable contribution is phased out, reaching zero at incomes of $110,000 ($160,000 for married couples). These phase-out thresholds have not been indexed for inflation since the advent of Roth's in 1998, while wages have crept upwards. I have dozens of clients who were allowed to invest in Roth's for years, but didn't. While now more than willing to invest, they can't because their incomes have risen above the thresholds. The message is, take advantage of the opportunity while you can. To make it affordable, you might start with small monthly contributions. You probably won't miss $50 or $100 a month, which over a number of years will add up.

"I'm too old. I'll never get the advantage of the tax-free growth."
Sure you will. You're shifting the funds from taxable accounts—remember, you pay tax on all the earnings every year—into permanently tax-free accounts. You'll never get the advantage of the build-up if you never spend the money, but your heirs will. They will be allowed to take withdrawals over their lifetimes, creating an intergenerational transfer of tax-free wealth. Bear in mind, you can make the investment only because you're still working (or your younger spouse is still working). Once the income from work dries up, you will no longer be allowed to invest in Roth's. You have nothing to lose by taking advantage of it while you can.

"I'm too old and will get no advantage of the tax-free build-up because I pay no tax and don't expect to ever pay again."
Indeed, a few clients are still working but pay little or no income tax because total income is less than the combined standard deduction and personal exemption amounts (over $18,000 for couples over age 65). However, you've got savings, you're not big spenders and the funds will almost assuredly be left to the children. Why not leave as much of those funds as possible in Roth IRAs? The kids, who are in high tax brackets, will take withdrawals over their lifetimes. They'll never pay tax on income building up inside the Roth's, which may amount to thousands of dollars in future tax savings.

Is it deductible? Yes. How much tax will it save? Zero.

A deductible expense may save no tax for a number of reasons. Those already paying zero generally get no benefit from additional deductions ("generally," because low-income earners with children are an exception). There is (again, generally) no savings from itemizing until allowable deductions equal the standard deduction. Plus there's an increasingly common instance in which middle- to upper-middle-income taxpayers reap no federal income tax benefit from certain deductions regardless of size. We can blame this seeming paradox on the Alternative Minimum Tax (AMT).

Income tax must be calculated two ways under what are essentially side-by-side systems. The first allows the usual deductions we've all come to know and love, yielding the "regular" tax. The second, the AMT, adds many of these deductions back into income. After subtracting an AMT standard deduction and applying an AMT tax rate (very different from the regular one), we get the Alternative Minimum Tax. The final tax is not a voluntary one and is the higher of the two.

Think about it: if the higher tax is the AMT, some of the deductions used to arrive at the regular tax must not have done a dime's worth of good. If the AMT is $20,000 and the regular tax $18,000, the deductions that shaved the last $2,000 off the bill in reality, didn't. It turns out, the last $7,500 in deductions *would* have saved $2,000, but didn't *because of the AMT*.

This can be relevant when determining whether to purchase a new home. If you're already hit with AMT, even though property taxes are "deductible," the federal tax savings from a property tax increase will be zero. This is because such taxes are added back into income when calculating the AMT.

Other common deductions that help create the paradox include state and local income taxes, DMV fees, State Disability Insurance (SDI), employee business expenses, investment expenses, medical expenses up to 10% of Adjusted Gross Income and personal exemptions including you and any dependents. The range of income most likely to trigger AMT is $150,000 to $600,000. Regular tax rate inflation indexing doesn't help those subjected to the AMT, because the AMT rate, standard deduction and phase-out of the standard deduction have not kept pace with inflation. In order to avoid public outcry, Congress has increased the standard deduction a bit over the last few years but has not seen fit to increase the standard deduction phase-out range.

If you are subjected to this phantom tax, it would be my pleasure to help draft a letter to the congressperson of your choice at absolutely no charge.

Adjusting for Inflation: What Would Roth IRA and Other Thresholds Be If Properly Adjusted For Inflation?

We last compared current limits for various deductions with inflation-adjusted ones three years ago. It's time for an update. Perhaps a few of you would write your Congressperson about the inequity embedded in a system that fails to automatically make such adjustments. I'd be delighted to gather and forward your comments.

Letting inflation do the work of congress

Tax Rule	Actual Limits for 2006	Inflation-Adjusted Limits	Fixed Since
Roth Phase-Out Single	$95,000-$110,000	$118,020/$136,650	1998
Roth Phase-Out Married	$150,000-$160,000	$186,350/$198,800	1998
IRA Contribution Limit	$4,000/$5,000	$7,180	1975*
Rental Loss Allowance	$25,000	$44,560	1987
Rental Loss Phase-Out	$100,000-$150,000	$178,260/$267,400	1987
One/Two Dependant Care	$3,000 and $6,000	$7,900/$15,800	1975*
Capital Loss Deduction	$3,000	$9,300	1978
Alternative Minimum Tax Exemption	$42,500/$62,550 single/married	$47,300/$63,060	1993*
AMT Exemption Phase-Out Range	$112,500/$150,000 single/married	$157,650/$210,200	1993
Social Security—50%Phase-in	$25,000/$32,000 single/married	$48,725/$62,370	1984
Social Security—85% Phase-In	$34,000/$44,000 single/married	$46,460/$60,120	1994

*Limit has been increased. Inflation-adjusted limit is calculated from inception.