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"True, governments can reduce the rate of interest in the short run. They can issue additional paper money. They can open the way to credit expansion by the banks. They can thus create an artificial boom and the appearance of prosperity. But such a boom is bound to collapse [sooner or later] and bring about a depression."

— Ludwig von Mises, the great Austrian-school economist, explaining that artificial booms brought on by credit expansion cannot go on forever. Or, as I put it, have your family try living beyond its means. See how long your family can earn $60,000 yearly and spend $90,000 yearly. It will end badly.

Tax and Financial Strategies

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Wealth Creation Strategies

The Challenge of the Season

A Change to Appointments

This Season posed some unusual challenges. Congress couldn't decide on 2012's tax law until January 2, 2013. We're used to Congress making law all the way into December of each year, but this was a bit ridiculous. (Obviously, this made 2012 planning a bit challenging as well.) Then, while our privately-developed software included all the changes by about January 12th, the IRS didn't get its act together and wasn't ready to accept e-filed returns until January 30th. In addition, they couldn't process many common and ordinary forms and schedules until early March. Worse, because these issues were so well-publicized, more of you than usual didn't send timely tax packages (i.e., by mid-February), creating a huge backlog for us by the 1st of March.

It was a bit more relaxed than usual during much of February, but by late-month both our actual and virtual mailboxes "blew up." I was concerned going in because we had three fewer days in the filing season this year than in the last two*. By early March I realized we'd slipped further behind than usual and would stay that way unless I cut off live appointments, which is something we'd never done before late March. Although we were behind the rest of the Season, we soon returned to our "usual" back-up. After being initially overwhelmed the stress also returned to "normal."

This Season's experience got me thinking about two challenges with March appointments. First, I've known many of you for decades and love to "catch up" and shoot the breeze. Yet, time in March is precious. We get about 60% of our year's workload in the six or seven weeks ending (most years) April 15. Taking information by fax, mail, drop-off, e-mail and telephone dramatically reduces the odds of excessive conversation and allows us to focus on your taxes and financial well-being. Second, sending info by fax, mail, drop-off, e-mail and telephone increases the pre-preparation on your part. The more prepared your documents are, the more efficient we can be. For a business that receives 80% of its primary workload in a ten-week period, that efficiency is crucial. (In case you wonder how we do it, you can't imagine the preparation we undertake in the off-Season, among other things we do to help everything go smoothly.)

The increased efficiency allows us to focus on what we do best and enjoy most: planning and strategizing. We also have more time to review, reducing the odds of silly errors (rare though they are). Nearly two decades ago we stopped taking April appointments, often allowing us to complete returns for which information is received (by mail, etc.) as late as April 10th or 12th. I wondered why I hadn't previously thought of extending this idea to March.

In light of this, we will extend our hiatus on live appointments to at least part of March. You will still be able to see us late-April through January and, of course, February, when we extend our hours to include Saturdays (which have been surprisingly open the last few years as more of you have found value in our "by mail" package and style). For those who want to *see* us, please plan for January or February; we are not promising any availability in March (we'll see). We will start taking tax season appointments in late December—plenty of time to reserve a good day and time. And, we will still see certain clients during March and April—usually for serious matters like death, serious illness and other situations—by invitation.

For those who think "seeing" us is essential, allow me to make an important point: we prepare and complete returns, and even strategize, with about 80% of our clients without a personal visit each year. We have clients in 25 states, many of whom we've either never met in person or haven't seen in decades. We've never met several who live as close as a half-hour away. This also works for you by saving you time and fuel. In nearly every case we can prepare your tax return

and strategize without a meeting.

There is one planning strategy for which we often find the need to meet in person and present alternate scenarios—Roth conversions, but only because our use of those is unique. In addition, we sometimes need to meet to help you make decisions regarding the buying or selling of property, retirement and estate planning and other matters having a large impact on your life and financial well-being. And of course most such meetings take place outside of the Season.

Talk to us *during the year* about major changes. Even February. Please, not April 10th.

A related issue revolves around clients who send little or nothing before mid-February or, worse, before April 10th, whose income/deductions are dramatically different from the previous year *and*, as a result, owe unexpected tax; *or* for whom unexpected decisions—especially those revolving around retirement plan contributions—must be made by April 15.

Tax season is often compared to a marathon. March is challenging, but April is a do-or-die juggling act. We e-file scores of returns for which signed e-file documents are received in the final few days. We extend a hundred-plus returns for which little or no information has been received (which is another problem; please read the article on disallowed extensions, below). We extend another 30-50 returns for which we either don't have final information or have not yet received signed e-file documents. And we're still trying to complete returns up to and including the last day**.

There are always several of these last second clients whose "mix" of income has changed from employment to self-employment. Unfortunately, it doesn't always dawn on them that not only do they owe income tax on self-employment income, but also the employee and employer halves of Social Security and Medicare ("Self-Employment") tax. Several others invariably have taken a premature retirement plan distribution and have no idea that additional tax and penalty might be due. "But they withheld 20%!" This doesn't cover what is often a 33% to 47% combined tax and penalty***. This adds to the confusion and stress: "We owe *how* much?!" and—"yes, you owe that much—and now we can't do a thing about it!" Other clients haven't a clue they have an opportunity to contribute to IRAs, or should do so, because they didn't know a subtle change to their income, deductions or work situation afforded them new lucrative options. Receiving little or no information until April 10th leaves very little time to determine the optimal strategy and advise how much, if anything, should be contributed to a retirement account (IRA, Roth IRA or other retirement plan). It leaves precious little time to explain the advantages of such a strategy, to let it sink in while you consider it, and to actually make that last-second contribution. And there are almost always a few retirement plan contribution or Roth conversion and recharacterization errors near April 15 (contributing to the wrong IRA, for example) leading to time-consuming discussions with clients and their financial institutions.

We have long pleaded with clients to send us their **OLDs** (**Official Looking Documents**—W-2s, 1099s and the like), by early February. "But we get some documents late!" That doesn't matter—we can at least give you an idea of where you stand even without all of the documents, especially when we know what we're waiting for. "But the brokers always issue corrected 1099s!" That's okay—we can at least get an idea of where you're at and simply wait for those corrections. "But I'll have more time later!" How long does it take to stuff the OLDs into the envelope we provide every year with our "by mail" package and then mail it or, alternatively, scan and e-mail, fax, or drop off the documents? Besides, "more time later" never seems to happen, does it!

The lesson in all of this is the earlier you send your documents, even if only the OLDs, the better the service we can provide, the easier it will be for you to take full advantage of your financial options and the happier you will be. And we love to provide excellent service, discuss unique strategies and put a smile on your face!

* The 2011 Season ended April 18 and 2012's Season, with an additional day due to leap year, ended April 17.

** Even though we're busy, we get everything done. We love your referrals! New situations often provide the inspiration for some of our most creative ideas, which frequently benefit the rest of you.

*** 20% withholding is required on non-IRA distributions, but none on IRA distributions.

Inaccurate Estimates of Taxes Owed May Result in Disallowed Extensions

In the previous article we mentioned a problem involving filing extensions when we have little-to-no tax information. While this hasn't mattered much in the past, possible enforcement of existing law could create big headaches for some.

The problem with extension filing is the proverbial Catch-22—the IRS can disallow your extension if the tax you report owing is less than 90% of the tax on the final return and you can't show that you made a "reasonable" attempt at estimating accurately. However, to get to such a semi-accurate number, we need to complete much of your tax return! While the IRS has been lenient on this magic 90% number in the past, they are now threatening to start disallowing extensions for which estimated tax owed is later shown to be grossly inaccurate. Penalties on unpaid taxes for a disallowed (or no) extension accrue at 5% per month rather than the ½% per month with an allowed extension (plus interest either way).

We have in the past made some very inaccurate estimates of tax liability on extensions simply because we have

no OLDs (Official Looking Documents) for all-too-many clients. The IRS hasn't disallowed these extensions—yet. But, we are subject to the whims of the IRS—and, as we have seen in the area of foreign financial accounts and the scandal over recognition of 501(c)4 organizations, we have learned how capricious the agency can be. We urge—as we have for decades—that if you generally extend or intend to extend, you supply us with your OLDs *and* estimated tax payment records by early February. Any OLDs received later can be sent later. Corrected OLDs can be sent when you get them. Assuming other items are fairly stable, with the OLDs received by early February we can generally complete an extension using defensible numbers. If your "mix" of income and/or deductions has changed considerably you should have already let us know in a late-year planning session. If you didn't, at least do so in January (please don't wait until April 10th).

If an extension is disallowed, penalties may be the least of your problems. The right to make certain elections and retirement plan contributions for the preceding year are lost, potentially costing more in foregone tax savings than you'd ever pay in penalties. For example, you're planning on contributing $10,000 to a retirement plan by August, saving you $3,400 in tax. If your extension is disallowed, you can't deduct a prior year retirement plan contribution. You'll owe $3,400 more than planned, in addition to penalties on whatever you still owe. The good news is you'll have the $10,000 to help pay the extra tax and penalties!

DOMA: Be Careful What You Wish For

Currently under the Defense of Marriage Act (DOMA), same-sex couples are not allowed to file joint federal income tax returns. However, same-sex couples who are either married or "Registered Domestic Partners" in community property states (including California), must split community income such as wages. Each reports half of such income on their own separate (single) returns, along with separate income such as Social Security and most pensions. Because it acts as a sort of "income averaging," this income splitting often results in a lower overall tax than married filing joint or traditional "single" returns on which only one's own income is reported.

With the possible demise of DOMA (the fate of which has likely been determined by the time you receive this), same-sex couples may no longer be allowed to file as "single," losing this tax advantage. Those who aren't already married and quickly run out and perform nuptials, as well as those already married, could be required to file jointly, in many cases increasing their overall tax. The old adage, "be careful what you wish for," applies.

Three married same-sex couples to whom these rules apply are clients. They get the benefit of joint filing for California state income tax purposes. The current regime, under which we report half of the community income on each of their Federal "single" returns, results in lower total taxes for two of the couples (MUCH lower for one of them) than they would pay on a joint federal return. In other words, two would suffer a "marriage penalty" and one likely would not.

Edith Windsor takes on the U.S. Government

One of the financial advantages of eliminating DOMA would be to put such couples on equal footing as other married couples for estate tax purposes: regardless of the size of the estate, there is no tax on the first to die (there's an unlimited "marital exclusion": all assets left to a spouse are exempted from any estate tax). And it will be an advantage for one Edith Windsor. She and her partner, Thea Spyer, were together for 40 years when they realized the end was near for Thea, who had long suffered from multiple sclerosis. They flew to Canada to marry and returned to New York, where Thea died a year later. Edith got slammed with a $363,000 tax on Thea's estate, which would have been completely avoided had their marriage been recognized by the U.S. government. So, the 83-year-old dynamo brought her case before the Supreme Court, which is expected to rule (or not) in June.

At the time of Thea Spyer's death, the estate tax was 45% on net worth in excess of $3.5 million. If they are ruled to have been legally married, Ms. Windsor will get a $363,000 (plus interest) refund, but tax will apply to Ms. Windsor's estate when she dies, which under current law will be 40% of the excess over $5.25 million (adjusted for inflation).*

How many people will this benefit? Currently only 14 out of every 10,000 deaths (.14%), fewer than 4,000 estates annually owe any estate tax. Ignoring personal preferences and other benefits of marriage, the income tax cost to the 9,984 people who don't owe estate tax is likely, cumulatively, much greater.

How would a libertarian approach this problem? First, we'd eliminate the estate tax altogether. Very little is collected and it's an incredibly unfair and irrational tax** on accumulated wealth, most of which has already been taxed at least once and often twice. Second, libertarians believe the recognition or non-recognition of marriage should be outside the tentacles of government. On the other hand, it would seem we're stuck with the current system. If we were to deal with it fairly given the confines of the current income tax system, we'd allow married couples to file as if legally single, thereby eliminating any possibility of a marriage penalty. However, this would dramatically decrease government revenues (not to mention greatly complicate individual income tax return filings because of the choices involved) which, given the rapaciousness of government, will happen when pigs fly.

Still, be careful what you wish for.

* This exclusion can be doubled when the first person dies by filing an estate tax return, even though no tax is owed. However, it's too late for Ms. Windsor, since this rule was not in effect when Thea died.

** I intend to explain why this is true in a future article.

Tax Return Identity Theft

Your e-filed tax return is rejected because a tax return using your name and Social Security number has already been filed. You are a victim of tax return identity theft.

You are far from alone. The number of victims has sky-rocketed in recent years even if very few of you have been affected. But anyone can be stricken.

Before 2012, only one client had been affected, which I didn't even realize until much later, because the IRS was so vague about what went wrong. In 2012, when I called the IRS regarding a suspected theft I discovered the gravity of the problem. An extremely knowledgeable agent told me the number of identity-theft returns had increased from a hundred thousand as recently as a few years earlier to an expected two million, or at least 1% of all returns filed, for 2012*. The IRS has paid what is suspected to be billions in fraudulent refunds from these scams, not to be confused with the billions in refunds from claiming fraudulent Child Tax Credits and (low income) Earned Income Tax Credits.

This problem is so common a special set of procedures has been developed to file a "real" return for victims of identity theft. I was told to have our client include an ID theft affidavit and proof of identity with a hard-filed return (since we can't e-file it). The agent urged us to have our client check with the three major credit reporting agencies for any other use of their Social Security number. Thankfully, there has been no such use or other problems for any of our affected clients; criminals seem hell-bent on focusing on those easy-to-get refunds.

And easy-to-get they apparently are. You'd think there might have been protections in place to prevent someone from filing 2,137 returns from one address, but in 2010 someone did exactly that. Instead, the IRS was holding conferences in which a keynote speaker was paid $17,000 to inspire IRS employees to "free up their thought process and find creative solutions to challenges" by drawing pictures of Bono, Albert Einstein, Michael Jordan and the Statue of Liberty; the conferees also engaged in a "Star Trek" parody and a line dance (http://joemiller.us/2013/06/your-tax-dollars-at-work-irs-turns-over-idiotic-line-dance-star-trek-and-gilligan-island-videos-to-congress/) (we don't know whether they sang the "YMCA" song). In another case, a single bank account was used to receive 590 fraudulent direct-deposit refunds totaling more than $900,000. Today, the IRS says it has better controls in place. Let's hope so**.

Identify theft will delay your refund because case resolution can take up to a year. The good news is the government pays interest at 4% per annum on late refunds when issued more than 45 days after filing a (real) tax return. Where else can you get 4% certain? The bad news is if you need the money there's no way to accelerate the process. If you are concerned about identify theft and usually get large refunds, lower your withholding amounts by increasing the exemptions you claim, leaving less of your money in the government's hands.

* While the percentage of our affected clients is substantially lower, it still hurts if it hits you.

** Kristin Ericson came up with a simple yet brilliant idea: require current filings to include filing status and Adjusted Gross Income figures from a couple of prior year returns. This would require a scammer to obtain copies of those returns to successfully file a return using your name and SSN, which is probably a lot more difficult than getting your name and Social Security number. Apparently the IRS hasn't thought of this yet.

What Will Happen to the Value of My Bonds, Stocks and Real Estate ~~If~~ *When* Interest Rates Increase?

Interest rates have been generally declining for more than three decades. At some point, they will reverse course — in fact, they may have already done so. The question isn't so much if, as when.

Japan has had hyper-low interest rates (and economic stagnation) for nearly two decades. While the U.S. could see rates continue to remain historically low, they've been creeping up for the past year (and, since I began writing this piece, they quietly spurted up). What if rates return to the 20- or 40-year average?

The 20-year average mortgage rate is, according to one source, close to 7.50% and the 40-year average is (gasp!) about 9.5%. I've discussed what that could do to housing values (Spring 2012 *WCS*), but how badly would stocks and bonds get hammered?

In prior decades, interest rate increases didn't necessarily correspond with a collapse in stock prices. Sometimes, interest rates increased during economic recoveries and, with such recoveries, stock prices recovered. However, we've already had a massive increase in values in what many consider a pathetic recovery (total employment, for example, is still 2 million below the level of 2008 and there are 2 million more temp jobs, which in prior recoveries would have been full-time jobs—not to mention more people of working age). While dividend yields were 3% at Dow 10,000, at Dow 15,000 yields are a pathetic 2%. Prior to the roaring '90s, whenever such yields dropped below 3%, such as 1929 and 1987, stock prices were peaking. Dividends yielded 7% at several prior stock market bottoms, which today would require a collapse in prices. At current dividend payouts, dividends would yield 7% if the stock market as measured by the Dow Jones Industrials plummeted by about 75% to barely

over 4,000. If mortgage rates hit 7.5%, 30-year U.S. Treasury Bond yields, currently less than 3.5%, would likely yield around 6.5%. Which would you rather own, a sure thing yielding 6.5% or a not-so-sure-thing yielding 2%? If you haven't already sold in such a market environment, you are likely to do so, adding to downward pressure on values. Stocks will drop to prices that yield a high-enough dividend to compensate for the risk of owning a volatile asset when the "risk-free" competition is paying 6.5%.

Interest rate increases *always* correspond with plummeting bond values. Let's say you own a 4% bond and the current market rate for a similar bond increases to 6%. What would a buyer of a $1,000 bond that pays $40 be willing to pay when he can get a $60 yearly coupon? While that depends on the years-to-maturity for that bond, you might surmise he's not going to pay $1,000. In fact, for a bond that never matures (a "perpetual" bond) he'll pay ($40/.06 =) $667 (because $667 x .04 = $60). For a bond maturing in 30 years he'll pay about $725; for one maturing in 20 years, $770; 10 years, $850; and for one maturing in five years he'll pay roughly $915. So, a rate increase of 2% would cause the value of a 5-year bond to drop by 8.5%, wiping out more than two years of interest; a 30-year bond would drop by 27.5%, destroying nearly seven years of interest.

What do you do, then, if you are concerned about a higher interest rate environment hammering stock and bond values? There's not a lot that can be done except to invest in near-zero interest-yielding money market funds or Treasury bills, or in "stable value" funds, currently yielding about 2% and which are an option in nearly every 401k. Even these are not risk-free, since they depend on an insurance company living up to a guarantee that investors won't suffer a decline in principal and will continue receiving interest payments even if rising interest rates push down prices of bonds; these are the underlying securities in every stable value fund. Then you bide your time, waiting for the next great buying opportunity. In case you didn't read between the lines: my view is that time is likely not now, but a few years down the road.

Charitable Donations: the "Right" Receipts Required

Strict compliance vs. substantial compliance

Since 2006, taxpayers have been required to obtain and keep receipts for all charitable donations. For donations under $250, such receipts may include cancelled checks, credit card statements or acknowledgement of receipt from the charity. For donations of $250 or more, or for a series of "planned" donations under $250 but which total $250 or more during a calendar year, a written acknowledgment containing certain wording *must* be obtained from the charity on or before the earlier of the date the taxpayer files the return or the due date (including extensions) for filing the return. Because Congress wrote the law in such a way as to allow the IRS no leeway, tax court cases involving charitable donations have resulted in unimaginably unfair outcomes. The strict language of the statute does not permit "substantial compliance"* as allowed in many other areas of tax law.

As Inspector Javert put it, "The Law is the Law"

In a case that could involve any of us, in 2006 a taxpayer made 44 contributions totaling $10,022 to NDM Ferret Rescue & Sanctuary, Inc., an organization the taxpayer founded. Twenty-seven contributions were for less than $250 each, totaling $2,393, and 17 contributions were for $250 or more each, totaling $7,629, none of which were acknowledged in a letter, let alone one containing the appropriate language. Although the IRS and the Tax Court acknowledged that the contributions were made and the charity was an IRS-approved 501(c)3 organization, the Court disallowed the $7,629 deduction because there was no appropriate letter and the doctrine of "substantial compliance" does not apply to charitable donations.

The taxpayer then argued it would have been futile to issue an acknowledgment because she was the president of the organization and, therefore, on both sides of the transaction. The Court ruled the strict language of this statute does not preclude self-issuance of letters of acknowledgement; therefore, the president should have acknowledged the taxpayer's gift even though they are one and the same. Since "self-dealing," where one person (or a "related" person) is on both sides of a transaction, is expressly precluded in many other areas of tax law, this ruling was rather surprising.

In a similar case, a couple was denied a deduction for ten donations totaling $6,465 to their church because they didn't get a "contemporaneous" written acknowledgement. While the Tax Court admitted the acknowledgment and cancelled checks were reliable, the letter of acknowledgment was dated January 22, 2008 and was not received by the "earlier of petitioners' filing their income tax return or the due date of April 17, 2006." Deduction denied.

In yet another case, a taxpayer was denied $25,171 in charitable contributions, mostly to their church. Even though they produced cancelled checks and a timely-received acknowledgment from their church, which included the amounts and dates of contribution, it didn't specifically state that no goods or services were provided to them in exchange for their contributions. What would such a couple do? Of course,

they'd go back to their church and ask for a new letter that states that no goods or services were given in consideration for the contributions and, if there were any, they'd ask them to "describe and set forth a good faith estimate of the value of those goods or services." (The deduction, of course, is limited to gifts in excess of such consideration.) The Tax Court denied the deduction because, while the first (incomplete) letter was timely received, the second (complete) letter was not.

Another case highlights the extraordinary inequity embedded in this area of tax law. A couple was denied an $18.5 million charitable deduction for property donated because they did not attach a "qualified" appraisal. They attached an appraisal, but the husband, who was a real estate broker and licensed appraiser, figured it would be okay if he prepared it. The IRS said it wasn't okay because Congress stipulated that a "qualified" appraisal *must* be prepared by an independent third party. So, the taxpayer obtained an independent appraisal valuing the property for $20.2 million, eliminating the possibility he had overstated the value; then the charity sold the property for an even higher $23 million, showing he didn't "buy" the appraisal. The Tax Court, however, disallowed the entire $18.5 million deduction, explaining the appraisal wasn't "timely" since appraisals for more than $5,000 must be attached to timely-filed tax returns—and the third-party appraisal was obtained after the original filing.

This makes me seethe with even greater contempt than I already have for those who think they know how to run our lives and spend our money better than we do. It makes me ponder why laws such as "thou shalt not cross the border without permission" go unenforced because a politician or bureaucrat says they don't agree with it, while laws such as these are enforced with a vengeance and to the exact letter of the law (but maybe that's just me).

Which brings up a question: do we really want government running even more of our lives?

* "Substantial compliance" is compliance with the substantial or essential requirements of something (as a statute or contract) that satisfies its purpose or objective even though its formal requirements are not fully complied with.

Like-Kind Exchanges: Strict Compliance Rules Don't Apply

While charitable donations require strict compliance with rules, many areas of tax law allow "substantial compliance," or compliance based on "intent." A Tax Court case demonstrating this involved a tax-deferred exchange* in which the taxpayers exchanged an apartment building for a single family home. They intended to rent the home, posting flyers but never advertising it in a newspaper. The asking price was never lowered and tenants were never found.

Six months later the taxpayers could no longer afford the property. Rather than selling the house into which they exchanged, they listed the home they lived in and closed on the sale three months later. The family then moved into the house they had acquired via the tax-deferred exchange.

The IRS claimed the taxpayer never intended the home to be used as investment property at the time of the exchange. If it was intended as a home, the entire gain on the apartment building would be taxed. The Tax Court, however, ruled that the taxpayer's primary motivation in exchanging for the single family home was to hold the property as investment property and, even though they moved in only nine months later, allowed the tax deferral on the exchange.

The evidence proving original intent to rent the home included not only their own testimony, which is often viewed as self-serving, but also plenty of third-party testimony. This included witnesses who testified they didn't intend to move until their youngest child, who was then 15, graduated from high school. Still, compare this with the strict rules governing charitable donations. And they excluded—get this—tax on a profit of $429,296.

* A tax-deferred exchange involving real estate allows deferral of tax on embedded gains until the property into which you exchange is sold. Property must be "like-kind." This pretty much includes any real estate held for investment for other real estate held for investment, e.g., rental apartments for a rental house, or commercial property for land. This precludes an exchange into a personal home, or what you *intend* at the time of the exchange to be a personal home.

New Optional Method for Calculating the Home Office Deduction

Likely a boon for homeowners but not renters

Beginning with 2013 tax returns, the IRS has announced they will allow an optional "safe harbor" method for claiming home office deductions. To be allowable, the usual home office tests (exclusive business use, principal place to meet clients, etc.) must be passed. Those who meet those tests can deduct up to $5 per square foot per

year on up to 300 square feet, which limits the maximum deduction to ($5 x 300 =) $1,500. This deduction is in lieu of all actual expenses for renters; it replaces all non-interest and non-tax expenses, including depreciation, for homeowners. Therefore, it's one of the few areas of tax law where "double-dipping" will be allowed: homeowners will be allowed to deduct the full amount of mortgage interest and property taxes in the usual fashion (Schedule A, itemized deductions) *and* deduct $5 per square foot of a qualifying home office, even if actual costs were substantially lower, subject to the limitations of this method.

However, there is a huge possible negative. Home office expenses are deductible only to the extent of net income, with any excess carried over to years in which there is net income—but not for those using this method. We've had several clients over the years with $2,000 to $3,000 in yearly unallowable home office costs, which became fully deductible all in one year—resulting in $15,000 to $18,000 in highly auditable but justifiable deductions that would have been forgone had this election been taken.

While it may be a nice little hole for some to climb through, we looked at a random selection of clients and found virtually no renters who will benefit by using this method. Consider: you pay $9,000 per year for a 1,000 square-foot apartment, out of which 100 (or 300) square feet are used exclusively for business and you get a $900 (or $2,700) deduction on rent alone (not counting a percentage of utilities, insurance and repairs); the optional method will allow a deduction of only (100 square feet x $5 per square foot =) $500 (or $1,500). On the other hand, at least half of our homeowner-clients claiming home office deductions could benefit using the optional method (because they may deduct interest and taxes, in addition to this "optional method" deduction). We plan on reviewing all of our home office deduction clients' returns and will let you know if there's a shot at simplifying your recordkeeping. We're still going to ask for all the usual home expense information for those qualifying for an home office deduction for 2013—but if it looks like it will help we'll let you know.

Using Roth IRAs as a Long-Term Tax Shelter

The advantages of Roth IRAs have been a hot topic in numerous *Wealth Creation Strategies* articles. The most concise summary of the advantages is "I Can't do my Roth Because…." in issue # 25 of *WCS*. Using real clients' objections ("I can't do my Roth because I need the money for a new car," etc.) I explain that Roth IRAs can be used not only for retirement, but also higher education, periods of unemployment or disability, down payments for new home purchases, capital for new businesses and survivors' benefits (substituting, in part, for life insurance). Contributory Roth IRAs serve as a ready source of funds for nearly any use at any age—even a new car purchase—because the principal contributions can be withdrawn at any time for any purpose tax and penalty free (different rules apply to Roth conversions).

A new client who could have been funding Roth IRAs but hadn't (until we met this year) wondered how much she could have invested in her Roth if she had been offered appropriate advice at their inception in 1998. She had just turned 50 in 1998 and qualified for the maximum Roth in every year since. She could have contributed $69,500, which by now might have easily grown to $100,000 even with the low returns on investments over the last 15 years. She could have had an additional $30,000 in tax-free retirement income, which would have saved her at least $10,000 in income tax (or $27,000 if she had managed to turn the $69,500 into $150,000). If she was married the entire time and her spouse also qualified, we can double these numbers. Do you see how Roth IRAs, although non-deductible up-front, may be the best tax shelter available?

Maximum Allowable Contributions to Roth IRAs by Year

	Age 49 and below	Age 50 and above
1998-2001	$2,000	$2,000
2002-2004	$3,000	$3,500
2005	$4,000	$4,500
2006-2007	$4,000	$5,000
2008-2012	$5,000	$6,000
2013	$5,500	$6,500

Total maximum contributions to Roth IRAs through 2013 are $59,500 for those under age 50 and $69,500 for those over age 50 since their inception.

Borrowing from Your 401k — There is Risk Where You Thought There Was None

Borrowing from 401ks is allowed under most plan documents so long as the repayment is amortized over no more than five years (longer for home purchases). Many people think it's a no-cost alternative to borrowing from third parties, but it's not.

First, you're repaying the 401k with non-deductible interest (currently about 4.25%). Second, you'll pay the tax on this non-deductible interest when you withdraw the funds. That's the equivalent of making non-deductible 401k contributions and paying tax on withdrawals. Third, to the extent of your borrowing, you lose out on investment income earned from third party payers, i.e. the stocks, bonds and banks where you would have invested the funds. This doesn't increase your wealth and, worse, to the extent taxes must be paid on withdrawals, your wealth actually decreases. Fourth, you run the risk of defaulting, which immediately triggers taxable income on the balance owed. This is especially risky since 20-28% of people eligible to borrow from 401ks have loans against their accounts and 9-18% of these debts are defaulted on every year.

Defaults occur in two ways. One, the loan isn't repaid according to the amortization schedule. Two, you leave the employer and don't repay the loan within the required timeframe (usually 60 days; be sure to check). This can lead to terrible tax results, especially if you are under 59 ½ and your income is substantial in the year of default.

One married client got the worst of all possible worlds. They inadvertently defaulted on $15,000, resulting in immediate recognition of that income. Incredibly, the tax and penalty totaled 71.8% of the $15,000 loan balance, or $10,770.

How could the tax be so exorbitant when "nominal" tax rates are 15% or 25% for most people? Let us count the ways. To their 25% bracket add 9.3% state of California tax, 10% federal penalty and 2.5% state penalty. If that 46.8% tax and penalty rate isn't bad enough, they were paying more than $4,000 in tuition for each of two full-time college undergraduates, each of which qualified them for a $2,500 tuition credit. Their income was smack in the middle of the phase-out range ($160,000 to $180,000 for joint filers) for this credit. The two $2,500 credits were mostly phased out as their income increased from $162,500 to $177,500; their "add-on" rate was 25% (12.5% per credit phase-out). So, 25% + 46.8% = 71.8%.

You think if they'd called we would have found a way to pay off that loan? Of course, but hindsight doesn't help. We're a phone call, an e-mail or a fax away and, unlike many tax pros, we're here all year.

Report Your Room Rentals or Lose Your Home!

Congress now requires taxpayers with room rentals to report their existence. Failure to so report will subject taxpayers to fines of $10,000 per room rental per year per owner (if the home has multiple owners each owner will be subject to such fines). The IRS has announced an amnesty for those who previously haven't reported income from room rentals. Taxpayers who come clean and report (and pay tax on) room rental income for the last six years via amended returns will forfeit only 27.5% of the value of their home. Those who do not come clean and get caught later will forfeit their entire home, be required to pay the tax due on all room rental income since the room(s) was (were) first rented and risk criminal prosecution.

Kidding!

However, if the government can do the equivalent of this to taxpayers with foreign financial accounts—which they essentially have done (see *WCS* # 49, Summer 2012); trade "taxpayers with room rentals" for "taxpayers with foreign financial accounts"—what prevents them from doing this to taxpayers with undeclared room rentals? If the government thinks undeclared foreign financial accounts are a problem area for tax compliance, why not room rentals? Who's next? Donors to conservative 501(c)4 organizations? Or, when Republicans regain power, donors to liberal 501(c)4 organizations?

This gets tiring, not to mention scary, doesn't it? Tim Nerenz, in his blog "Moment of Clarity" (on hiatus but still accessible at http://www.timnerenz.com/; he has two books of compilations of his brilliant essays available at Amazon.com) wrote:

> "Democrats, write down how much of your own income you would have given to George W. Bush if he could spend it any way he chose; Republicans, you do the same with President Obama in mind.
>
> "What did you decide? 5%, maybe less? There you go—nearly everyone is already half-libertarian; now just keep *both* the left hand and the right hand out of your wallet—and your school, your work, your bedroom, your gun rack, your church, your charity, your emails, and your stash—and you will complete the journey."

Such a system would be much more civil than the one we have, don't you think?