Highlights

- ·The low-down on home office deductions
- · Answers to your questions--brand new "Letters to Doug" column
- · Gifts or incentives--tax court decision that may affect *your* business
- · Vehicles--donate or sell? What's right for you?
- · Stock market graphs--still massively overvalued

Wealth Creation Strategies

Tax and Financial Strategies

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Office-in-Home Deductions

We often claim the office-in-home deduction for those who qualify. However, there are some actions that need to be taken and concerns that should be fully understood before taking advantage of this tax savings tool.

First, a "map" of the house or apartment is essential. The layout should give the measurements of both the entire home and exclusive business-use areas. Second, there should be photos of the spaces used for business. The reason for maintaining such records, along with the usual proof of costs, is that the IRS can challenge the deduction long after you've moved. You could be required to provide proof for a 2002 home office deduction in 2005 or even as late as 2006. This could be a real challenge if the business no longer exists and you have no photographs. Pictures, worth a thousand words, may also be worth thousands of dollars in tax savings.

It's even more challenging for those able to use a number of years of non-deductible office-in-home expenses all at once. This occurs after a series of business losses, during which time these costs are not immediately deductible. They are instead carried forward and allowed in a year in which there is a profit, up to the extent of net income. For example, let's say you incur net losses for five years in a row, deferring $3,000 per year in office-in-home deductions. If net earnings are $18,000 in year six, the $15,000 in carry-forwards along with current year expenses become fully deductible. It should not be shocking that this may trigger an IRS inquiry in which proof could be required for all the prior office-in-home deductions. Even $10,000 net profit will free up $10,000 of carry-forwards, which could easily result in a dreaded letter from our government. In the meantime, you and your business may have moved several times.

While we rarely pass on the opportunity to claim an office-in-home expense for self-employed clients who rent and have no other place of work, we tend to forego this deduction for homeowners. When a house is sold, tax is owed on any gain attributable to a home office. Essentially, two properties are deemed to have been disposed of: one, the home, the gain on which is probably tax-free; two, an office, a profit on which is subject to tax. The gain is calculated from the original cost plus improvements, not from the value of the property on the date business use began. Often, the potential tax dwarfs the savings accumulated from claiming the deduction. In addition, any depreciation allowed since May 7, 1997 must be recaptured, often resulting in tax almost as great as the accumulated savings even where there is little or no profit.

Other factors reduce the savings for homeowners. The interest and taxes are probably already being deducted. Business supplies, computers, telephone costs and office furnishings used exclusively for the business are fully deductible even though an "office-in-home" is not claimed. The only expense not deducted is the cost of the space, which includes a piece of the building (not the land) depreciated over 39.5 years, along with a fraction of the utilities, insurance, maintenance and repairs. The tax savings are often not worth the price in terms of audit risk and tax on future gain. Worse still, it is possible to realize no tax savings (due to a non-deductible home office resulting from continuing business losses) and yet get stuck for the tax on a gain from the sale of the office portion of the home!

This is not to say we don't do it. We may claim this deduction for those who use a substantial portion of the home for a business and who regularly incur large repair and maintenance costs. The tax savings can become sizable since such expenses, along with interest and property tax, are deducted for both income and Self-Employment tax purposes. (To get a bit technical, 50% in tax savings can be realized on any business deduction in 2002 for a non-itemizing single self-employed person with net income of between $33,000 and $84,900, while non-business deductions are worth at best only 35% for this taxpayer. Further, the tax paid on depreciation recapture and capital gain is slightly tax-favored and not subject to the Self-Employment tax.)

A more compelling argument for taking this deduction is developing, despite the risks. I have long felt that even

though we don't claim an office-in-home, automobile costs may be deducted when, after walking to work in the morning (from one's bedroom to the office, even though not exclusively used as such), one drives to another business location. After all, driving from one business location to another is deductible. Recent tax court cases suggest that we may lose this deduction in an audit unless we actually claim the office-in-home. This could involve a substantial foregone deduction for those whose first business stop is far from home. One possible solution may be to use and claim a very small part of the home for exclusive business use, resulting in the same small part being subject to tax on any sale.

The exposure to tax is greatest when a client for whom an office-in-home deduction is claimed fails to inform us of an impending sale. A huge tax cost may ensue. If we are made aware of it, there are several ways of minimizing the damage, including a tax-deferred exchange. There is also a case to be made for alternating years in which the deduction is claimed, which may preserve a tax-free sale (careful to actually disqualify the use in years in which the deduction is not claimed). Recall that a property must be used as one's principal residence in any two of the five years immediately preceding the sale to qualify for the exclusion of the entire gain (up to $250,000 single and $500,000 married). If the office in home is not claimed every other year, the home should qualify. The IRS may argue, however, that it's just a ploy (the idea is new and has not been tested).

This area is filled with complications and subtleties. Please tell us now if you think that a deduction for an office-in-home that we have not been claiming may be appropriate, so that we can discuss any special considerations in the off-tax season, while all of our heads are clear. Also, a prospective sale of one's home used in part for business is one of many areas that should be considered a "big change," about which we should be informed as far ahead as possible.

Business Gifts: When A Gift is Not a Gift

Business gifts have long been subject to a deduction limitation of $25 per person or couple (deemed to be one person) per year. The only error in having subjected ourselves to this limit for the past 40 years or so is that in almost every instance in which we thought a gift had been made, it may not have been.

This was brought to light in a recent Tax Court case. Holland America Bulb Farms deducted, in full, a set of $1,455 golf clubs given to a flower bulb salesman/broker in the Netherlands as a "sales incentive." The IRS re-characterized the golf clubs as a business gift, subject to the limitation. Holland America took their case to Tax Court.

They pointed out that the golf clubs were an incentive to encourage the salesman's continuing relationship with the company, which they considered vital. The Tax Court had previously ruled that a voluntary transfer of property by one to another without payment was not necessarily a gift. If the transfer "proceeds primarily from the constraining force of any moral or legal duty," or from "the incentive of anticipated benefit" of an economic nature, it is not a gift. They further ruled that a gift "proceeds from a detached and disinterested generosity…out of affection, respect, admiration, charity or like impulses." The Court concluded that Holland America purchased the golf clubs "as an incentive for future performance and in appreciation for his past services to the company. Thus, Holland America did not give the golf clubs…out of a 'detached and disinterested generosity'; rather, Holland America anticipated receiving an economic benefit in the future."

Before you give away the farm, the "sales incentive" had to be ruled "ordinary and necessary" and not "lavish," a prerequisite for all business deductions. An expense is "ordinary" if it's customary in the taxpayer's business and "necessary" if it is one that is appropriate and helpful in developing or maintaining business. Given the particulars and size of Holland America along with the revenues the salesman produced, the incentive was considered ordinary, necessary and not lavish.

Many, if not most, business "gifts" are made with the hope of eliciting a future business benefit, while few, if any, are made out of a detached and disinterested generosity. The Tax Court may have effectively eliminated the $25 deduction limit for what will now likely be called "sales incentives." However, watch for further developments. The IRS is not likely to give up without a fight and could ask Congress for a remedy. In the meantime, we've got a leg to stand on in sometimes arguing that a gift, oddly enough, may not be a gift.

Charitable Donations of Automobiles: Fad Goes Mainstream

Donating automobiles for tax savings has become increasingly popular in recent years. Rarely does a day go by near the holidays when one does not hear a pitch to donate cars for "valuable tax savings." For some, the benefits are worth the cost. However, for many, it is too good to be true.

A vehicle that a dealer can sell for $3,000 can generally be sold privately for at least $2,000. Dealers give credits of similar amounts for trade-ins. Yet, even

if a $3,000 deduction can be justified (and that's a big "if"), the maximum income tax savings for a taxpayer in the highest (45% federal/state) income tax brackets is about $1,350. The savings for most is a far lower $450 to $1,050 (at 15% to 35% tax rates), and is zero for those who don't itemize their personal deductions. From a purely financial point of view then, a sale or trade-in puts more dollars in one's pocket than tax savings at any level.

However, donors gain peace of mind and privacy. Many want to avoid the hassle of having to sell a vehicle, along with the loss of privacy associated with taking phone inquiries and allowing interested parties to come to one's home. There's also the time invested in making a sale, along with the cost of advertising.

On the other hand, the same benefits can be secured by selling the vehicle to a dealer. As suggested above, a dealer is likely to pay $2,000 for a car that he can sell for $3,000. There is no loss of privacy, no advertising costs and little time spent in negotiating a sale.

If the motive is to enrich the charity, a better result can be achieved by selling the car and donating the money. The audit risk is lower, as are tax preparation fees. After all, the value of a vehicle is gray, while there can be no argument over a check (as long as a receipt is given by the charity for donations exceeding $250). Moreover, the charity gets to keep 100% of donations made by check (known as "cash" gifts). Charities split the proceeds from sales of cars with a "facilitator," whose business is to assist non-profits in soliciting donations, reconditioning vehicles and reselling them to the public. The amount the charity actually retains is often less than 50%. Therefore, a $3,000 vehicle provides the charity with a maximum net benefit of only $1,500. Cash received from a sale and donated to a charity goes much further for both charity and taxpayer.

Yet another factor weighing against donations of automobiles is prior business use. If a $20,000 car was used 90% of the time for business over an eight-year period, that $18,000 portion is fully depreciated. One might think that, even with the deduction limited to the lesser of the adjusted cost basis (cost less depreciation allowed) or fair market value, a donation of $2,000 would be in the bag. However, since the donation consists of business and non-business property, its $3,000 value must be allocated $2,700 to business use and $300 to personal. The cost basis of the business portion is zero (remember, that part of the car has been fully depreciated), yielding zero deduction. The donation for the personal portion is also limited to the lesser of cost or fair market value, which is only $300. Since a sale is taxable, a donation yields the same result. On the other hand, a better tax result can be achieved with a trade-in (tax-deferred if 90% of the new vehicle is also used for business) and donation of cash.

For those still insisting on donating a vehicle, be sure to take pictures and keep copies of the repair receipts along with any other proof of its condition. Print out the Kelly Blue Book estimated value from www.KellyBlueBook.com, even though such value is at best a very rough guide. Bear in mind that IRS agents are not stupid--they know that this is a popular area for inflating deductions. I try not to cringe when someone asks whether a $5,000 deduction can be claimed for a vehicle that could only be sold in the best of circumstances for $2,000. Unfortunately, the deduction is limited to the true value, not its theoretical value if it had wheels. And if the value (the real value) is over $5,000, a written appraisal using IRS approved guidelines must be obtained. My recommendation: if you donate a vehicle, make sure it's worth less than $5,000. Or, just sell it—especially if you can use the money.

Selling, Trading, or Giving Away a Vehicle Used for Business

When disposing of a vehicle that was used for business be sure to:

KEEP COPIES OF ALL REPAIR RECEIPTS AND THE PURCHASE OR LEASE CONTRACT

We were recently reminded of this when a client who used his vehicle for work underwent an IRS inquiry for tax-year 2000. When the auditor got to car and truck expenses, guess what he asked for first? Repair receipts and purchase contract (to determine the correct depreciation). Unfortunately, our client had sold the car in 2001. And yes, figuring he'd never need them again, he gave the receipts to the buyer and tossed the purchase papers.

Why would the auditor want to see these receipts? Isn't the charge card or check made out to the repair shop enough to prove the expense? Well, no, because the charge or check may have been for another vehicle, perhaps even a friend's. (Auditors are, as you might imagine, trained to be suspicious.) More important, along with vehicle make and license plate number, receipts have dates and odometer readings, from which the total mileage for the year can be estimated. This is, in fact, the starting point for all automobile audits. A receipt from near the beginning of the year (or the end of the preceding one) along with a bill from near the end (or from the beginning of the subsequent year) can be used to extrapolate the yearly mileage. Only after making a determination of total and business miles is the auditor interested in actual expenses and the vehicle's cost. And these aren't even relevant in instances where the standard mileage rate (36.5 cents per mile for 2002) was claimed.

Failing to keep repair bills is almost as bad as presenting receipts from which 12,000 miles for the year can be logically extrapolated, when 29,000 was claimed. It's essential that the yearly mileage be figured accurately. If you have any doubt as to how to extrapolate the correct mileage, give us repair dates

with odometer readings. (We actually prefer this, since having this information in our files can help if audited.) Always keep copies of the receipts, along with the purchase and/or lease contract, until at least five years after the vehicle has been disposed. And, if you remember, take an odometer reading on December 31 of every year.

By the way, our client tracked down the new owner, who could not find the receipts. Most of the repairs were done at a shop that was no longer in business. Despite this, we did ok in the audit—but the client had established some pretty good credibility by first proving a number of other business expenses. Not everyone is that lucky.

Letters to Doug

Dear Doug,

I'm a single, 37 year old, self-employed renter. My skills allow me the flexibility of living almost anywhere without suffering a drastic reduction in net income, which averages $80,000 per year. You've recently explained that the new and improved Simplified Employee Pension Plan allows me to invest 25% of my net income after plan contribution (which, due to some convoluted government math, allows about 19% of the $80,000). Yet, even with this $15,000 deduction, federal, state and Self-Employment taxes total over $25,500, leaving me only $39,500 "take-home" after tax and pension. While about $12,000 of my $25,500 in tax goes to Social Security, you included a chart in your last newsletter showing that I will have to live to be 121 to get a measly 3% return on my "investment." Can you suggest a place that I could move to which will allow me to keep more of the fruits of my hard work?

Frustrated in America

Dear Frustrated,

Although I prepare many returns with numbers similar to yours, it's still hard to fathom that you get to keep less than 50% of your net income for current consumption when doing what you can to pay for your own retirement. You certainly provide more than a reasonable share of tax dollars with which to fund our profligate government.

You can save $3,300 by moving to a state that has no income tax: Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington or Wyoming. Alternatively, there are several other states that have far lower income tax rates than California. Those with maximum rates of 5% include Alabama, Arizona, Colorado, Connecticut, Illinois, Michigan, Mississippi and Pennsylvania. Other states that deserve honorable mention, with top rates no greater than 6%, include Delaware, Georgia, Kentucky, Louisiana, Massachusetts, Missouri and Virginia. California's top advertised rate of 9.3% begins at taxable income for single persons of $37,000 (your state taxable income is $56,500). You'll save a minimum of 3.3% on additional income by moving to any of these states, and very likely more after Governor Davis is re-elected in November.

You could also incorporate, elect to be taxed as an S-corporation and pay yourself a reasonable wage. The government will argue that "reasonable" is the full $80,000. Since wages are subject to Social Security tax, you'd end up paying the same amount when your own corporation employs you. On the other hand, I think we have an excellent case for paying you $60,000, contributing $15,000 to your pension and $4,590 to the employer's half of Social Security. By doing this, you avoid Social Security tax on $20,000 of income, saving about $2,500 after adjustments.

While you could be more aggressive and pay yourself even less, this could expose you to an audit in which the government argues you should have paid yourself more. You may be subjected to penalties and interest on the tax the government determines you should have withheld and paid but didn't, as well as opening up the rest of your tax return to audit. However, it is a position that many are taking. Those who don't act like hogs (which get slaughtered) are generally not being challenged.

By the way, do you speak Russian? I previously mentioned their new 13% flat tax on individuals. A proposal has recently passed their lower House in which the profits tax will be reduced from 24% to 15% on most small businesses. The reform also makes capital expenditures immediately deductible. It is rumored that Karl Marx is spinning in his grave, while Thomas Jefferson spins the other way in his.

Dear Doug,

In your article "Gambling and Roth IRAs" you made a great case for aggressive investing in Roth IRAs as a substitute for gambling. What if I don't like the idea of gambling? Is there anything else I should consider when deciding how to invest in my Roth?

Not a Gambler

Dear Not a Gambler,

Great question. Every dollar we earn in other investments will ultimately be taxed, while everything we make in a Roth IRA permanently escapes tax (assuming you follow the rules). This means that a dollar earned inside a Roth is worth a dollar, while dollars earned elsewhere are worth, ultimately, only 50 to 90 cents, depending on the type of income and marginal tax bracket when the profits are taxed. Therefore, a case can be made to devoting more time to watching a Roth than to other investments of similar size. My conclusion is invest aggressively, but watch carefully.

Dear Doug,

Your chart, "Social Security Maximum Wage Base Increases at a Rate Far Greater Than Inflation," was truly frightening. You showed the actual rate of Social Security tax times the current wage base at $10,528, vs. $3,524 had the tax rate remained at 1972 levels and wage base adjusted for inflation since then. My trusty calculator shows this to

be a real tax increase of 300% in just thirty years.

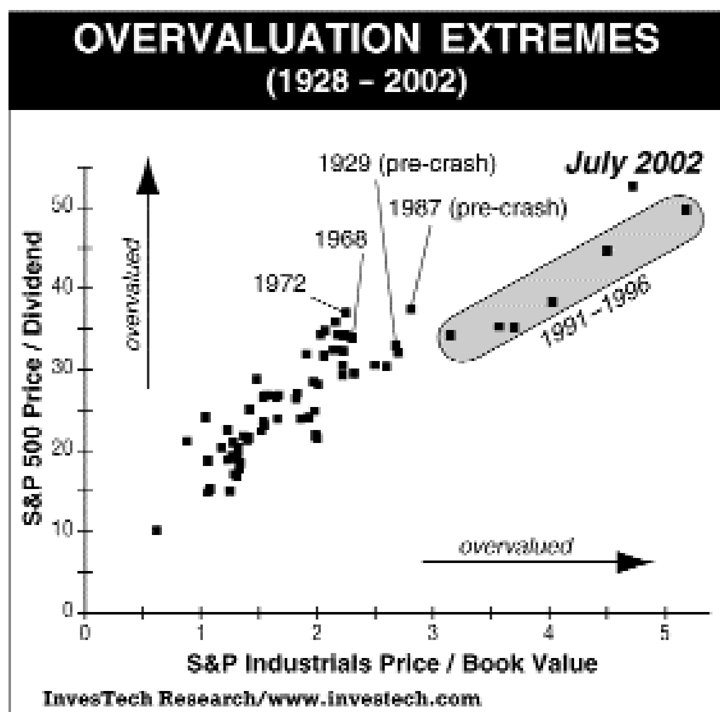
However, the 12.4% rate that you showed doesn't seem to give the complete picture. Am I missing something?

Perplexed

Dear Perplexed,

You're not missing anything—I missed it! I didn't include the Medicare tax of 2.9%. For the record—and to give you something even more frightening—the Medicare wage base was equal to the Social Security wage base until 1990, when it was increased to $125,000. In 1991 it was bumped to $135,000 and afterward, the limit on which this tax applies to wages and earnings from self-employment was eliminated. Want something even scarier? Watch what Congress does with prescription drug benefits after the mid-term elections. For a bit of predictive value, when the Medicare system was enacted in 1966, President Lyndon Johnson estimated that the Medicare program would cost $8 billion in 1990. The actual cost was $98 billion, more than twelve times higher than the projection.

Barely Back Inside the Box



One dot represents each of the past 75 years of stock market valuation.
The higher the dot, the more overvalued in terms of Price-to-Dividend ratio.
The farther to the right, the more overvalued in Price-to-Book Value Ratio.

"Overvaluation Extremes" is reprinted courtesy of InvesTech Research, which publishes an excellent newsletter offering stock market commentary. Call 1-800-955-8500 for a trial subscription. Note that valuations are barely back inside the box and still far exceed the extremes reached in 1987 and 1929.

"S & P 500: Dividend Yield" and "S & P 500: PE Ratios," on the next page, are reprinted courtesy of Leuthold Group, which is the institutional research arm of the Leuthold No-load Mutual Funds (800-273-6886 or www.LeutholdFunds.com). The S & P 500 would have to plunge from its current price of about 900 by 62.5% to 340, for dividend yields to return to their 76-year median of 3.97%. Such a collapse would represent an almost 80% decline from the peak registered in 2000. The Dow Jones Industrials would be valued at 2300 if the stocks in that well-known average suffered a similar decline.

The S & P 500 would have to sink by over 30%, to about 620, for the Price-Earnings ratio to return to its 76-year median of 16 times earnings. Consider the fact that in a recession corporate earnings will drop, causing the fall towards the median to become even greater. If corporate earnings fell by 50% and the S & P 500 sold at the historical median P/E multiple, its price would be barely over 300. This is *not* a forecast.

Your Local Theater

I've been a supporter of our local live theater, Granada Theater, for at least 15 years. Almost every play has not only been good to superb, but also showcased a number of outstanding performers. The last show, "Man of La Mancha," included a female lead and male supporting actor who were extraordinary. Previous plays included "The King and I," "Showboat," "My Fair Lady," "The Sunshine Boys," "The Odd Couple," "South Pacific" (which was far better than the movie), "Kiss Me, Kate," "A Shot in the Dark," "Fiddler on the Roof," "Arsenic and Old Lace," and almost 100 other great stories and musicals. (My favorite was probably "The King and I," a wonderful story about a king in a land, Siam, where tradition is far more important than seeking knowledge. The play depicts his quest to overcome this obstacle to growth.)

The theater needs some help right now to keep it all going. They are looking for new patrons, especially season ticket holders. It's a great buy, and those who sign up before December get an extra special deal on this year's programs as well as complimentary drinks next year. Call them at 818-363-6887 for more information and tell them we sent you. If you live elsewhere (and most of you do), please patronize your local theater. Almost every area has at least one worthy of support.