December 2006

tax and financial ISSUES

NOT Reported on CNN or Fox

The war in Iraq and the November elections have dominated the news. There are some less-headline grabbing items of interest that appeared in the media during 2006, but didn't make the cut with the cable news channels. Not to worry! The following articles are being covered as if they were reported on "The O'Reilly Factor." (Those unfamiliar with the show's format should suffer through it for an hour.)

Top Story: Retirees at Risk

Stealth Medicare tax set to go into effect in 2007.

Legislation enacted in 2003 provided for increased Medicare Part B premiums to be paid by individual based on income levels. There is a three-year phase in. Here are the eventual income-based surcharges:

Income Range	Surcharge	Estimated 2009 Premium Surcharge
<$80,000	0%	$ 0
$80,000 - $99,999	40%	$ 565
$100,000 - $149,999	100%	$ 1,414
$150,000 - $199,999	160%	$ 2,262
$200,000+	220%	$ 3,110
Estimated base premium for 2009 = $1,414 ($117.70/month)		

If the income levels that trigger surcharges are not indexed to inflation, more individuals will end up paying the surcharge as inflation increases incomes over time. As Medicare premiums increase as a function of healthcare inflation, the surcharge will increase. This is a typical strategy to conceal the eventual impact of legislation:

- to make the change have no immediate impact so that few notice, and
- to program in tax increases that occur because of inflation.

Remember when the Alternative Minimum Tax was expanded in 1986? Very few people were immediately impacted. The effect of 20 years of inflation has made the AMT pervasive. We have even seen taxpayers who don't itemize deductions incur AMT. The government is hooked on the tax revenue and it will be difficult to repeal.

Taxpayers should be aware that the surcharge is based on the income reported on tax returns from two years prior. For example, the deadline for filing 2005 tax returns is October 15, 2006. This is the most current data on the income of Medicare participants that the government has available. Since 2007 charges are based on 2005 income, the government is looking through a rearview mirror in determining taxpayer's ability to pay. Income in certain years can be skewed by nonrecurring events, like the capital gains from asset sales or unusually high IRA distributions.

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The government has announced that individuals can appeal the surcharge based on changed circumstances. There should be lots of appeals activity, especially for those who just stopped working. It's not clear whether expecting decreased capital gain income will carry any weight during the appeals process.

Come to think of it, O'ReIlly would cover the administration of this surcharges and appeals process as
"The Most Ridiculous Item of the Day."

Medicare Part B is a voluntary program. Individuals must elect to participate and pay the premium. Usually the premium is withheld from Social Security benefits. It is possible that the imposition of the surcharge will prompt taxpayers to opt out and purchase alternatives (like catastrophic coverage) from commercial insurers.

The most important thing that individuals should recognize is that Medicare is quickly moving away from being a government entitlement towards being an arrangement where anyone left standing who has income, will pay. Watch as the Medicare surcharge swallows up Social Security benefits. This is an unfunded liability that individuals will have to consider in their retirement planning.

Action:

Be prepared to appeal the 2007 surcharge if 2005 income is not representative of what will be earned in 2007.

Medicare Part B participants should keep an eye on the Part B and commercial premiums with an eye towards opting out of Part B if participation becomes uneconomic.

Financial plans should be adjusted to reflect higher health insurance costs during retirement.

Talking Points Memo

There is a disconnect between housing prices and the Consumer Price Index.

People's inflationary expectations drive a wide variety of decisions, including:

- investing in real assets (natural resource stocks, personal residences, etc.)
- whether to buy long-term bonds
- how much to save for future obligations (retirement, college educations, etc.)

The most widely used measure of inflation is the Consumer Price Index. It's computed based on changes in a basket of things that a representative consumer would purchase. The CPI is important to retirees because it's used to index Social Security benefits to inflation. Housing makes up about 25% of the CPI.

Most individuals are not aware that changes in home prices are not used as a component of the CPI. Instead, an imputed rent figure for housing is used. This computation reflects the interaction between the price of the housing and interest rates. For example, if housing prices go up but interest rates decline, there might be very little change in the rent index because the two changes are offsetting. (With low interest rates it costs less to carry an asset.)

From 2000 to 2005 the increase in house prices far exceeded the imputed rent component of the CPI. This occurred because lower interest rates allowed marginal buyers to bid up the price of houses, but declining rates offset this increase in the computation of imputed rent. Housing prices were up about 100% during the period, but the rent index was only up 25%. With interest rates increasing, housing prices have declined from their 2005 peak, so the relative changes seem to be reversing.

What is the significance of this to an investor? If you expect the rate of appreciation in real assets to closely track the inflation rate, you may be disappointed. At least in the short term, changes in interest rates from the time when the asset was purchased may have more of effect on the market value of assets than a change in the CPI.

Recent action in housing prices demonstrates once again that taking advantage of low interest rates may not be a good investment strategy, as least as it relates to buying real assets. Marginal buyers bid up the price of the assets, and when rates go back up to a more normal level, the price declines resulting from higher interest rates may swamp inflation-related appreciation.

Action:

Be wary of asset valuations when buyers are using borrowed money. Increases in interest rates and tightening in lending standards may produce a losing investment.

Unresolved Problem

Government disclosure of retiree benefit liabilities starts in 2007.

The Government Accounting Standards Board has required that large governmental entities and school boards must disclose certain post-employment benefit costs and liabilities as well as define specific parameters for their determination. Smaller governmental units will start reporting this information in 2009.

This is important information for individual and businesses setting up shop in new locations, and making decisions about whether to stay where they are. The explosion in real estate prices has led local governments to view the real estate tax as the solution for funding all programs. You want to make sure that you're not in a position to have to bail out irresponsible governments.

This is similar to the due diligence that's done when buying a condominium. You look at estimates of deferred maintenance and the size of the association's reserves before buying. This prevents walking blindly into a special assessment.

The case of San Diego is instructive. Out of sight, retirement benefits of municipal workers were expanded dramatically. Over time, the growth in unfunded liabilities increased, impairing the city's ability to pay its creditors and maintain operations. (Actually this is a rather plain vanilla description of what went on over a period of years.)

Reported in the press 11/15/06:

- San Diego reached a settlement with the Securities and Exchange Commission over allegations the city failed to tell municipal bond investors it was underfunding its pension plan and had been paying for retiree health benefits out of a reserve fund that would be depleted by 2006.

- San Diego failed to disclose that its unfunded liability to its pension plan was projected to increase from $284 million at the beginning of fiscal year 2002 to an estimated $2 billion by 2009. In addition, the city's liability for retiree health care was an estimated $1.1 billion.

- Six former members of the San Diego retirement fund and one person who was still on the board were charged in May 2005 with felony violation of securities laws. The SEC said its investigation of individuals and other entities is continuing.

Perhaps San Diego should adopt the following as the city motto

"The climate's great. Bring your wallet."

This is likely not an isolated occurrence of fiscal mismanagement. As the GASB disclosure requirements are implemented from 2007 through 2009, more examples of unreported liabilities will likely surface. You'll know what states and cities are under pressure to raise taxes.

Action:

Individuals and businesses moving to a new location should check the financial health of governmental entities that have the power to levy taxes.

Individuals investing in the bonds of specific states and municipalities should review the new disclosures. (These should be available via the Internet.)

Impact Segment

Longevity is found to have a low genetic correlation *(NY Times, 8/31)*

An individual's expectation of their life span has a profound effect on financial decisions. For example, is life insurance a good investment? Would I rather have the cash or a life annuity? How much of my current earnings do I have to squirrel away now to pay for my retirement years? How long do I have to work?

Researchers determined that the age at which parents died only has a 3% effect on their children's life spans. The top inheritable traits were found to be:

Height -- 85% • Existence of attention-deficit hyperactivity -- 75% • Weight -- 70%

If you're a short, overweight person with ADD, blame your parents. But don't expect good family genetics to make up for bad personal habits in determining your longevity.

If your parents died at a relatively young age, then it doesn't follow that loading up on life insurance is a great strategy. In a similar vein, if your parents lived until 90, you don't have a 100% probability of getting a great payback from life annuities.

Action:

Individuals should be cautious about making financial decisions solely based on attaining the longevity of their parents.

Consider other factors such as your current health status and changes to population wide survivorship data as computed by the Society of Actuaries.

The author apologizes for not coming up with items to match these O'Reilly Factor segments.

Fridays With Geraldo or **Bloviating With Bill**

2006 Tax Law Changes

The following are notable tax developments that occurred during 2006. Anything that affects the management of pension and IRA assets merits your attention, but the first two items (Roth conversions and passing retirement plan assets to non-spousal beneficiaries) affect a large number of taxpayers. This was not special interest legislation.

1) Roth IRA conversions liberalized.

Taxpayers approaching retirement who have saved diligently and accumulated significant pension and regular IRA assets have a problem. With the exception of after-tax contributions, assets in these accounts represent untaxed income. If the size of the accounts gets large enough, when distributions are required to commence at age 70½ there may be a high rate of tax on the money withdrawn.

Roth IRA distributions are not taxable, and there are no required lifetime distributions. The problem with Roth's has always been in getting assets to the account. Contributions are not allowed when Adjusted Gross Income exceeds $150,000 for a joint filing or $105,000 for a single filer. Rollovers from regular IRA accounts had not been allowed if AGI exceeded $100,000 (computed without regard to the taxable income from the conversion).

The Pension Protection Act of 2006 had made it much easier to move assets from regular to Roth IRA accounts.

- Starting in 2008, qualified plan to Roth IRA conversions are permitted.
- Starting in 2010, the $100,000 AGI limit is eliminated.
- There is a special benefit for 2010 only that allows the income from 2010 Roth conversion to be recognized in 2011 and 2012.

These provisions will also aid the transfer of after-tax contributions from regular IRA's into Roth accounts.

Caution: Roth IRA conversions are taxable transactions to the extent of the taxable income of the distribution. Careful planning is required to minimize income tax on the conversion.

Action:

Individuals nearing retirement should think about engineering low tax years in which Roth conversions can be done advantageously.

2) Inherited account transfers from qualified plans to IRA's are now allowed for non-spousal beneficiaries.

Previously surviving spouses were able to roll over pension plan balances in their own IRA accounts or transfer the balance to an inherited IRA account. These transfers were not allowed for non-spousal beneficiaries. If the pension plan did not allow for extended distribution schedules for non-spousal beneficiaries, accelerated distributions could be forced. Starting in 2007, the law change gives beneficiaries total freedom in transferring pension balances to inherited IRA accounts and in taking lifetime distributions.

Caution: These transfers must be direct account-to-account transfers. Beneficiaries are not allows to receive cash and they redeposit in the inherited IRA within 60 days.

Action:
Owners of pension benefits should review the advantages of naming non-spousal beneficiaries.

3) For 2006 and 2007, individuals over 70½ can make charitable contributions from IRA accounts without recognizing taxable income.

Previously for an individual to make a charitable contribution from IRA assets, a distribution would have to be made, increasing taxable income and then generating a contribution deduction. Unfortunately, many states tax IRA distributions but don't allow for charitable contribution in computing taxable income.

For 2006 and 2007 only, individuals can arrange for contributions to be paid directly to charities from their IRA accounts without generating taxable income. This eliminates the state tax drag on the contribution. These payments also satisfy the minimum IRA distribution requirements.

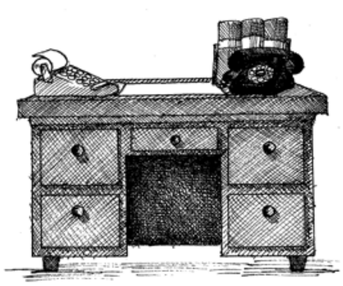
Caution: The money must go directly to the charity. The account owner cannot receive the cash and make the payment.

Action:
Individuals over age 70½ should consider using charitable contributions to meet their minimum distribution requirements.

4) Federal excise taxes refunds are to be claimed on 2006 income tax returns.

Federal excise taxes were charged by long distance companies from 2003 through 2006. After losing a string of court cases on the validity of the tax, the government has agreed to refund the tax. Refund claims are to be included in 2006 individual and business income tax returns. The issue for taxpayers is whether the collection of the information will entail more expense than the amount of the refund.

Action:
Taxpayers should sample a few long distance bills so see if filing for this refund is economic.



2006 Year-end Tax Planning
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