

Financial Security by Design

Planning and Compliance for Individuals, Trusts and Estates

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Dear Customers and Friends,

The biggest financial events last year were California's conformity to the federal pension rules, final regulations for minimum required pension distributions and the decline in the equity markets for an almost unprecedented third year in a row. Income tax rates are reduced slightly as we enter the new year and we may see further tax reductions under the mantra of fiscal stimulus.

My thoughts as we enter the new year are, first and foremost, that an investor who delays their re-entry into the equity market is risking the gains they achieved by sidestepping the market decline. I will also discuss why I foresee pressure on investment fees in the California market; changes in the delivery of income tax services; why I removed Social Security numbers from tax questionnaires; my ambivalence about expensing stock options and about the administration's proposal to make dividends tax-free; and why I am not impressed by advertisements offering huge tax deductions for pension contributions.

The Stock Market. I've been telling customers to hang in there and not sell simply because the market is falling. In retrospect, this has been bad advice. The decline since the millennium has been the deepest and longest lasting in a generation. Those who sold are worth ten or twenty or thirty percent more than those who held on.

I don't want to rain on anyone's parade but sidestepping a market fall produces only a paper profit until the investor actually re-enters the equities market. The challenge is knowing when to effect this re-entry.

Market prognosticators see glimmers of hope for the economy. Of course, they were saying the same thing a year ago. They are reminding us that it has been eons since there was a down market in the year before a presidential election. But, last January, they were remarking on the historical rarity of three down years in a row. It seems like most forecasts end up being wrong.

Nonetheless, I suspect that now is the time to re-enter the equities market. I'm not saying this because of my skill as a market timer. Readers will remember that I suggested re-entering the market a year ago. My reasoning is related to the devastating losses suffered by my tomato plants last summer.

Moles are ubiquitous in this part of the world, especially in well watered, fertile spots like vegetable gardens. It is usually easier to live with the damage rather than to eliminate the moles. Surveying my garden, I was reminded of the market adage "Pigs get fed but hogs get slaughtered." It was time to take action!

It is also time to take action in the stock market. Don't risk your paper profits by waiting for the absolute market bottom since the rebound, when it comes, could be

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rapid. (The market rose between 50 and 100% in the twenty-four months following the market low in each recession since the '29 crash. It rebounded even faster following the '29 crash.) If the bottom was October of last year, it would not be surprising if the market were up fifty percent from current levels by October of 2003. Don't be a hog and risk missing the rebound.

If you have stayed in equities all the way down, now is the worst possible time to sell.

Recent bond returns have been stupendous because bonds appreciate when interest rates fall. When interest rates eventually stabilize, price appreciation will reverse and bonds will fall. If you bought bonds as a temporary haven until the equities market sorted itself out, inaction could mean that you would reverse the gains in your bond portfolio as well as missing the market rebound.

We envy the young for their health and for their optimism and because they have the time to weather the downs in the equities markets. Indeed, market declines are beneficial for the younger person investing regularly. It is called "dollar cost averaging." Younger readers who are concerned by market declines should resist the temptation to underweight equities in their retirement accounts.

If you are no longer young, it is prudent to have money in bonds. The exact allocation is a personal decision. If you have a job that you enjoy, disability insurance and good health, bonds are less important because you have the option to continue working if the market heads south. If you are looking forward to retirement, or discomfited by market gyrations, you need more bonds.

A retired person should have enough in bonds to cover their expenses of daily living during a protracted market decline. It can be a disaster to withdraw from a stock portfolio in a falling market. See www.lingane.com/tax/risk.htm#part3. If the market is back to the March 2000 levels two years from now, the current decline will have lasted five years. Holding five years of living expenses in bonds would be a reasonable rainy day fund. A conservative investor might prefer more.

The rainy day fund approach to determining bond allocation has the advantage of automatically increasing stock market exposure when the market declines, since you are living off of your bonds, and automatically decreasing stock market exposure during market advances, when you are rebuilding your rainy day fund. These are the qualitatively appropriate asset allocation changes for a successful portfolio.

A reminder. Savings for a near term goal like the down payment on a home should not be risked to the volatility of the equity markets.

Competition Puts Pressure On Investment Fees. The estate plan for a married California couple often involves a by-pass or credit shelter trust. The trust is funded with the property of the first spouse to die and can be used to support the surviving spouse or for emergencies. But this property is not re-taxed at the second death since the surviving spouse does not own property which is owned by a by-pass trust.

There are administrative hassles with a trust, an additional income tax return for starters. And trust assets should be invested separately from the survivor's personal assets; see www.lingane.com/tax/tx_eff.htm. These chores can be handled by a surviving spouse with only minimal professional assistance if they have the inclination and health and mental capacity.

If these chores become burdensome or if there are health or capacity issues, these chores can be transferred to an independent trustee. An independent trustee is not

likely to be sensitive to family dynamics, which could be good in some situations and bad in others. An alternate is to hire a professional to handle the administrative and investment chores while retaining decision making in the hands of a family member.

What is a reasonable price to pay an investment professional? Jonathan Clements suggested no more than about one percent, including any fees charged by the mutual funds in which the advisor invests your money. ("Some Advice Worth Paying For: Most Planners Cost Too Much," August 7, 2002.) I agree with this assessment, especially if the professional employs a relatively passive investment strategy as I do.

For those who do not know of him, Mr. Clements is a transplanted Brit whose columns appear regularly in *The Wall Street Journal*. Mr. Clements sought my opinion for a column on converting to the Roth IRA several years ago.

Vanguard is one of the providers mentioned favorably by Mr. Clements. Search on "asset management and trust services" at www.vanguard.com for details.

Others may offer comparable services at comparable or lower rates. My point is that if you are paying substantially more than one percent for investment management, you should probably review the value of the additional services being provided.

I had recommended against Vanguard as trustee a couple of years ago because they were insisting that the trustee be governed by Pennsylvania law. Few of us know the differences between California and Pennsylvania law. I'll bet even fewer wish to learn.

Vanguard representatives say that they now offer trusteeship services governed by the state of residence. However, Vanguard writes ("Our Estate Planning and Trust Services," ©2002, p. 15) that "*The principal place of administration of the Trust shall be the county and state in which the VNTC office administering the trust is located. All questions relating to the administration of the trust shall be governed by the laws of such jurisdiction. VNTC may change the principal place of administration, after notice to the beneficiaries then eligible to receive Trust distributions.*" Vanguard National Trust Company (VNTC) has no offices in California. Draw your own conclusions¹.

We Are On The Cusp Of A Revolution In Income Tax Services. February marks the beginning of the personal income tax season. You may have noticed that brokerage firms have installed web links to tax software providers and that they are offering discounts on tax software and automated transfer of year-end tax information.

On-line tax preparation and e-filing costs \$15 - \$35. It is free for low income taxpayers. "Free File" is the result of an agreement that the IRS signed last fall with a dozen or more firms. The goal is free on-line tax preparation and e-filing for 60% of all individual filers. To match taxpayers to participating firms, the IRS created an on-line wizard at www.irs.gov/app/freefile/welcome.jsp.

Each participating firm has established their own eligibility criteria. For example, H&R Block provides a free federal return for California residents if AGI is less than \$28,000 with a charge for a state return, if required. TurboTax provides California residents both federal and state returns free if income is below \$27,000 or if the taxpayer qualifies for the Earned Income Tax Credit.

¹ For my correspondence with Vanguard, see www.lingane.com/tax/newsletr/vanguard.pdf.

The firms hope to make money when some of this year's Free File customers upgrade to a fee product next year. TurboTax may gain more new customers than the competition since they appear cheaper. Is there an investment opportunity here?

I don't fear competition from the on-line offerings because it has been my strategy to compete on service rather than on price. However, those who have built businesses based on a high volume of low income returns are threatened by on-line tax services.

The arrival of inexpensive, on-line tax services has implications for the volunteer organizations who prepare free returns for low income taxpayers. Five or six of us assist thirty taxpayers on a typical Saturday at the Oakland Library. I'll bet that we could help more if some effort was redirected to educational programs designed to teach taxpayers to do their taxes on-line. Some of those helped even might gain the confidence to prepare their own taxes the following year without further assistance, something which happens too infrequently with the present programs. Incorporating on-line tax preparation into next year's TCE/VITA programs is something to consider.

Low income taxpayers often have complex tax returns because of the complexity of their personal lives. Volunteers at the Oakland Library are routinely asked for help by nonresident aliens, for example. We send nonresidents away because we were not confident of our skills in this specialized tax area.

Unhappy with my inability to assist immigrants with very low incomes or students from very poor countries, I did some research and concluded that there are a variety of ways to transform nonresidents into normal taxpayers. I wrote an article showing how this is done and I illustrated the article with vignettes based on my volunteer experience. "[Elections Make Quick Work of Nonresident Returns](#)" was featured in the January 2003 *EA Journal*. Right in time for tax season.

Protecting Your Social Security Number. There has been a small brouhaha among tax preparers about a new California law designed to protect your privacy. It is now generally illegal in California for someone to send you a document with your Social Security number printed on it. There are exceptions for W-2s and the like or if the item is an application; or if the sender has included Social Security numbers in the past (unless you ask them to stop); or if the sender is a government agency.

Tax preparers have routinely preprinted Social Security numbers on the questionnaires that we send our customers at the beginning of tax season. These questionnaires fall under the continuing customer exemption. I spoke with Jenny Bretschneider of Senator's Bowen's staff - Ms. Bretschneider had staffed this legislation - and she indicated that tax questionnaires would also be exempt if they could be construed as an application for tax services. The bottom line is that I could probably continue to preprint Social Security numbers on tax questionnaires.

But do I really need to verify your Social Security number every year? After all, if the IRS or FTB processed your return normally last year, we have effectively verified the accuracy of the information on my computer. My decision was to remove Social Security numbers from the questionnaires that I'll be mailing out next week.

Corporate Scandals and Fiscal Stimulus. The news last summer was all about corporate managers who manipulated earnings to make performance appear better than it was and thereby inflated their company's stock price. Complex rules, and the law of unintended consequences, often mean that unethical manipulations are legal. I'll bet that a simpler tax code would put a stop to some of these shenanigans.

Some are advocating that companies be required to subtract the value of employer stock options from reported earnings. The theory is that anything that reduces earnings will reduce stock valuations and the incentive to manipulate prices.

There are difficulties. First of all, I doubt that investors really believe the earnings growth models. If they did, they wouldn't yo-yo stock valuations up and down whenever a firm revises earnings. Instead, they would only change stock valuations when they perceived a significant change in the long term earnings trend.

Second, investors do not use adjusted earnings currently even though companies report on employee options in the footnotes. If the calculations were all that difficult, you would not be seeing headlines like "Expensing Options Would Halve Earnings of ABC Company." If investors are choosing to not adjust earnings, they are either lazy or dumb or they don't consider options as an expense.

I don't see options as an expense, or at least not an expense like the cost of lumber represents to a company making wooden boxes. Options clearly have value and the company clearly paid an opportunity cost by granting free options to employees instead of selling the options to the general public. But opportunity costs have a very tenuous relationship to earnings. Might expensing options be the sort of earnings manipulation, albeit for a good cause, that expensing options is supposed to stop?

The current news is about ending the double taxation of dividends and how this will stimulate the stock market, provide jobs for all and re-elect Mr. Bush. Whether it is the income tax cut proposed by the Bush administration or the Social Security tax holiday favored by the Democrats, it is hard to see congressional action before the summer. I hope that there will be clearer evidence of economic recovery by then. In other words, any fiscal stimulus will probably come too late to do much good. The politicians must know this notwithstanding their rhetoric. I conclude that the debate is not about stimulus but about the size of government and about tax policy².

The Bush administration is arguing for tax-free dividends because they believe smaller government (less tax revenue) is better. I'm not taking a position on this. But there is a reasonable case to treat interest and dividends equally and a plausible argument that encouraging companies to pay dividends is good because earnings can be manipulated whereas dividends cannot. So, it probably makes sense that both interest and dividends should be deductible at the corporate level.

Why then is the administration arguing for a cut in personal income taxes rather than in corporate taxes? Two reasons, I think. First, Democrats like reductions in corporate taxes even less than they like reductions in personal taxes. The administration probably figures that they can weather a "tax cuts for the rich" counter campaign better than "tax cuts for corrupt corporations."

Second, changes at the corporate level would mean a larger initial reduction in tax revenue. A larger reduction in revenue would be harder to sell. Cutting taxes on the personal side has a smaller revenue impact because current law already exempts corporations from paying tax on some dividends and because dividends on stocks

² David Wessell ("Government Size Is at Heart of Tax Battle," *The Wall Street Journal*, January 23, 2003) makes a similar observation. He provides a chart of fifty years of federal spending and receipts and concludes with a warning. "Without a more honest public debate about the optimal size of government, the risk is that both parties will win. We'll get Republican tax policy and Democratic spending policy - and deficits bit enough to alarm even Mr. Bush's economists."

owned within a pension or IRA will still be taxable even if dividends on stocks owned outside a pension or IRA are tax exempt.

As someone who wrestles with the realities of personal income tax returns, I am leery of proposals, even proposals which reduce my taxes, which increase tax complexity. Let's look at the dividend proposal for its effect on tax complexity.

The administration's proposal³ is for dividends to be non taxable if the corporation paid income taxes in the prior year. REITS, like mutual funds, generally distribute their taxable income to their shareholders and thus dividends from REITS would still be taxable. Although this sounds complicated, individuals probably won't have to worry about the details when preparing their tax returns because the taxable and non taxable dividends will be identified on the Forms 1099-DIV that taxpayers receive.

If a profitable company chooses to reinvest in its own operations rather than paying dividends, the administration proposes to treat such internal reinvestment as a tax-free distribution which the shareholders enthusiastically and immediately reinvest in the corporation. That is, cash flow not distributed by a profitable corporation is to be treated as increasing shareholder basis in the company stock and reducing capital gains (or increasing losses!) when the stock is sold.

This part of the proposal adds new record keeping requirements for individual taxpayers. This new complexity would have been avoided if the administration had chosen to make dividends deductible at the corporate level.

A New Way to Save Big Bucks for Retirement? I was first exposed to 412(i) retirement plans at a continuing education opportunity in November. We were told that insurance providers are sponsoring a big advertising campaign during the Spring tax season. The very next day, I came across a prominent advertisement in a professional magazine promising huge tax deductions for contributions to a specific 412(i) plan.

What are these plans and what are their potential benefits?

A 412(i) plan is a multiyear commitment to purchase a multimillion dollar cash value life insurance policy or annuity. The income tax deduction can be huge for older, high income employees because the premiums are designed to pay guaranteed benefits after retirement of as much as \$160,000 annually. Search the Internet for "412 defined benefit plan" to learn more.

A 412(i) plan could be a great way for the high income owner of a small business to acquire cash value life insurance using tax-deferred dollars. At retirement, the life insurance policy is rolled out to the participant who only owes tax on the cash value.

The insurance providers manipulate surrender charges to keep the cash value, and hence the income tax, low in the years when the policy might be rolled out to the participant. Manipulating surrender charges to lower taxes does not pass my smell test. I suspect that the IRS could challenge such strategies.

What about those business owners who do not need millions of dollars of life insurance? Why not contribute to a conventional defined benefit plan instead since conventional plans also allow huge tax deductions for older employees?

A pension contribution is not necessarily a good investment just because there is an immediate tax deduction. Excessive costs can overwhelm the tax benefit. The only

³ For the details, now requiring twelve pages, see www.treas.gov/press/releases/kd3781.htm (1/21/2003).

way to tell whether a 412(i) plan is right for you is to compare your agent's proposal to a comparable guaranteed investment, such as high quality bonds. You will probably conclude that investing big bucks after-tax in bonds provides more than a huge tax-deductible contribution to a 412(i) plan.

My advice is to approach these plans with skepticism, and a calculator. Please contact me if you need help with the calculations.

If you have questions, please call or check out my website. If you know of someone who needs assistance with a personal income tax return, or with a return for an estate or trust, I'd appreciate your recommendation.

Sincerely,

Peter James Lingane