CREATIVE
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"If you were a farmer, would you rather save tax on the purchase of your seed in the springtime and pay tax on the sale of your harvest in the fall, or would you rather pay tax on the seed and sell your harvest without any tax on the gain?"

– Douglas Andrew, *Missed Fortune 101*

CRITICAL PLANNING DECISION: TAX ON THE SEED OR TAX ON THE HARVEST?

If you have any financial aspirations – if you want to make money, save for retirement, buy real estate, invest in the stock market, etc. – you must acknowledge a fundamental fact of financial life:

If you make a profit, the government will tax it.

Once you become aware of this "financial fundamental," you will shortly thereafter be faced with an accumulation decision:

Will you pay tax on the seed or on the harvest?

The seed-or-the-harvest question is author Douglas Andrew's simple analogy to explain the issue that faces any individual who decides to save or accumulate. And Andrew is part of a growing number of financial pundits who are veering away from the conventional thinking of the past two decades which emphasized delaying the payment of tax until the harvest.

Actually, there are three tax options to consider: besides the tax on the seed *or* the harvest, there's also the possibility of tax on the seed ***and*** the harvest. To quickly illustrate:

Tax-on-the-harvest plans are government authorized accumulation plans that allow deposits to be made with pre-tax dollars, i.e., if earnings are deposited directly to such plans, the individual pays no income tax on the deposit. The deposits held in these plans are also allowed to grow (through compounded interest, share appreciation, capital gains) without tax being assessed. It is only when these funds are distributed ("the harvest") that tax is assessed, at the current income tax rates at that time. IRAs, 401(k)s, TSAs, and SEPs are examples of tax-on-the-harvest plans.

Tax-on-the-seed plans are ones in which deposits receive no tax break. However, once invested in the plan, the same

tax-free growth occurs, just like the tax-on-the-harvest plans.

The difference is at distribution, where all disbursements (providing they meet specific regulations) can be taken tax-free. Roth IRAs and Roth 401(k)s fit the tax-on-the-seed format, and with some caveats life insurance cash values are often considered tax-on-the-seed plans as well.

Tax-on-both-the-seed-and-the-harvest plans are savings and accumulation options that offer no tax advantage on the deposit and require tax to be paid as soon as a gain is recognized, even if the owner of the account doesn't distribute the funds. Examples: a simple savings account accepts after-tax payments, and reports a taxable gain each time interest is added to the account; a mutual fund held outside of any government-qualified plan will report taxable income any time a dividend is paid, long- or short-term gains are declared, or the account holder liquidates shares for more than their purchase price. The tax rate may vary depending on the type of gain, but every time a profit is declared, tax will be assessed.

For long-term accumulation, where the expectation is that funds won't be liquidated until retirement, the decision usually comes down to either tax-on-the-harvest or tax-on-the-seed plans.

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How to decide.

Andrew's analogy may be simple to understand, but like anything that involves government regulation, especially tax regulation, the devil is in the details. In making an assessment of the ramifications of paying tax on the seed or the harvest, you could apply any number of evaluation methods – and still arrive at a split decision. For example, ***Andrew provides the following scenario:***

An individual deposits $8,000 a year to a 401(k) for 25 years and 4 months. Assuming a 7.5% annual rate of return, the account balance will grow to approximately $600,000. If this individual was in the 33.3% marginal tax bracket during these 25 years of accumulation, the annual savings on the deposit would be $2,666, (i.e., the tax-on-the-harvest plan allowed the $8,000 of earnings to be deposited without $2,666 of tax assessed). For 25 years, that results in a tax savings of $66,650.

Now the individual decides to begin retirement, withdrawing $45,000 each year. At a marginal tax rate of 33.3%, this means $15,000 of the retirement distribution pays taxes and $30,000 stays with the individual. Andrew's conclusion:

> *"You will pay back every dollar you saved in tax on twenty-five years of contributions during the first four and a half years of retirement (4.5 x $15,000 = $67,500). If you live twenty-two years after retiring, you'll potentially pay back five times more in taxes during the distribution phase than you saved in taxes during the contribution phase."*

Wow. Sounds like a steep cost to pay at harvest, doesn't it?

Of course, there might be another way to look at it…

Let's suppose the same individual put $8,000 in a tax-the-seed plan. Assume the same tax rates and the same rate of return. What happens?

First, only $5,334 gets deposited each year, because $2,666 is paid in taxes. After 25 years and 4 months, the account balance has grown to $400,000 – one-third less than the hypothetical 401(k) account in the previous example.

In the tax-on-the-harvest plan, the $45,000 distribution netted $30,000 after-tax, and did not reduce the principal. With a tax-the-seed plan, there's no tax on distribution, so a $30,000 withdrawal accomplishes the same net result. Same amount of money in the pocket, same preservation of principal.

Hmmm. That sure looks like a split decision. And it is.

Except…

Tax rates aren't static. They change all the time, either because legislation changes or our financial situation changes. In a graduated tax system like ours, your top tax rate could be 15%, 28%, 31% – hey, during World War II it was as high as 90%! And your marginal tax rate isn't only a factor of the size of your income. It's also contingent on your deductions: for dependents, charitable contributions, medical expenses, mortgage interest, etc.

Rates of return aren't static either. An accumulation vehicle might produce an average annual return of 7.5 percent, but it's very unlikely it will earn 7.5 percent *each* year.

And given other financial circumstances, maybe contributions won't be regular either. Maybe they are higher before the kids are born, drop when you buy a house, go up after that promotion, stop while you're paying for college, and catch up when you've emptied the nest.

With such flexible variables, even simple assumptions make for almost impossible calculations. Let's try an "easy" example:

Phase 1: Take a young couple, just married, working two entry-level jobs. They want to save – for retirement, and for a house – but also have student loan debt.

Phase 2: Husband gets a promotion; couple buys a house, starts a family. Wife stays home with the youngsters. Lots of deductions, and a drop in income. The stock market is booming.

Phase 3: Kids go to school, wife works part-time. Family is growing, needs a bigger house. Couple starts thinking about paying for college. There's a correction in the stock market, but real estate is hot.

Phase 4: Both are working full-time, hitting their peak earning years. In fact, there's more money available than can be deposited to the plan. Kids are moving out. Might be nice to buy a second home (that mortgage interest deduction would really make a difference).

Phase 5: Is it retirement or semi-retirement or a second career? There's part-time work, travel, and wondering whether a major medical incident could turn into a financial catastrophe.

Got it? So, armed with this information, go ahead and select a marginal tax rate. In fact, pick several. Same thing goes for rates of return, and contribution levels. Do you really think your assumptions are anything more than educated guesses? Can you confidently choose between a tax-on-the-seed or tax-on-the-harvest plan based on mathematical analysis?

It's not just the mathematical part of the evaluation that's problematic. There are other devilish details to consider, like annual contribution limits, minimum distribution requirements, early withdrawal penalties, hardship exceptions, etc. Does your employer offer a plan? What is your adjusted gross income? Answers to those questions can affect your decision as well.

Even after you've sifted through all the details relevant to your current situation, you must also account for factors beyond your control. You may be able to make educated guesses regarding your particular circumstances – future income, expenses, and deductions - but you can't account for what the government might do (change the rules, change the rates) or what might occur in the economy.

At this point, the simple question of "tax-on-the-seed-or-on-the-harvest" probably looks a bit more complicated. Overwhelmed, you might just throw the whole idea out the mental window of your conscious thoughts and channel surf for a "Seinfeld" rerun. But assuming you want to make an intelligent decision, you have three choices.

1. Become an expert on the various types of tax-advantaged accumulation plans. There are plenty of sources of education. There are books, television programs, and classes. Do an Internet search ("retirement plans" yielded over *89 million* results). This is your money, and your financial future.

It doesn't have to become an obsession, but would it hurt to make your financial program one of your hobbies?

2. Get expert assistance – and act on it. Competent financial professionals make their living by obsessing about the details and issues that impact a decision to participate in tax-advantaged accumulation plans. If you don't want to make your financial plans a hobby, then get some help.

And assuming you find a good financial professional, take action on the conclusions that follow! A recent survey of 300 financial professionals commissioned by ING found that one of the biggest frustrations encountered by them was the reluctance or unwillingness of clients to take action.

3. Look for alternatives. Ian Hodge, in his book *Making Sense of Your Dollars* (Ross House, 1995) offers this pithy comment:

> ***Never, ever make investment or business purchase decisions based on tax considerations – unless you can afford to lose the investment. For starters, the government will probably change its mind next week and the advantage you hope to receive will fail to materialize. Since there is no way to protect yourself from arbitrary legislation, it is best not to have your wealth dependent on the whims of the politicians.***

A somewhat cynical perspective, perhaps, but worth noting.

There are plenty of options besides tax-on-the-seed or tax-on-the-harvest programs. After a thorough analysis, you just might find there are alternative approaches that offer more flexibility, more benefits – and more money.

The question of whether you will pay the tax on the seed or on the harvest is a critical financial decision. But no one said your best decision might be finding a different plan.

Want to become an expert? Or do you want assistance? Want alternatives? Contact us to talks about it.

TWO "BIG MONEY" LISTS – AND A PROVOCATIVE WEBSITE

THE ANNUAL BIG MONEY LIST

Every year, *Forbes* magazine trots out an updated list of the richest individuals in the world. For the 12th year in a row, Bill Gates topped the list, with an estimated net worth of $50 billion (although the combined net worth of the four heirs of Wal-Mart founder Sam Walton would exceed Gates).

THE ALL-TIME BIG MONEY LIST

Not to be out-done, the on-line magazine AskMen.com recently posted the ***Top 10 Richest Men of all Time*.** The magazine consulted with economists, financiers and historians to rank these individuals by wealth in 2001 US dollars. According to AskMen.com writer Dennis O'Connell, this meant considering "inflation, GDP growth, currency exchange rates and fluctuation in share prices."

THE ANNUAL BIG MONEY LIST

Rank	Name	Country	Est. Net Worth	Source of Wealth
1	William Gates, III	USA	$50 billion	Microsoft
2	Warren Buffet	USA	$42 billion	Berkshire Hathaway
3	Carlos Slim Helu	Mexico	$30 billion	Telecom
4	Ingvar Kamprad	Sweden	$28 billion	Ikea
5	Lakshmi Mittal	India	$23.5 billion	Steel
6	Paul Allen	USA	$22 billion	Microsoft and Investments
7	Bernard Arnault	France	$21.5 billion	LVMH
8	Prince Alwaweed Bin Talal Alsaud	Saudi Arabia	$20 billion	Investments
9	Kenneth Tompson Family	Canada	$19.6 billion	Publishing
10	Li Ka-shing	Hong Kong	$18.8 billion	Diversified

THE ALL-TIME BIG MONEY LIST

Rank	Name	Country	Est. Net Worth
1	John D Rockefeller (1839-1937)	USA	$200 billion
2	Andrew Carnegie (1835-1919)	USA	$110 billion
3	Cornelius Vanderbilt (1794-1877)	USA	$100 billion
4	John Jacob Astor (1763-1848)	USA	$85 billion
5	William Gates III	USA	$60 billion
6	Larry Ellison	USA	$55 billion
7	King Fahd Bin Abdul Aziz Alsaud	Saudi Arabia	$30 billion
8	Warren Buffet	USA	$28 billion
9	Paul Allen	USA	$25 billion
10	Sheikh Zayed Bin Sultan Al Nahyan	Saudi Arabia	$23 billion

(Of the top 10, six are alive today. But the top four are all from the past, and all made their fortunes in either the 19th century or the start of the 20th century.)

The Web Site – Where Do *You* Rank?

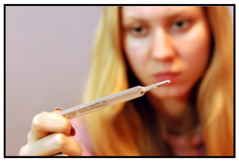
Hey, you probably didn't see your name on either of the above lists. And a $20 billion net worth probably exceeds your personal wealth by a pretty significant multiple. But more than likely, your annual earnings still place you far above the rest of the world. Want to see how far? Pay a visit to **www.globalrichlist.com**. Enter your annual income, and find out where you stand in relation to the rest of the global community.

For example, an individual with a $100,000 annual income is among the top 0.6 percent of the richest people in the world. Using the web site's numbers, that means there are 5,963,992,435 people poorer than you.

NEWS DIGEST

(Snippets from stuff we've read, including differing points of view, not all of which we agree with. Want to know more? Give us a call and we can provide you with the complete article.)

DISABILITY RISK GREATER FROM ILLNESS THAN ACCIDENTS



A survey by the Consumer Federation of America and the American Council of Life Insurers found that 82% of people do not have long-term disability insurance or believe their coverage to be inadequate. Yet according to America's Health Insurance Plans, one-third of working adults say that their families could only live for three months or less on their savings, if the primary wage earner lost his or her income due to a disability.

"It's not just those with hazardous jobs or dangerous hobbies that have to be concerned; in reality illnesses keep more people out of work than accidents. Americans need to get beyond the misconceptions and make sure they are financially protected in the not-so-unlikely event they suffer a disability during their working years," said David F. Woods, president of the non-profit LIFE Foundation.

Business Wire, March 3, 2006.

HIGH-DEDUCTIBLE HEALTH PLANS ARE BOOMING

Nearly 3.2 million people were covered by high-deductible health plans in January, American's Health Insurance Plans reported Thursday. That's more than triple the number of people covered by the new breed of benefit less than a year earlier, according to AHIP.

High-deductible plans paired with Health Savings Accounts are appealing to employers and consumers because they carry lower deductibles than traditional health plans and offer people a pretax option for saving money. "This is a very significant increase" in enrollment, said AHIP President and CEO Karen Ignagni.

Katie Merx, Detroit Free Press, March 10, 2006.

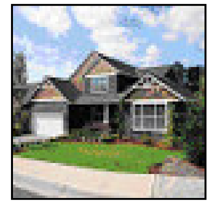
FED SOLUTION: RAISE RETIREMENT AGE, RAISE TAXES, DECREASE BENEFITS

Raising the U.S. retirement age faster could help the United States weather the fiscal strains of the retiring baby boom generation, St. Louis Federal Reserve Bank President William Poole said on Friday.

"Clearly, as a matter of arithmetic, we're going to need some combination of higher taxes or lower outlays because the current outlays are outrunning the projections of the tax revenues," Poole told a St Louis Forum luncheon. "I think what we should be looking at, as much as we can, are reformed ideas that improve the efficiency with which we make the spending. I think it might be desirable for us to move more quickly to extend the retirement age, for example," he added.

Reuters, February 24, 2006.

AMERICANS USING UP THEIR HOME EQUITY? MAYBE NOT



The popular image is that America's homeowners are turning into debt junkies, hocking their houses to the hilt, and are banking on double-digit appreciation rates to bail them out. Among 2004-2005 borrowers: Nearly one out of 10 was in a zero or negative equity position as of last September. Five percent were in negative territory by more than 10%. Nearly 30% had equity cushions of less than 20%. Forty-four percent had less than a 30% cushion.

But overall, the state of the nation's home equity holdings is hardly so dire. The First American study cites Federal Reserve research that found, contrary to some critics' assumptions, most of American homeowners have plenty of equity – 57% stakes on average as of the third quarter of 2005.

Kenneth Harney, *The Nation's Housing,* February 26, 2006.

NEW RETIREMENT PARADIGM: PART-TIME WORK, HEALTHY DIET AND EXERCISE

One thing is clear – many people will struggle at some point in their retirement years if they continue to cling to the outdated notion that they should stop working at age 65. Reasons…

The average 401(k) balance for people in their 50s and 60s is only a little over $100,000.

The average American life span is increasing. One out of four Americans who reach 65 will make it to age 90.

A more viable model is what I call "phased retirement." You secure your future by working at least part-time in your 70s and making wise investments. Of course, you need to maintain your health through diet and exercise, which will help to prevent costly medical problems as you get older.

Steve Vernon, *Bottom Line Personal*, February 15, 2006.

AVERAGE U.S. INCOME DOWN

After the booming 1990s when incomes and stock prices soared, this decade has been less of a thrill ride for most American families.

Average incomes after adjusting for inflation actually fell from 2001 to 2004, and the growth in net worth was the weakest in a decade, the Federal Reserve reported Thursday.

Average family incomes, after adjusting for inflation, fell to $70,700 in 2004, a drop of 2.3 percent when compared with 2001. That was the weakest showing since a decline of 11.3 percent from 1989 to 1992.

The Fed's results were published in the 2004 Survey of Consumer Finances, a document which provides a comprehensive view of how Americans are faring on such pocketbook issues as incomes and net worth.

Martin Crutsinger, *Associated Press*, February 24, 2006.

WHEN GIVING COUNTS AGAINST YOU

It's not exactly a Law of Nature, but it's accurate to note that all human laws, even those crafted with the best of intentions, inevitably cause unforeseen consequences. A current example of unforeseen consequences might be legislation passed January 31, 2006 regarding the determination of individual eligibility for Medicaid long-term care benefits.

A portion of the Medicaid program provides long-term care coverage for those who can't afford it on their own. The intent is to provide nursing home care and other assistance for those individuals who have limited financial and familial resources to cope with the challenges of declining health, debilitating disease and dementia. Obviously, Medicaid can't provide these benefits to everyone; thus the government insists on using various eligibility tests to ascertain which individuals are truly "qualified" to receive this assistance.

Here's where unforeseen consequences enter the equation. As Joel Belz notes in a February 25, 2006 *World* essay, "in good entrepreneurial (but sometimes dishonest) style, folks seeking aid have through the years sought ways to quietly move assets off to their children or other safe parking spaces."

Sensing the end-run, the government has in the past attempted to close qualification loopholes by imposing a three-year "look-back" that includes all "gifts" (to children, relatives, etc.) when calculating one's eligibility for benefits. Using an example provided by Belz: "If Aunt Mabel decides to give her $100,000 house to her struggling son in the hopes that her own assets will be reduced, she discovers to her chagrin that Medicaid will immediately also trim $100,000 from her future benefits."

Even with these restrictions, it was Congress' perception that creative individuals were still gaming the system. Their solution: make a new, "better" law. The look-back period for disallowing asset transfers is extended to five years. And now, *all* charitable contributions during that five-year period – including donations to churches, service organizations and charities – are included in the amount that will be calculated for the reduction of benefits.

For people like Belz's Aunt Mabel, this law creates a dilemma: As they age, they must constantly weigh the desire to give to charities against the possibility that doing so may artificially inflate the calculation of their assets and reduce the likelihood of receiving assistance in their old age.

Hmmm… Based on these conflicting incentives, will the government also provide guidelines on when people should *stop* giving to charity, so as to preserve their chances to receive full benefits?

PRACTICAL MEASURES TO PREVENT IDENTITY THEFT

The Information Age has resulted in many far-reaching societal changes. Never before has so much data been available to so many people so quickly. This proliferation of information and connection means new ways of doing business, new ways of conducting personal relationships – and new ways of stealing.

Identity theft occurs when personal information, such as name, date of birth, Social Security Number (SSN), financial account or credit card numbers is illegally appropriated and used by another person.

The Federal Trade Commission estimates that 1 of every 20 Americans is affected by identity theft. It received 246,000 reports of identity theft last year, nearly triple the number received in 2001. While the FTC has attributed much of that rise to heightened awareness of the issue among consumers, making them more likely to report incidents as identity theft, accurate statistics on identity theft are still spotty.

In many cases, individuals aren't certain that they are truly crime victims and don't know how the incident occurred. Further, research has found that most victims of identity theft don't report the crime to police; usually the contact is with the bank or financial institution from which the theft occurred. And while banks increasingly alert authorities when incidents occur, even those disclosures can be incomplete.

Besides adopting the information safeguards being introduced by financial institutions and communication providers (such as encryption software, secured accounts and the like), there are things you can do to minimize your exposure to identity theft. Culled from several sources, the list below is not exhaustive, but offers practical insight into areas of vulnerability and preventive measures.

Stealing mail and sorting through garbage ("dumpster diving") are simple, low-tech ways identity thieves operate. Therefore,

- **Shred all offers of pre-approved credit, and any other mail which contains personal information.**
- **Consider a P.O. Box or some other locked/secured mailbox.**
- **Ask the post office to hold your mail when on vacation or out of town.**
- **Don't put outgoing mail in unlocked or open mailboxes.**
- **Cut up or destroy old credit cards.**
- **Only put the last 4 digits of your credit card account number on the "memo" of your payment check. The credit card company will know your account number, but a thief cannot guess the rest of it.**

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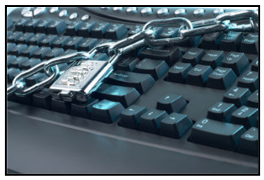
If an ID thief gains access to your Social Security Number, all sorts of bad things can happen. Even though your SSN is your de facto personal identification, be very cautious about giving it out – to anyone.

- **Do not carry your Social Security card (or military ID) in your wallet or purse.**
- **If your state driver's license has your SSN printed on it, contact your DMV to request a different number.**
- **Ask if other ID verification is possible. Many legitimate service providers offer alternative forms of ID verification if you don't want to provide your SSN.**

The Internet can give a local thief global access to other's financial information. As part of your personal protection,



- **Use a firewall on your personal computer, and keep it updated.**
- **Memorize computer passwords. If you can't memorize them, keep them in a secure place – away from the computer (not in your wallet, and not on a post-it note stuck to your monitor!).**
- **Delete e-mails from unknown senders.**

Finally, implement some sort of monitoring system. Several companies offer forms of ID protection/insurance. For a fee, these firms offer assistance in tracking your credit reports, closing or changing accounts, and re-establishing your credit should a theft occur. Whether you choose to use these services or not, you should exercise some regular due diligence.

- **Order copies of your credit report regularly.**
- **Verify all financial statements monthly.**

Most of these recommendations are common-sense types of things. In the course of human history, theft has been a constant threat. The format may change, but the basic issues – and remedies – are the same. Be cautious, careful and alert. Avoid trouble before it has the chance to cause problems.

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