Sentinel

Personal Financial Management Ideas

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Sentinel, Looking Back And Looking Forward

Larry M. Elkin, CPA, CFP®

A lot has changed since I published the first issue of this newsletter, but a surprising amount has not. Both are reflected in the first paragraph of that May 1993 edition, from an article titled "For The Best Gifts, Keep On Giving."

"Much has been made about last year's abortive effort in Congress to reduce the $600,000 gift/estate tax allowance (the "unified credit" amount) to $200,000," I wrote. "Just this week, another somber-sounding tome crossed my desk warning of attempts to revive the proposal later in 1993 and urging readers to make their big gifts now. (Like many somber-sounding tomes, this one came from an insurance company which suggests that the big gift would best be made in the form of an insurance policy.)"

Today that unified credit amount is $11.58 million, a nearly 20-fold increase. The threatened reduction to $200,000 never happened, but efforts to roll back the tax-exempt allowance continue. Also as in 1993, life insurance companies still tend to present their product as the perfect vehicle for nearly any financial strategy. Those claims still warrant close examination.

I launched the newsletter less than six months after I left Arthur Andersen, then the world's largest accounting firm, to open my own financial planning practice in Westchester County, New York. Naturally, I referred to my new enterprise as the world's smallest accounting firm, at least for a little while.

At first I worked alone in a small office my wife found for me in a converted movie theater in the village of Hastings on Hudson. The name of that building, Moviehouse Mews, appeared on the front page of the newsletter for the next eight years. I named my new publication *Sentinel*, after a mountain that stands next to the University of Montana campus in Missoula, from whose journalism school I had graduated in 1978.

I was not a fan of most financial firm newsletters. Even the best seemed canned and antiseptic, designed to showcase the smarts of their authors without risking offense to anyone who might ever become a client or a referral source. Someone like an insurance agent, for example.

The cachet of running the world's smallest accounting firm wears off pretty quickly. My goal for my new business was to build an enterprise that could eventually prosper even beyond my own working career. To do that, I needed to attract clients and staff to serve them. Why should any of them choose me when they could go to a larger, better-known firm? My best hope was to communicate my views and my personality, as well as my knowledge, as widely as possible.

Inevitably, this meant taking positions that upset some people. Long-term care insurance was being heavily marketed in the 1990s; I was convinced that the product's economics made no sense. My colleagues and I wrote many times in *Sentinel* that the product could not work, and usually we received (and printed) irate rebuttals from those in the industry. But the product did prove to be a financial debacle for many companies that offered it and consumers who bought it.

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Inside This Issue Of *Sentinel*

What Ails The Internal Revenue Service?

Paul Jacobs, CFP®, EA

Few people feel sympathy for employees of the Internal Revenue Service. But as the government asks them to take on increasingly complex tasks with dwindling resources, the pressures on the agency are becoming obvious even to the least sympathetic observers.

Since 2011, Congress has dramatically slashed IRS funding. Larry Elkin observed as much in this space in April 2015, in his post "Hollowing Out The IRS." The trend has continued in the years since. According to ProPublica, the IRS enforcement budget is a quarter lower than it was in 2010 (adjusting for inflation). The IRS workforce is 21% below its level eight years ago, and the number of examiners who perform audits shrank by 38% between 2010 and 2017. Staff numbers for criminal investigators and collections officers are also down.

Part of this reduction has been strategic on the part of lawmakers. Many fiscal conservatives have touted the idea of "starving the beast" as a way to reduce government bureaucracy through budget cuts. Even today, certain legislators publicly question whether money spent on the IRS would yield any return on investment. The Service's reduced funding also reflects the political reality that it is hard to sell voters on the idea of increasing the IRS' budget once it has been cut back.

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Tax professionals have noticed the consequences for years. I remember a time when you could reach someone at the Service by phone without too much trouble. These days, you can forget it. As far back as 2016, only 38% of callers trying to reach an IRS employee succeeded. Everyone else either gave up after a long hold time, found themselves disconnected or ran into the wall of a busy signal. Perhaps more critically, the IRS does not have the resources to meet its main objective: collecting the taxes that fund all other government programs. The U.S. is losing significant revenue due to IRS understaffing – $18 billion per year, by one estimate from ProPublica.

It is within this environment that Congress delivered a major tax reform package in 2017, including some complicated new rules. For instance, consider the deduction for qualified business income. The QBI deduction rules, as written, deliberately included large gray areas. As my colleague Anthony Criscuolo explained his May 2019 *Sentinel* article, "A New Tax Break Was Hardly 'Simplification,'" the rules governing specified service businesses and rental real estate are far from clear-cut. The new rules made for a very difficult tax season for most tax professionals. It may be even more difficult for IRS examiners to review tax returns that were affected by the new rules and to catch misstatements (whether intentional or unintentional).

In the meantime, audits of complex returns are falling, which means that proportionally more taxpayers with simple returns face audits these days. Low-income taxpayers who claim the earned income tax credit accounted for almost 40% of the IRS' total audits in 2018. While mistakes involving the earned income tax credit are relatively easy to catch and are a form of low-hanging fruit for the IRS, correcting the improper credit claims doesn't lead to significant additional revenues.

In contrast, auditing complex returns could lead to higher revenues, but these audits require many hours from experienced senior auditors. Those experienced auditors have been leaving at higher rates due to heavy workloads. It's also worth noting that overall audits are down to a mere 0.59% of individual taxpayers, the lowest level since 2002. There may be more simple audits than complicated audits, but there are not a lot of either type.

IRS Commissioner Charles Rettig issued a report in September, responding to congressional criticism of the Service's auditing practices. He expressed a desire to fix the imbalance lawmakers identified but said frankly that the IRS can do no such thing unless Congress

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The Elusive Right-Sized Emergency Fund

Benjamin C. Sullivan, CFP®, CVA, EA

Determining an emergency savings fund level that is right for you takes a bit more thought and effort than pulling a number from a headline or rule of thumb.

Emergency funds protect against the inevitable bumps in our lives, but how much should you set aside? There are plenty of answers in the media, but none of them is right for you. Human beings tend to like certainty, even on subjective questions. Rules of thumb play a role in financial planning, but one-size-fits-all answers are bad financial advice.

A common benchmark for emergency funds is that you should have enough saved to cover three to six months of expenses. Some analysts have suggested a more modest aim of six weeks of take-home pay, though a recent study from JPMorgan Chase found that two-thirds of American households still fall short of that mark. These suggestions at least use your personal earnings and lifestyle under normal circumstances as a starting point. Recently I encountered a study from economists that did not. Instead, they offered a true one-size-fits-all suggestion: Save a minimum of $2,467.

The theory goes that this figure is roughly one month of income for a lower-income household. It is enough to serve as a one-time buffer against missing a rent payment or falling behind on student loans. Emily Gallagher, a professor at the University of Colorado and an economist for the Federal Reserve Bank of St. Louis, told MarketWatch that once someone has at least $2,467 saved, the probability of short-term financial hardship drops. Researchers found that emergencies costing hundreds of dollars are much more common than emergencies that cost thousands.

The economists who conducted the study suggested that $2,467 is an attainable and practical goal for people struggling to save at all. But what if you are not that person? Even the broader rules of thumb – a certain number of weeks or months' worth of expenses or income – don't offer a full picture of how much you should save. The best financial advice is always customized.

Consider the opportunity cost of setting aside money in an emergency fund. Maybe you can't pay down high-interest-rate debt, or you can't go out to eat so often, or you can't max out contributions to your retirement account. Just as you can save too little for emergencies, you can also save too much, meaning you have less to invest or devote to other priorities. You should understand the trade-offs you make when deciding on a specific size of emergency fund.

While this article can't tell you how much you should set aside for emergencies, I can suggest some questions you should consider to come to the right answer for you. (This is not meant to be an exhaustive list, so give some thought to your own circumstances and priorities.)

• How comfortable are you with risk? Some people sleep better at night with a bigger cushion at the ready in case of the unexpected. It is OK to sacrifice financial optimization for a little extra security, but recognize that your savings account can lose value to inflation over time. Keeping more cash readily available means having less to invest for higher returns elsewhere.

• How do you define the word "emergency"? Some emergencies are clear-cut: a burst pipe that floods your living room, a broken ankle or a lost job. Some things are also obviously not emergencies. You should not dip into your emergency funds for an unplanned vacation. But what happens if you need a new car sooner than you expected? Some people build flexibility for this sort of expense into their standard budget. For others, this would be a significant unexpected and involuntary expense. The clearer you are with yourself about how you plan to use the fund, the easier it will be to determine how much you should save.

• How high are your insurance deductibles? If you have to deal with a significant issue with your health, your home or your car, your deductible will determine how much you need to cover before your insurance will take care of the rest. If you don't have insurance at all, your exposure to losses is even greater, which may lead you to need to save more.

• If you run into an expense larger than your emergency fund, what is your plan B? Can you ask family members

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A New (But Not Improved) Retirement Option

Paul Jacobs, CFP®, EA

The SECURE Act is primed to make annuities available in more retirement plans. But just because an investment is available does not make it a good idea.

The Setting Every Community Up for Retirement Enhancement Act will affect retirement planning in a variety of ways. I have written in this space about some of the changes it will make to individual retirement accounts in my December 2019 post, "'Stretch IRAs' Snap Back." The law will also result in many other changes to IRAs, required minimum distributions and employer-provided retirement plans. Among these changes are new protections for defined contribution plan sponsors who offer annuities to participants.

Before the new law, annuities were rare in workplace retirement plans. According to the Plan Sponsor Council of America, as reported by CNBC, only 10% of 401(k) plans currently offer annuity options. In large part, employers avoided annuities out of fear that they could be held liable if an insurer failed to meet its promised obligations. The new law provides safe harbor for plan sponsors who offer annuities as long as they follow specific guidelines for choosing insurers, even if an insurer later goes under. This makes it more likely that employers will offer annuities in their 401(k) plans.

This is a big win for one specific group: people who sell annuities. Annuities are often expensive, which makes them particularly attractive to people who earn commissions by selling them. Brokers often earn as much as 6% or 7% on an annuity sale. It is little wonder that the prospect of more people buying annuities excites them. For investors, however, the change demands caution rather than celebration.

Annuities are designed to provide a steady stream of cash, usually in retirement. While they are often packaged like investments, annuities are better understood as insurance products. The specifics vary, but at their core, an annuity is an insurer's promise to pay you on a schedule. You give an insurer a particular sum, either all at once or over time. The insurer then makes regular payments for a period of time, often to the end of the annuity owner's life. In exchange for this certainty, annuity owners typically pay high fees and operating costs, and are subject to steep surrender charges that apply for long periods.

Besides being expensive, annuities are also complex. This complexity means that the word "annuity" can indicate a variety of functionally different products. Common examples are fixed annuities, which pay out at a predetermined interest rate, and variable annuities, which can offer a larger payout depending on the performance of underlying investments. Various types of annuities offer different conditions and rules, and none come cheap. When you factor in all the potential variations in terms, conditions and structures, one annuity may look very little like another. It becomes essential for a prospective buyer to look closely at any individual annuity's prospectus in advance, though these can often run hundreds of pages.

Most of the time, investors will get a better retirement planning outcome elsewhere. This is because insurers price in the fact that annuity buyers are shifting investment risk to them. Yes, you can lock in a steady payment for life with an annuity – but the rate of return you lock in is generally quite low.

In a low interest rate environment like the current one, the cost of guaranteeing lifetime income is relatively high. This is because insurers don't stand to earn much from safe, stable investments. And if interest rates rise, you will have locked in today's low interest rate for many years to come, if not the rest of your life. Locking yourself out of future rate increases would be frustrating on its own, but could be disastrous if inflation starts to rise too. Even though your payout is guaranteed, its purchasing power could fall. If you eventually want out of the annuity, contract terms and the insurer's surrender fee structure can effectively lock you in for years.

Another serious risk in purchasing an annuity is early mortality. In other words, what if you die much sooner than you expect? Some annuities include a minimum payout if you die before a certain, relatively young, age. But in general, your heirs cannot recoup the excess of the amount you paid into the annuity if you die sooner than you expect. You can add certain riders that may allow for some amount to pass to your heirs in particular circumstances. Annuities

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structured this way, however, will be even more expensive as a rule. In the end, insurers are businesses, and their goal is to not lose money when they sell annuities.

Annuity supporters argue that, as defined benefit plans continue to vanish, workers need the assurance of a steady retirement payout. But there are other ways to generate a steady income stream. Annuities offer tax deferral, but so do traditional IRAs. In many cases, so do the company-provided retirement plans in which potential investors are already participating. It is true that these accounts do not come with guarantees. But they offer more cost-effective ways to invest, increasing the potential size of your nest egg. Gains on annuities are also taxed as ordinary income, rather than at the lower long-term capital gains rate. This is not to say there are no circumstances in which an annuity makes sense – but in my experience those circumstances are rare and specific.

Before the SECURE Act shielded them, employers did not want to take on the risk of recommending an insurer that could later go bust. But maybe if an employer is convinced that its retirement plan should offer an annuity, that employer should shoulder the blame if the insurer fails, the same way it would face liability if other parts of the retirement plan were mismanaged. The guarantee that makes an annuity valuable is only as strong as the company issuing that guarantee. Insurers have done themselves no favors when it comes to their reputation for honesty and transparency, especially when it comes to annuities. Rules absolving retirement plans from thorough due diligence should make participants more vigilant about their choices.

Of course, just because plans can offer annuities with less risk of being held responsible if they fail does not mean they will open the floodgates. Issues of cost and complexity may limit employers' appetite for including annuities in their 401(k) or other defined contribution plans. This is especially true for smaller businesses with fewer resources to devote to researching their options. The safe harbor rules do not mean plan sponsors are absolved from their fiduciary responsibilities altogether. Even in plans that do offer annuities, there is no guarantee that significant numbers of participants will want them. Plans will not be able to make an annuity a default option under the new rules, meaning individuals will need to opt in if they want them.

At Palisades Hudson, we rarely use or recommend annuities when planning a retirement strategy for our clients. This is not because they aren't available. In most cases, annuities are simply the wrong choice. Making annuities available in a 401(k) or other employer-provided plan is a change the average person didn't need, didn't want and didn't ask for.

If you are set on considering the annuity options coming to your 401(k), consult a fee-only financial professional – in other words, someone you know will not earn a commission if you do decide to buy an annuity. Investors should proceed with extreme caution, even as lawmakers gave retirement plan sponsors the all-clear.

This article originally appeared on our blog, "Current Commentary," on Feb. 4, 2020.

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for help? Do you have access to a preapproved credit line, such as a home equity line of credit (or HELOC), that you can draw on? Can you take a loan from a retirement plan, such as a 401(k)? Can you sell investments? Or will any excess spending end up on your credit cards? All these options have costs, but your access to them and their overall impact on your finances can vary widely.

• What do you do for a living? Some jobs have a lot of built-in security, and some are in high demand, which would make it easy to find a new position if you needed to. Others are more inherently precarious. Where you live may also affect this question; you may be more confident of finding a new job if you live in or near a major metro area. You should also be honest with yourself about how willing you would be to take a lower-paying position if you needed to make ends meet.

• How flexible are your monthly expenses? Some regular expenditures, such as eating out, spa treatments or shopping,

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are easy to cut if you need to streamline your cash flow. Others, such as student loan or mortgage payments, are more or less fixed. If you are able to reduce or eliminate many of your monthly expenses in case of an emergency, you can comfortably afford to save less.

• What are your annual expenses, and when are they due? For instance, you may only pay real estate taxes or an insurance premium once or twice a year. But if those payments are due in the middle of another emergency, you will want to know you can cover them.

• How many real and tangible assets do you own? You shouldn't consider the preceding questions in isolation. If you own multiple properties and vehicles, all with their own insurance policies and maintenance needs, you will need a higher cash reserve in case things go wrong in multiple places at the same time.

However much you decide to save in your emergency fund, remember that the entire point is for the funds to be accessible. You should be able to get at your money relatively quickly, with little risk that it will decline in value. That means you should not invest your emergency fund in the stock market. Even certificates of deposit are not ideal if their terms are long and you face early surrender charges if you need the money before the end of the term. Look for investments with maturities of three months or less, and keep at least some of your emergency fund in money market funds or a high-yield savings account.

Like most financial planning decisions, funding an emergency account is not a one-time event. You should replenish any withdrawals, of course. But you should also revisit your savings level every few years, or if you face a major life event such as marriage, the birth of a child or a major promotion. The right level a few years ago may not be the right level for you today.

As for me, I tend to be conservative in my spending and my savings rates, which came in handy when I had to replace a car recently. My emergency fund level might be too high, but I can add that to my list of financials sins.

This article originally appeared on our blog, "Current Commentary," on Nov. 15, 2019.

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restores its funding. While some proposals to increase enforcement spending have emerged in both the House of Representatives and the Senate, none would restore the budget to pre-2011 levels. So far, lawmakers are much less eager to increase the Service's budget than they are to point fingers over its attempts to cope with its lack of resources. The QBI deduction, like much of the 2017 tax reform, will expire at the end of 2025 if Congress does not extend it. But it seems unlikely that a simpler tax code is in our future. The candidates for the 2020 Democratic presidential nomination have begun unveiling tax plans, many of which would add new levels of complexity. Bernie Sanders has advocated adding more tax brackets for top earners and instating a wealth tax. Elizabeth Warren has also supported a wealth tax and has included enough details of her plan to get commentators discussing the array of complications it would introduce (assuming it is even constitutional, a proposition almost certain to be challenged). If a wealth tax became law and withstood legal challenges, it would require a massive increase in manpower at the IRS, along with significant investments in training and expanded infrastructure.

As time passes and it becomes clearer that the IRS is not doing its job of catching and fixing incorrect tax returns, more and more taxpayers will notice. They may feel less compelled to rigorously follow the letter of the law as a result. This could lead to a downward spiral in which people cheat on their taxes, leading to less revenue, leading to more IRS cutbacks, leading to even more people cheating on their taxes. Even if none of the complicated new tax proposals candidates are discussing become law, the combination of budget cuts and new complexities like the QBI deduction may create enough problems to shake the foundation of our tax system. In the future, if Congress makes taxes complex enough and cuts funding sufficiently, the IRS could simply fall apart.

This article originally appeared on our blog, "Current Commentary," on Oct. 30, 2019.

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Another frequent topic was same-sex marriage. Just before launching *Sentinel*, I completed the first draft of "First Comes Love, Then Comes Money," which was the only book at the time that focused on financial planning for unmarried couples. Doubleday published it in 1994, followed by an updated paperback edition a year later. There were no legally recognized same-sex marriages anywhere in the world at the time.

With the 1996 elections approaching, Congress passed the Defense of Marriage Act. It declared that the federal government would not recognize any same-sex marriage and that no state was obligated to recognize such a union performed in another state. I was working with gay clients to protect the financial interests of their families, and I did not feel the situation called for mincing words.

"Nasty things sometimes crawl out of legislative bodies in an election year," was the lead of a page 1 story in the August 1996 issue. On page 2, I recounted the legal history of interracial marriage leading up the 1967 Supreme Court decision in *Loving v. Virginia*, which declared marriage to be a fundamental right. I predicted the court would eventually reach the same conclusion regarding same-sex marriage.

"Sure, Justice Antonin Scalia will dissent, as will Justice Clarence Thomas … But the majority of the Court, like the majority of the country, can be counted on to be fair-minded in the long run as the current of history carries us past the noisy gaggle of haters on the shore," I wrote.

It took some time, but in 2015 the Supreme Court reached exactly the conclusion I expected in *Obergefell v. Hodges*. Justices Scalia and Thomas were among the dissenters in that 5-4 decision. But in the five years since, same-sex marriage has all but ceased to be controversial. I am pleased that *Sentinel* was around to see that process through.

Other issues have not reached nearly so satisfying a conclusion. In 2005 we made Social Security's history, structure and precarious future the focus of an entire issue. President George W. Bush was pushing for an overhaul that would have allowed the millennials just joining the workforce to put money into private accounts, rather than funding retirement benefits for aging boomers. Social Security's trustees at the time were predicting its old age and disability insurance fund would run out of assets in 2042. Restructuring – which would have required an increased retirement age or reduced benefits, or both – could have been phased in gradually, protecting workers close to retirement age.

Nothing happened. While Bush no longer faced future elections, members of Congress did – and do. While "protecting" Social Security is an evergreen issue on the campaign trail, proposals are unserious, unspecific or rely on politically unrealistic tax increases. The most recent trustees' report put the exhaustion of the old age and disability fund at 2035, seven years earlier than when we ran that special issue and 15 years from now.

Besides reporting and commenting on current events, *Sentinel* introduced readers to many of the staffers who joined the firm. We reported on their weddings or the arrival of children, until the staff got too big and the happy events too numerous. But those reports helped many clients and friends get to know us. We were delighted to have several of those clients travel long distances to join us in 2018 for the firm's 25th anniversary party in Fort Lauderdale, Florida.

Everything changes with time. Over the years my colleagues have taken over a lot of the writing load, sharing insights from their own experiences. We launched a blog, "Current Commentary," in 2009; as of this writing it has run every business day since. We started posting *Sentinel* articles online between quarterly print issues, and our monthly email bulletin features articles and blog posts alike.

These avenues are more efficient at reaching our audience today, which is why this will be the last issue of *Sentinel* that we print and mail to you. It has been a privilege and pleasure to enter your home or office via your mailbox all these years. If you do not already receive our material electronically, we hope you will subscribe at our website (palisadeshudson.com/get-sentinel), or follow us on Facebook, Twitter or LinkedIn.

There is more material on which to report and comment, and more of us to share our experiences with you, than ever. So goodbye to printed *Sentinel*. If you are just joining us online, please pull up a screen and make yourself at home. Our lights are always on for you.

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Duly Noted

Tax Relief For Puerto Rico Earthquake Victims. U.S. taxpayers in southern and western Puerto Rico who were affected by the earthquakes that began last December have extra time to file various tax returns, as well as relief from certain penalties. Most federal tax returns and quarterly estimated payments due between Jan. 15 and April 15 can be filed until April 30 without penalty, the Internal Revenue Service announced. Penalties for payroll tax deposits due before Jan. 31 will be waived as long as the money was deposited by that date. *PR-2020-01*.

SEC Offers Regulatory Relief For Coronavirus Reporting. As effects from the novel coronavirus spread through global supply chains and financial markets, the Securities and Exchange Commission offered some flexibility for publicly traded companies with reporting deadlines in March and April. The commission said it would grant an extra 45 days to make public disclosures, provided the company provides an explanation of why it needs the additional time and also discloses and explains the anticipated impact of the virus on its business risk profile, if the impact is material. The commission said it may extend or grant further relief depending on future developments. *Release No. 34-88318*, March 4, 2020.

How Bad Is The Mail Delivery, Really? Michael and Nancy Seely wanted to take a dispute with the IRS to the U.S. Tax Court, and they had until June 26, 2017, to file their petition. That petition arrived at the court in Washington, D.C., on July 17, in an envelope that was undamaged but without a postmark. The IRS pointed to the lengthy delay as proof that the petition was not mailed before the deadline and sought to dismiss their case. But Tax Court Judge Juan Vasquez gave the benefit of the doubt to the taxpayers and their attorney, Scott Boyce. Boyce said in a sworn statement that he deposited the petition in an official mailbox in Richland, Washington, on June 22. IRS attorneys said it should take no more than 15 business days for a first-class envelope to make that cross-country trip, which would have expired on Friday, July 14. Vasquez chose to overlook the additional business day in this case, noting that the Fourth of July holiday had intervened and could have caused a backlog at the U.S. Postal Service. Timely mailing is considered timely filing. The judge found that what was untimely in this case was more likely to be the mail delivery. *Seely v. Commissioner of Internal Revenue,* T.C. Memo 2020-6.

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