Financial Security by Design

Planning and Compliance for Individuals, Trusts and Estates

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Dear Customers and Friends,

Market Forecast. "Economic Recovery Gains Strength" headlines the Wall Street Journal on October 17, citing generally positive signals on production, inflation and employment. And the stock market, often a precursor of economic tidings, is up a third from a year ago. What is an investor to do?

No one knows whether it is "safe" to return to stock investing. Stock prices have bounced in previous bear markets only to later fall to new lows. My advice is to forget about whether the economic news is for real and apply the principle that the best portfolio is a broadly diversified portfolio. If your portfolio is dominated by bonds, buy some stocks. If you have been rebalancing, your portfolio is probably overweighted in stocks and you should buy some bonds. If you have promised yourself that you would reduce your stock exposure once the market recovered, begin to act on that promise.

Which stocks should you own? Regular readers know that I encourage an investment strategy based on simplicity, broad diversity, cost control and tax efficiency. My preference is for index or exchange traded funds which track the S&P 500 or the Wilshire 5000 indices, the EAFE international index and REITS[1]. If your stocks are concentrated in a particular market sector, technology perhaps, this would be a good time to begin to reduce your sector concentration. If you own funds with above average costs, or many funds, this would be a good time for some housecleaning.

What bonds should you own? The current yield on Treasury bonds is below the historical averages on an inflation adjusted basis. Buying bonds or bond funds now probably means locking in a below average interest rate. It may be

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[1] Numerous studies show that a low cost, broadly diversified portfolio outperforms the majority of actively managed equity funds. The most recent is Dalbar Inc. who report (July 2003)

> … investors continue to chase investment returns to the detriment of their pocket books. Motivated by fear and greed, investors pour money into equity funds on market upswings and are quick to sell on downturns. Most investors are unable to profitably time the market and are left with equity fund returns lower than inflation.
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> The average equity investor earned a paltry 2.57% annually; compared to inflation of 3.14% and the 12.22% the S & P 500 index earned annually for the last 19 years.
>
> The average fixed income investor earned 4.24% annually; compared to the long-term government bond index of 11.70%.

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wise to park your money temporarily in a money market account or short term CD. World Savings Bank offers 1.9% FDIC money market accounts and Ing Direct, an Internet bank (home.ingdirect.com), has 2% FDIC savings accounts.

If 2% seems paltry, 5-year FDIC CDs pay 4% (www.bankrate.com or your broker). If you cash in a CD for something with a higher yield when rates rise, you will pay a smaller penalty than if your money were in bonds or bond funds.

Comment. I am not enthusiastic about bond funds because expenses are a significant portion of the income when yields are low and because prices fall when interest rates rise. Bond prices also fall when rates rise but bond ladders can be used to ameliorate the damage.

Paying down your home mortgage is equivalent to buying high quality bonds with a yield equal to your mortgage rate. For the adventuresome, long California bonds yield 5% after-tax but our bonds have the lowest rating of any municipal bond. Or think about Treasury Inflation Protection Securities (TIPS).

TIPS have impeccable credit quality. Because TIPS pay interest on a value that increases with inflation, you are protected if inflation soars. The inflation adjustment is not paid until maturity but you pay tax on the adjustment each year. If this is an issue, TIPS can be owned in a pension or 529 account.

If TIPS and conventional Treasury bonds were competitively priced, the difference in yield would represent the market's view of future inflation. Conventional Treasury bonds maturing long into the future have yielded 2 to 2.5% more than TIPS during the past five years. Because these differences are in line with recent inflation, long TIPS provided about the same effective return and the inflation protection was essentially free.

Conventional Treasury bonds with shorter maturities have yielded 1 to 2% more than comparable TIPS during the past five years. Because this difference is less than recent inflation, intermediate TIPS have provided an extra half percent effective return, plus inflation protection.

Illustration: The 3.625% TIPS maturing in January 2008 were selling for 112% of par at the end of September. This corresponds to a 2.6% after-tax yield to maturity assuming 2.5% inflation between now and maturity and a 25% federal tax rate.

3% conventional Treasury notes maturing in February 2008 were selling for 101% of par. The after-tax yield to maturity is about 2.1%. Intermediate TIPS are better if inflation stays at current levels or increases from current levels.

I-bonds yield inflation plus a rate which is fixed for thirty years. The fixed rate is currently 1.1%, which does not compare favorably to the fixed rates for TIPS.

There are 5-yr. and 10-yr. FDIC insured, inflation-protected CDs which yield 50 basis points more than TIPS and whose effective yield is perhaps 100 basis points more than conventional Treasury securities. These CDs are illiquid, a

disadvantage. These CDs are subject to state income tax but this is of no consequence if owned in a retirement account. See www.lasallecdips.com.

For more on TIPS and I-bonds, see www.lingane.com/tax/tips.pdf.

New Tax Law. Congress passed 200 pages of tax changes last May. We used to joke that tax changes amounted to full employment for tax professionals. But too frequent change can be a malpractice hazard.

For an excellent summary of the new rules, see Ernst & Young's "What the 2003 Tax Act Means for Investors" on the website of Fidelity Investments.

If you have been reluctant to rearrange your portfolio because of unrealized tax on your current investments, lower capital gain rates make this a good time to act. But don't procrastinate since rates are scheduled to go up in five years and Democrats vow repeal as soon as the electoral tide turns.

We tend to hold the same sorts of investments in our pension and taxable portfolios *but it is better to hold the investments that generate the most current tax inside pension and IRA and 529 accounts*. Lower capital gain and dividend rates make such a strategy even more tax efficient.

The tax efficiency benefit is small but it can mean a couple of extra thousand dollars a year on a million dollar portfolio. Almost no extra effort is required.

Tax Complexity is rampant and it is getting worse. The new 15% rate on dividends and long term capital gains adds a dozen steps to the tax calculation on Schedule D. In addition, not all dividends are entitled to the lower rate.

- Dividends from money market accounts, credit unions, regulated investment companies and real estate investment trusts do not qualify.
- Dividends on foreign stocks do not qualify unless the stock is traded on a U.S. exchange and the U.S. has a special treaty provision with the foreign country. Notice 2003-69 lists the treaties which qualify; only four do not.
- Certain "dividends" do not qualify for the lower rates because they really are payments in lieu of dividends. This typically occurs in a margin account. The margin agreement allows your broker to loan out your stocks to short sellers. The company pays its dividend to the new owner and the short seller pays you an amount in lieu of the dividend.

  There had been no need to track payments in lieu separately from dividends since both payments and dividends were taxed at the same rate. Now that dividends are taxed at a lower rate, brokers have to reprogram their computers. The IRS has announced that taxpayers will be blameless if the broker-issued 1099-DIV misclassifies payments as dividends.
- You don't get the lower rate unless you own the stock for more than 60 days during the 120-day period beginning 60 days before the ex-dividend date,

the day on which the stock price declines because new shareholders are not entitled to the dividend.

Some issues are inherently complex. Birthdays, for instance. The young man in Gilbert and Sullivan's *The Pirates of Penzance* was indentured for life because his mother's financial adviser forgot about the implications of his February 29th birthday.

But it is not clear that Americans benefit from a tax code which uses age 17 to qualify children for the child tax credit and ages 13, 14, 18, 19 and 24 to qualify children in other circumstances.

Some readers were doubtless pleased to learn that the child tax credit increases to a thousand dollars this year. But I'll bet that you did not appreciate that a child achieves age 17 on the day before their birthday and that a child born January 1, 1986 was not eligible for the credit last year.

The IRS changed this rule effective with this filing season and a child born January 1, 1987 is eligible for the child tax credit this year.

Complexity increases the cost of compliance and breeds loopholes, mistakes and fraud. Problems are compounded when enforcement is less than vigorous. California is rumored to be laying off tax auditors in response to our budget crisis. I would have thought that good auditors would be profit centers!

California relies heavily on the high earners and tax revenues plummet when Silicon Valley gets a cold. Arthur Laffer (the conservative San Diego economist) argues that tax revenue would be more stable if real estate, sales and income taxes were replaced with a flat tax on personal and business income. Thus complexity may be indirectly responsible for California's revenue shortfall.

Tax Deduction for Hybrid Vehicles. The IRS has certified the 2004 Toyota Prius for a $2,000 "clean fuel" tax deduction on Line 33 of their Form 1040. Honda's hybrid gas-electric automobiles should be similarly certified soon.

Hybrids get twice the gas mileage of comparable gasoline-only vehicles and the extra initial cost is recouped in lower fuel costs. They are peppy and the new Prius is reported to be a bit larger than in the past.

We could reduce our energy consumption by moving to hybrid vehicles, with positive air quality and land use implications. Energy also colors our reactions in the Middle East. If I were Mr. Schwarzenegger, I'd insist that new state-owned passenger vehicles be hybrids and I'd lobby the California legislature to mandate hybrid power systems for Hummers and SUVs.

I'd even like hybrid vehicles without a tax deduction.

412(i) Pension Plans. Defined benefit pension plans allow small business owners to deduct more for retirement. The owner gets an extra large deduction with a 412(i) plan because the pension is funded with life insurance and the

rate of return on life insurance is less than the return on investments generally. The business owner gets to deduct more with a 412(i) plan because he must invest more to achieve the same retirement income.

Some 412(i) promoters are selling insurance policies which are larger than required to fund the pension benefit and distributing the insurance policy to the business owner before retirement at an artificially low price.

Manipulating cash surrender values does not pass my smell test and the IRS has addressed this issue. Q&A 10 in Notice 89-25 says that the higher of cash value or market value is included in a participant's gross income when the participant receives a distribution of life insurance from a qualified plan. Distribution of life insurance from a 412(i) plan at a bargain price produces taxable income even if the participant rolls the life insurance over to an IRA[2].

The Notice goes on to say that if the market value of the policy exceeds the participant's accrued benefit, the distribution would not be treated as a distribution from a qualified plan and thus not eligible for rollover treatment. Such a distribution might also disqualify the entire pension plan.

The rumor is that the IRS will be shutting down the more egregious 412(i) promoters because of these issues.

e-filing. There were eight minor earthquakes six miles beneath Happy Valley in Lafayette last weekend. The USGS posted an analysis and map location at quake.wr.usgs.gov/recenteqs/Maps/SF_Bay.html within minutes of each event. Such is the potential of computer technology.

The Internet have partially leveled the playing field for the small investor. Harry Domash maintains a list of his recommended investing sites at www.winninginvesting.com/best_investing_sites.htm and Kathleen Pender provided her list in the *San Francisco Chronicle* today. (Search on Pender at www.sfgate.com.)

Computers ease tax preparation but computers have also facilitated increased tax complexity. Computers have eliminated computational errors, reduced processing costs and made it harder to evade taxes.

Computer technology could make preparing and auditing your tax return as easy as the USGS has made earthquake analysis. But computer technology will not truly ease preparation and audit burdens until we approach e-filing creatively and completely rethink the reporting process. For example,

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[2] Life insurance cannot be rolled over to an IRA directly. But a special rule allows a qualified plan to sell the policy to the participant in a non taxable transaction. The participant then takes a distribution equal to the amount paid for the life insurance. It is this cash distribution which can be rolled over.

- e-filing makes for more work, not less, because you or your preparer must key in the payer's name and tax identifier for every W-2, 1099 and K-1. Even the address and ZIP code.

  We make errors keying in this information. Spell checkers suggest changes to typing errors and sometimes even make corrections automatically. The IRS computer could do the same when an e-filed return does not match the master file, but it does not[3].

  Better ways to transfer information to the tax return becomes apparent if we review the changes to inventory practices. A long time ago, stock boys went around with a pencil and paper and recorded what was on the grocery shelves. Writing "6" and "tomato soup" is analogous to what we do today when we key in the payer's information next to wages or other income.

  Someone got the idea to save labor by sending stockpersons around with a list. Writing a "6" next to a preprinted "tomato soup" would be analogous to preparing an e-filed return by reporting wages and other income and looking the payer up on a master list or reporting the payer's identification number.

  Stockpersons sometimes made mistakes and write the "6" next to the wrong size of tomato soup and taxpayers make mistakes copying tax identification numbers. Grocers eliminated human errors with hand held scanners which read the bar-codes printed on the grocery items. The e-filing analogy would be to have the payer and other information bar-coded onto the paper forms or encoded on a magnetic strip accompanying the paper forms.

- Nearly all returns contain errors, some innocent and some not so innocent. The Earned Income Credit pays out $30 billion too much each year and the Franchise Tax Board worries enough about Head of Household filers that they audit half of these returns each year. e-filing would reduce these errors if we changed how we qualify taxpayers for these benefits.

  Paper returns currently ask "Are you eligible for the earned income credit?" or "Are you eligible for Head of Household status?" There would be fewer errors if e-returns asked the questions on the audit checklists.

  Some tax software and some tax preparers already ask the audit questions. My suggestion is to make the answers part of the e-filed return.

These comments were prompted by California's decision to require paid preparers to file personal income tax returns electronically beginning next Spring, unless the taxpayer opts out. Smaller firms, like mine, are exempt.

Social Security. Amounts paid to retirees will increase by 2.1% in January to adjust for inflation over the past year. Amounts paid by Social Security

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[3] An Enrolled Agent tells of re-transmitting a return three times before figuring out that an employer's name was printed "Xxxx's Restaurant" on the W-2 but stored in the IRS computer as "Xxxx s Restaurant."

beneficiaries to help defray Medicare's outpatient costs will be $792 next year, up about $95 annually from current levels.

If you are not yet retired, Social Security offers some nifty calculators to estimate your future benefits (www.ssa.gov /planners/calculators.htm).

Have you ever wondered how benefits are determined? First off, you need forty quarters of coverage. It takes about $900 to earn one quarter of coverage; the exact amount is updated annually. Since Social Security income is now generally reported on an annual rather than quarterly basis, full coverage means earning al least $3,600 annually for at least ten years[4].

Your benefit is determined by multiplying your "primary insurance amount" by a factor. The factor reduces benefits if you begin payments before full retirement age and increases benefits if you delay payments beyond full retirement age. "Full retirement age" depends on the year of birth.

Year of Birth	Full Retirement Age	Factor at Age 62
Before1938	65 years	80%
1943-54	66 years	75%
1960 and later years	67 years	70%

The full schedule with the intermediate years is available at www.ssa.gov.

This table indicates that someone born before 1938 and who retired at age 62 receives 80% of their primary insurance amount. If they retired at age 65, they would receive the full primary insurance amount. If they retired between age 62 and 65, they would receive something between 80 and 100% of their primary insurance amount.

Your primary insurance amount depends on your "averaged indexed monthly earnings." Average indexed monthly earnings is the average of your Social Security earnings from your best 35 years. The earnings are adjusted (indexed) for changes in the national average wage so that earnings from prior years have about the same impact as current wages.

Caveat: Prior to the mid-sixties, Social Security tax was assessed on a wage base that extended only a bit above the national average wage. Congress gradually increased the wage base so that it is about twice the national average wage currently. Because of these changes, maximum indexed earnings were about $40,000 annually until the mid-sixties and have been about $80,000 annually since the mid-eighties. Consequently, wages earned many years ago have less impact than current wages for someone whose income routinely exceeded the maximum wage base.

[4] I'm summarizing several hundred pages in a few paragraphs so expect generalizations. Also remember than Social Security provides more than retirement benefits. For more than you ever want to know about Social Security, check out their website. For a nice mix of methodology, historical perspective and forecasts, see the annual Trustees Report at www.ssa.gov/OACT/TR/TR03/trTOC.html.

The primary insurance amount is determined by formula. The first $600 or so of average indexed monthly earnings are counted at 90%, the next $3,000 or so are counted at 32% and anything over about $3,600 is counted at 15%.

These dollar amounts are called "bend points" because the primary insurance amount, when graphed versus average indexed monthly earnings, is a series of line segments bent at these locations. The bend points are updated annually.

Your primary insurance amount is determined using the bend points for the year in which you turn 62. This means that your primary insurance amount keeps pace with the average national wage growth until age 62. After age 62, your primary insurance amount is escalated in line with inflation.

The Social Security benefit system is progressive. For example,

- If a retiree's average indexed monthly earnings were $1,500, which is about half the norm, the primary insurance amount would be 90% of $600 plus 32% of $900 or $828. This benefit represents 55% of average indexed monthly earnings.
- If the average indexed earnings were $3,000 or about average, the primary insurance amount would be 90% of $600 plus 32% of $2,400 or $1,308. This benefit represents 44% of average indexed monthly earnings.
- If the retiree's average indexed earnings were $6,200, which is about the maximum for someone currently nearing retirement age, the primary insurance amount would be 90% of $600 plus 32% of $3,000 plus 15% of $2,600 or $1,890. This benefit represents 30% of average indexed monthly earnings.

Your benefit will be based on one half of your spouse's primary insurance amount if this produces a larger benefit. This rule is great for stay at home spouses and families where one spouse is an unpaid business partner. Unmarried persons are entitled to a benefit based on half the primary insurance amount of an ex-spouse if this is larger than their own benefit.

Example. John's average indexed monthly earnings are $1,000 while those of his wife are $6,200. The primary insurance amount based on John's earnings is $668 whereas the primary insurance amount based on his wife's earnings is $1,890. John's primary insurance amount is $945. That is, the larger of his primary insurance amount or one half of his wife's primary insurance amount.

Federal civilian workers hired before 1984 and employees of state and local governments who have elected out of Social Security don't pay Social Security taxes and they are not entitled to a benefit based on their spouse's earnings.

Working does not reduce your benefits after you achieve full retirement age. If you elect to begin benefits before your full retirement age and continue to earn Social Security income, your benefits are reduced.

- In the year you reach full retirement age, benefits are reduced by one dollar for each three dollars earned in excess of $30,720. (This limit increases to $31,080 in 2004, based on the change in the national wage index.)

  Assume that you achieved full retirement age in September and that you earned $32,000 before your full retirement age. Your excess earnings are $1,280. You must repay one third of this excess, but not more than your entire benefit, to the Social Security Administration.

- In the years before you reach full retirement age, benefits are reduced by one dollar for each two dollars in excess of $11,520. ($11,640 in 2004.)

  Assume that you will achieve full retirement age next year. You will earn $48,000 this year or $36,480 in excess of the limit. You must repay half of the excess, but not more than your entire benefit.

The present value of an $800 check each month from the Social Security Administration is on the order of a hundred thousand dollars.

Generally speaking, you are ahead beginning benefits as soon as you reach age 62, assuming that you are single and not continuing to earn a lot of money. This is illustrated by the following table in which an $800 benefit at age 62 and appropriately larger benefits at full retirement age were discounted at 5% plus inflation[5]. The most recent CDC mortality statistics[6] were used to risk each payment by the chance that you will still be alive to receive the payment.

	NPV @ 5%, unmarried, $000	
Benefit Age	Male	Female
62 years	$ 107.6	$ 118.7
65 years	102.3	116.0
66 years	99.1	113.6
67 years	96.2	111.4

A surviving spouse receives the actual benefit the deceased spouse would have received if he or she were still alive, if this is larger than the benefit based on their own earnings. If the deceased spouse was being paid a reduced benefit because payments began before full retirement age, the benefit paid the widow(er) is also reduced.

Calculations summarized below indicate that there is no reason for the husband to delay the onset of his benefits when husband and wife are the

[5] About the return for a 50:50 stock to bond protfolio with the stocks growing at 7% plus inflation and the bonds yielding 3% plus inflation. The discount rate is expressed as "plus inflation" because the Social Security benefit is inflation adjusted.

[6] Tables 2 and 3. Life tables for males and females, United States, 2000. National Vital Statistics Reports, Vol. 51, No.3, December 19, 2002. From www.cdc.gov/nchs/data/nvsr/nvsr51/nvsr51_03.pdf.

same age and entitled to the same $800 benefit and the wife takes her benefit from age sixty-two. The total value received by a married couple increases slightly when a husband with a younger wife delays benefits.

The effects are unchanged if the husband is entitled to a substantially larger benefit than his spouse at age 62, $1200 and $600 respectively.

	NPV @ 5%, $800/$800		NPV @ 5%, $1200/$600	
Benefit Age	Same Ages	Younger Wife	Same Ages	Younger Wife
62 years	$ 226.3	$ 226.3	$ 226.3	$ 205.2
65 years	227.6	227.6	227.6	208.0
66 years	226.6	226.6	226.6	207.5
67 years	226.2	226.2	226.2	207.6

These differences are relatively small. You are probably ahead by delaying benefits if you think you will live a couple of months longer than the statistical tables predict because of healthy habits or long-lived genes.

It may also be better to delay benefits if you are in straightened circumstances. Waiting means that you will have a higher income later in life and that you will be in less danger of outliving your resources.

Year-end Tax Planning. It is probably to your advantage to defer income to next year, to make charitable contributions and to pay property and state taxes and discretionary business expenses such as malpractice premiums before year's end.

Lower federal tax rates mean more taxpayers will fall victim to the federal alternative minimum tax. Talk to a tax professional if your income exceeds a hundred fifty thousand dollars, especially if you have substantial capital gains or if you have paid lots of taxes this year or if you have "preference income" from stock options, municipal bonds or depreciation. About the only defense this late in the year is to defer the fourth quarterly state tax payment to January.

This missive has covered a lot of ground. Please call or e-mail if I have mentioned something that peaks your interest or if you wish to suggest a topic for a future newsletter.

Sincerely,

Peter James Lingane