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*Best Wishes for a Joyous Holiday Season and a Very Happy New Year!*


# Wealth Creation Strategies

## Tax and Financial Strategies


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# New Tax Laws to Complicate Your Life

Two sets of tax laws were passed in late 2004. At 800 pages, these were not as simple as the eight-page law passed in 2003 that, simply and dramatically, reduced taxes for millions of Americans. The new laws are the sort that promise to keep tax professionals working overtime and awake at night, wondering whether or not every client has been asked crucial questions.

**Sales tax deduction revived…sort of**

A deduction for sales tax paid wins the "comeback kid of the year" award. It also wins, by a landslide, the "most complexity for a minor deduction" award. Last deductible almost two decades ago, its rebirth promises to complicate tax return filings, often with little or no tax benefit. The problem isn't so much the deduction itself; rather, it's the choice between deducting sales tax OR state income tax plus any state-mandated disability insurance (SDI in California), along with the question of whether the additional calculations are worth the effort. This is a terrific example of how government attempts at making taxes "fair" (in this case, trying to equalize deductible opportunities between states without an income tax and those with one) complicates the tax system.

The choice is clear for those who live in states without an income tax. However, decisions must be made for the vast majority living in states that impose both income and sales tax at hugely varying rates. Federal tables provide a "standard" sales tax deduction depending on your filing status, locale, family size and income, to which we add sales tax on non-business motor vehicles, boats, aircraft and materials used to build or improve your home. You can use actual sales tax paid in lieu of the table amount (see item # 4 below). We'll compare the sales tax (greater of actual or table amount) with state income/SDI tax paid and deduct the larger of the two.

Several factors complicate matters: (1) the Alternative Minimum Tax (AMT), (2) the "standard deduction" problem, (3) the "state tax refund" issue, (4) the "actual receipt" method, (5) the "available income" question, (6) the tables themselves and (7) the "various taxes hit different types of income" issue.

The first two factors may render a deduction for additional state tax worthless. Those affected by the AMT get little or no benefit from an additional deduction for state income or sales tax. For practical purposes, this was a non-issue back in 1986 when sales tax was last deductible. The increase in the "standard deduction," reduced availability of other itemized deductions and an AMT that affects an increasing number of taxpayers have served to reduce the number who benefit from such deductions. Many people will spend hours trying to figure out which deduction is larger, only to find their time was ill spent.

The third issue revolves around the fact that those who deduct state income tax must report any refund as income in the year received. If you paid, say $1500 in state income tax and got a refund of $800, your net benefit was really only $700. This complicates the calculations for a taxpayer qualifying for a sales tax deduction of $1,000. You've got to know the bottom-line before deciding which deduction to take.

The fourth complicating factor is that we are given a choice of IRS-approved tables for determining the sales tax deduction or adding up actual sales tax paid on non-business expenditures (any deduction for business items already includes the sales tax paid on those items). People who saved their receipts (prescient enough to have guessed at a change in law occurring ten months into the year) may do well. However, those paying moderate state income taxes will have to guess whether or not it will be worth one's time to add up sales taxes paid. If your state income tax plus SDI is $800, is it really worth the time and effort to tally up $900 in sales tax? Not when you consider it took five hours of time and your tax bracket is 15% (net savings: $15). I may argue, however, that we can "calculate" the sales tax you "must have" paid based on expenditures after rent or mortgage payments, insurance costs, travel and other items not subject to sales tax. I also could make a case that you probably paid sales tax on 100% of your credit charges at Nordstrom's and about 30% of grocery store purchases, with or without your receipts. So, before you add everything up, it may be wise to wait for us to suggest you do so. One of our goals is to save you time.

The fifth is the "available income" question. The sales tax tables are based partly on "available income," which is total income before adjustments such as

IRAs and itemized deductions including mortgage interest, plus non-taxable "items" including workers' compensation and the non-taxed part of Social Security income. I can make a case for the idea that such income also includes any increase in net consumer indebtedness during the year. For example, if you began the year with $10,000 in such debt and ended the year owing $25,000, your "available income" for purposes of buying items subject to sales tax is $15,000 more than may otherwise appear.

Sixth, the tables themselves are highly variable and complicated. They are based not only on "available income," but also exemptions claimed on your tax return and the state in which you reside, along with an adjustment for local sales tax. If "total available income" is $50,000 to $60,000, you're married with two dependent children and live in Los Angeles County the "table" sales tax deduction is $1,070. The same person who is single with no dependents has a sales tax deduction of $820. Yet, deductions for similar taxpayers with $100,000 in total income are only $1,400 and $1,100 respectively, which generally is a fraction of the state income tax paid by such taxpayers.

The final issue is the ultimate mind-boggling one, the fact that "various taxes hit different types of income." This makes it impossible to create some sort of formula for determining which deduction will be larger. However, that never kept me from trying.

If California taxable income is $35,000 for our examples above, state income tax after dependent credits for the married couple is about $450, while almost $2,200 for the single person. However, if total available income includes $50,000 in wages in 2004, $590 in SDI was paid. A total state income tax and SDI burden of $1,040 is barely less than the "table" sales tax deduction. We can hazard a guess that married couples who derive most of their income from wages in California with two children and taxable income greater than $40,000 will not likely benefit from the new sales tax deduction, unless a motor vehicle or boat, etc., has been purchased. Single filers with a taxable income greather than $24,000 can expect the same results. However, we will look at every situation case by case.

### "SUV deduction" gone…partly

The much-vaunted "SUV deduction," applicable to purchases of SUVs or trucks weighing over 6,000 pounds and for which over 50% of miles driven are business related, has been scaled back. The maximum deduction was reduced from $102,000 to $25,000 effective for purchases made on or after October 22, 2004.

While the decision to claim the deduction is complex, there are several excellent reasons to depreciate such vehicles using the slower "regular" method (i.e., to NOT claim the extra deduction):

1. Any reduction in business use requires payment of tax on the "recapture" of depreciation in the year such use is reduced, in many cases unnecessarily complicating the tax return. For example, if 80% of the miles were business-related in year one and only 70% in year two, the deduction needs to be recalculated for year one as if it were 70% and the extra depreciation must be "recaptured" on the "year two" return. What fun!
2. To the extent depreciation is taken now, it is reduced in future years. This can be very costly if in a low tax bracket now and a higher one later.
3. Depreciation reduces the "cost basis" of an asset. If business equipment, including a vehicle, is purchased for $60,000 and depreciation deductions of $50,000 are taken, the "cost basis" is reduced to $10,000. If sold for $30,000, tax must be paid on a $20,000 profit, even if $40,000 is still owed on the asset. (If used partially for business, the numbers must be pro-rated, further complicating the situation.) If on the other hand, only $14,000 in depreciation has been claimed on a 100% business-use asset purchased for $60,000 which is sold for $30,000, a loss of $16,000 can be claimed. While there are other factors to consider (alternative minimum tax for employees using such assets, changes in marginal tax rates and a reduction in self-employment tax for depreciation but not for losses on sales of assets), this is largely a "timing" issue: you'll get the deduction eventually.
4. A large deduction in one year is far more likely to attract IRS scrutiny than little deductions over many years.
5. Many states do not have an equivalent deduction (for example, California's TOTAL allowable Section 179 expense allowance is $25,000). This results in a different tax basis, further complicating matters should the vehicle be sold or traded.

### Car donations for fair market value, mercifully along with the ads promoting them, are now gone

One of the most obnoxious kinds of radio ads, aside from those aired during the political silly-season, are those touting charitable donations of automobiles. As I thought might happen, Congress finally tired of $5,000 deductions for cars lacking an engine. The rules change effective December 31, 2004.

Deductions for vehicles for which the claimed deduction exceeds $500 (including cars, trucks, SUVs, boats and RVs) will be limited to the ultimate sales proceeds realized by the charity, often only a fraction of fair market value. While one source points out that this rule doesn't apply if the charity uses the vehicle in a substantial way before selling it (such as delivering meals to home-bound individuals for six months, perhaps), consider the fact that charities can use only so many vehicles for their own purposes. Generally, we will no longer deduct the actual fair market value. And to police it, the charity must report sales proceeds to both you and the IRS.

However, we can at least make lemonade out of lemons. By creating such a limitation, Congress has given tacit recognition to the idea that the fair market value of donated items is not, aside from the newly proscribed, limited to the price at which the charity sells them. The argument presented in this

letter several years ago on the subject is stronger than ever. The deduction for a tie that costs $40 new, $1 at a garage sale, $2 at a Salvation Army thrift store and $8 at an American Cancer Discover thrift store should be $8, regardless of which charity you donate it to and the price at which it sells the item. That's great news for the rest of us!

**Sale of home previously exchanged into**

Effective October 22, 2004 the $250,000/$500,000 exclusion of gain on the sale of one's main home doesn't apply if the residence was acquired in a like-kind exchange in which any gain was not recognized within the last five years. I may have one or two clients living in homes into which they had previously traded; in other words, a rental property purchased pursuant to an exchange was later converted to personal use. While rare, the potential tax dollars at issue are huge.

Interestingly, Congress has NOT addressed the issue of how long a property that has been exchanged into must remain a rental before converting it to a primary or secondary residence. This remains a "facts and circumstances" issue. However, one thing is certain: at the moment an exchange is consummated, there can be no intent to ever move into the property exchanged into. Therefore, trading rental units for a magnificent estate (such properties make lousy rentals) is not likely to pass muster.

**Deduction for environmentally friendly cars**

Tax breaks in a number of areas that had been scheduled to expire next year or over the next few years have been extended, in some cases through 2009. These include the child tax credit, 10% bracket, increased AMT exemption, increased standard deduction, 15% bracket for married people and refundable child tax credit (increased from 10% to 15%). Since these are automatic calculations, they require no planning or additional information in the preparation of your return. However, you need to inform us that you have purchased a NEW qualifying "clean fuel vehicle" for personal use. These are hybrid cars, including the Toyota Prius and Honda Civic hybrid, along with all-electric cars. Oddball deductions like this are one of the reasons we strongly encourage you to regularly read this letter.

# City of Los Angeles Business Tax

Many of you have recently learned that the City of Los Angeles received information from the State of California about your home-based business. Beginning in 2001, the city was able to track down taxpayers living within L.A. city limits with income on a Schedule C (sole proprietorship) or business entity (corporation, partnership) who did not have a business license. Contact letters were sent asking that city business license returns be filed and taxes paid.

If you had a business prior to 2004, you are probably already in their system. However, you may not be (contact letters may have not yet been sent for 2003, or you began your business in 2004), in which case you need to call the Los Angeles Office of Finance (phone number 213-473-5901) and ask for a "Tax Registration Certificate" ASAP. If you have a burglar alarm permit, be sure to tell them, since they use the same account number for any small business you operate. Registrations and business tax returns both need to be timely filed to be eligible for certain waivers of tax for small businesses. (If a new business files timely and gross income is under $500,000, there is no tax for the first two years. In addition, small businesses with gross income under $50,000 will be exempt beginning in 2006, but MUST file on time to claim this exemption.) We will be happy to assist you, a service we have been providing at little or no charge but for which we will charge our regular rates if you wait until after January 25. The forms are "due" January 31 and deemed late after February 28.

I had mentioned this tax on a couple of prior occasions over the years, warning that, eventually, Los Angeles and other cities would go after non-registrants for back taxes. Whenever I mentioned this to new small business owners, the response was invariably, "How will they catch me?" The chickens have come home to roost. Anyone brave enough to start a new business is advised to immediately call his or her city clerk's office and ask to register his or her business. Keep in mind that if there is no income tax withholding (i.e., a W-2) on payments made to you for services, rents (yes, rental income from property located within city limits is also subject to this tax) or sales of goods, you are probably "in business."

# Use Tax: Sales Tax on Out-of-State Purchases

Although the "use tax" law, which requires California residents to report unpaid sales tax on out-of-state purchases, was enacted in 1935, California only recently (2003) added a line to the income tax return for self-reporting "use tax." Twenty states now have a similar line on their income tax returns. Most were added after the former Chairman of Tyco, Dennis Kozlowski, was indicted for failing to pay the state of New York tax on $6 million of artwork purchased in New Jersey. This tax is due on all out-of-state purchases, whether paid for in person, by mail order or over the Internet. I know it may be shocking, but only about one-tenth of 1% of California income tax returns for 2003 included a liability for "use tax," which is probably a tiny fraction of the number on which the tax should have been

reported. Other states likely experienced similar levels of non-compliance.

We may have inadvertently failed to ask all of you whether or not you owed this tax. While not intended as an excuse, if we asked every possible question, we could easily spend all day preparing a simple return. (On the other hand, if we were aware of extensive travel out of state or e-bay purchases—in other words, where obvious—we asked and you paid.) So, we will ask that you inform us if you owe any use tax (the question has been added to our telecommunications checklist) and whether we omitted the tax on your 2003 tax return. If so, we will be happy to amend your 2003 state form at no charge if you inform us of the amount omitted by January 25, 2005.

Be sure to let us know about such purchases when we prepare your 2004 tax returns. While we realize that the level of compliance may remain similar to those reporting household help, we have to ask. And remember that some states, particularly California, can be extremely diligent and competent at collecting taxes owed.

How might they find such tax? New York was rather creative: they have a table for taxpayers lacking documentation of amounts they should "admit to" owing in use tax, based on income level. The line cannot be left blank, so that if you report "$2" and they later prove "$2,000," they could charge you with fraud. Some states are beginning to exchange information obtained in audits of out-of-state sales by in-state retailers (such as Washington State telling California about the $5,000 in Amazon.com purchases you made). They will always find any unpaid tax when auditing a California-based business. I will be surprised if California, over the next couple of years, fails to bring a highly publicized fraud case against someone omitting a far more moderate use tax than the amount Mr. Kozlowski left out on his return.

# Tax Free Gains on Main Home

When Congress passed the $250,000/$500,000 tax-free gain rules back in 1997 relating to the sale of one's main home, we never dreamt that more than a few would ever pay taxes on profits from such sales. The recent massive increases in California real estate prices have put that expectation to rest. Call us if you need to plan for such an event.

Worse, there are also quirky tax traps. The rule requires both owning and living in your primary home for two of the preceding five years. Therefore, if you live in one house for two years and then a second home for two years, you'd think both would qualify for the exclusion. However, the rules also prohibit selling two homes within two years. The trap, along with unexpected tax, can occur in this scenario, among others: you move out of house # 1 and into house # 2 on May 15, 2005. You close on the purchase immediately, using other funds for the down payment. An unexpected problem delays the close of escrow on the sale until June 15. You sell house # 2 on June 1, 2007, after having lived in it for two years. You recognize the gain on the home with the smaller profit. That the delay was no fault of yours is irrelevant.

Another scenario: you live in a home for at least two years, then move out and rent it out for two more years. You purchased another home when you moved, in which you lived for two years. Now you want to sell both homes. You cannot avoid tax on both unless you rent out home # 2 for two years after the sale of home number one. What a mess.

On the other hand, you may fall under one of the exceptions to the rules that allow for a partial exclusion of gain even though you didn't live in the home for the requisite two years. It may even be possible to create an exception, providing the potential for tens of thousands of dollars in tax savings. Call us if you need to sell before the two years is up and we'll see whether a little tax planning can save you a tax headache!

# Telecommunications Checklist Addendum

Digesting the new tax law enacted October 22 made it impossible to timely update our unique telecommunications checklist before it went into this year's By-Mail package. Here's a brief list of additional items we'll need to prepare your tax return.

1. Sales tax paid. We'll need to know about any big purchases such as cars, boats and RVs, in addition to your best estimate as to how much you paid in sales tax on other items during the year. For reasons stated above, I wouldn't spend a lot of time on this unless you feel strongly that your actual expenditures on sales taxable items was large relative to your income or your state income tax is relatively low. If we think it would be worth your while to spend some time at the calculator, we'll let you know.
2. Sales tax you should have paid but didn't because you purchased something on-line or by catalogue from an out-of-state retailer who did not collect your state's sales tax (or you bought items while travelling outside your state that you brought back).
3. Did you purchase a brand new "environmentally-friendly" car such as a Toyota Prius or other hybrid? If so, we'll need to know.

While more than half of you send us your information via mail, fax or email, it's never too soon to set up your appointment if you choose the old-fashioned way. And remember to request your FREE book from our eclectic collection if you send us the bulk of your information or see us before February 1 (or after April 15, with the usual exception of early October)!