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"Without fanaticism, we cannot accomplish anything."
— Eva Perón, First Lady of Argentina 1946-1952

"...instead of a mind, universal literacy [gave the common man] rubber stamps inked with advertising slogans, with editorials, with published scientific data, with the trivialities of the tabloids and the platitudes of history, but quite innocent of original thought."
— Edwards Bernays, "Propaganda," 1928

Tax and Financial Strategies

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Wealth Creation Strategies

The Season from Hell

The 2021 Tax Season was more of a challenge than even the more extended 2020 Season. In addition to the numerous tax law changes throughout 2020, which we prepared for, in March of 2021—mid-Season—there were *multiple* unexpected changes affecting many clients.

The craziest change sprung on us was the retroactive exclusion of unemployment. I was watching for such an exclusion and correctly assumed it would not be passed as a separate bill; instead it was unexpectedly included as part of ARPA—a last-minute deal to bribe Sen. Joe Manchin (D-WV) for his vote. Instead of passing such a bill the prior year, giving us time to prepare and better plan for clients, the American Rescue Plan Act (**ARPA**) of March 2021 retroactively excluded up to $10,200 of unemployment income for 2020. To qualify for the exclusion, **"Modified" Adjusted Gross Income (MAGI)** had to be below $150,000, *regardless of filing status*.

Because the enactment of ARPA immediately raised questions that were not easily comprehensible in the cryptic language of the bill, we had to await IRS interpretations. The first question was whether the potentially excluded unemployment income was included in **MAGI** in calculating the $150,000 cap. The law is so incoherent it could have been interpreted either way. The IRS's initial interpretation was to *include* gross unemployment income in MAGI; if income including total unemployment exceeded $149,999, you could not exclude *any* unemployment. The IRS reversed course *a week later*, ruling that the first $10,200 of unemployment income *would not be* included in MAGI for this purpose. So, if you had $10,200 of unemployment *plus* $149,999 of other income, the unemployment was excluded because *Modified* AGI was *below* the $150,000 threshold. If you had $10,200 of unemployment plus one more dollar of any type of income on top of the $149,999, the unemployment was *not* excluded, because MAGI was $150,000; same with $20,000 of unemployment plus $140,200 of other income, because MAGI was ($20,000 - $10,200 + $140,200 =) $150,000. Finally, if you had $20,000 of unemployment plus $140,199 of other income, the $10,200 would be excluded because Modified AGI was under $150,000 ($20,000 - $10,200 + $140,199 = $149,999).

We immediately recognized the value of adjusting income where possible (more difficult after the year has passed, but not always impossible), because an additional dollar added to **MAGI** could create an additional ($10,200 x 24% nominal rate =) $2,448 of tax (for a 244,800% instant *real* marginal tax rate on the extra dollar of income). We also quickly realized that because the cut-off was $150,000 ***regardless of filing status***, married clients with joint income (MAGI) over $150,000 could take advantage of the exclusion by filing two separate "Married Filing Separate" returns. (This was likely a once-in-a-lifetime opportunity for most of you!) We could split joint incomes and reduce each spouse's income to below $150,000, allowing *each* spouse to exclude tax on up to $10,200 of unemployment. Fortunately, our tax program has a "search" function that helped us find two previously e-filed joint returns that would benefit from this strategy. While you normally cannot switch from joint to separate filing status, we refiled under special "superseding return" rules, which allowed these clients to get the benefit of this unique strategy.

Another question raised by the vague language of the law involved the correct treatment of the exclusion for spouses in **community property (CP)** states when one spouse received more than $10,200 and the second received none or less than $10,200. So, if one spouse received $20,400, could we argue each received $10,200 and exclude both halves? Or could both exclude

only $5,100 each? Or could only the recipient exclude $10,200?

In CP states, normally half of each spouse's income is taxed to the other spouse. However, there are exceptions to splitting income 50-50—such as with Social Security and retirement income. But how to treat unemployment? Is it deemed earned only by the spouse receiving it, or is it deemed earned by both spouses regardless of who received it? If $20,400 was paid to only one spouse, could each spouse exclude up to $10,200 of unemployment? And could you do this only by filing separately?

The debate among tax professionals was complex, heated and even vitriolic. Many tax pros used old Tax Court cases to argue that the unemployment exclusion could not be split because in one case a spouse's foreign earned income exclusion was not doubled for U.S. citizens working abroad, whose tax home was a community property state; therefore, they argued, it should not be done for the unemployment income exclusion either. Other tax pros argued that because in community property states wages received by one spouse are deemed earned *by both spouses*, unemployment payments, which are based on wage income, should also be community income. They also argued the foreign earned income exclusion was completely different than the unemployment income exclusion and therefore we should not apply the former's rules to the latter. Without a clear answer, we devoted many Tax Season hours to reading, reviewing, and discussing the meaning of this one area of law—we copied and pasted over 100 pages of online discussions on this one topic into a Word document devoted to these questions. Because the dissenting and less favorable answer came from many top leaders in tax law, we sat on piles of returns, creating additional logistical challenges. After several nerve-wracking weeks of back and forth daily discussions, the IRS finally provided its administrative interpretation of the law—that unemployment is community income and therefore the unemployment income exclusion could be doubled to $20,400, even if only one person received the unemployment income. We could, therefore, split returns, apply the exclusion to each spouse, and subtract as much as ($10,200 x 2 =) $20,400 total from overall AGI to arrive at Modified AGI—even though only one spouse collected unemployment. This saved as much as $4,500 per couple. *

After this acquiescence, nearly everyone thought this could be done only on separate returns. Shockingly, the IRS later approved an even more aggressive position allowing a double exclusion of unemployment on a joint return, even if only one earned the unemployment. However, this worked only if MAGI on the joint return was less than $150,000; if it was higher, we filed separate returns. What a confusing mess!

Another mid-Season change was the addition of a third "stimulus" payment, which is theoretically based on 2021 MAGI (the first was doled out in the middle of 2020, while the second was paid in December 2020). The third payment is $1,400 per person, and the pre-payment (it will be reconciled on the 2021 return!) was based on 2019 income if 2020 was not yet filed. If 2019 income qualified clients for the full pre-payment amount while 2020 income did not, we had to hold off filing the 2020 return until the payment was received (another of those logistical challenges). And in cases where 2019 income did not qualify our client for the payment, but where 2021 income might increase above the phase-out ranges, we took pains where possible to reduce 2020 income below the threshold.

Any 3rd "stimulus" pre-payment based on 2019 or 2020 is not clawed back, even if the 2021 income exceeds the threshold amount. The importance of this was magnified by the fact that the 3rd payment has an absurdly tight phase-out range. For joint filers, the phase-out of the $1,400 payment *per taxpayer and dependent* begins at $150,000 AGI and is fully phased out at $160,000 AGI, a $10,000 stretch of income. This creates an add-on 14% effective marginal tax *per taxpayer, spouse and dependent* on any increase in income over the bottom of the range. The 3rd payment is phased out for single filers with AGI between $75,000 and $80,000, creating a ($1,400 / $5,000 =) 28% add-on marginal tax rate for such filers, and for head of household filers with AGI between $112,500 and $120,000, creating a ($1,400 / $7,500 =) 18.7% add-on marginal tax rate for a head of household filer who does not claim their child as their dependent (which translates to a $2,800 / $7,500 = 37% add-on marginal tax rate for a single parent—on top of the regular income and payroll tax rates—with one child and a $4,200 / $7,500 = 56% add-on bracket for a single parent with two children). If you suspect total effective tax rates with enough dependents could exceed 100%, you would be correct. Nothing was cut-and-dry this tax season, and every detail made a big difference to the ultimate tax and "stimulus" payments.

To help keep income below these thresholds, we implemented a variety of strategies. Splitting returns to exclude unemployment income was one; others included reducing income for the self-employed by expensing newly-purchased equipment, such as business-use vehicles; reducing income of rental property owners by expensing (via "bonus" depreciation) qualifying capital improvements; and contributing to 2020 retirement plans for self-employed taxpayers and deductible IRAs and HSAs for eligible taxpayers.

Filing separate returns for normally joint filers with incomes over the phaseout range *could* increase "stimulus" payments where there was some non-community income. So, a family of four with income of $160,000 vs. $150,000 would lose their ($1,400 x 4 =) $5,600 "stimulus" payment, as well as potentially some of the 1st and 2nd "stimulus" payments (the phase-outs for which began at $150,000, but at only a 5% rate); adding regular income and Social Security taxes on the additional income subjected them to inordinately high real marginal tax rates on that "chunk" of income.

Where non-community earnings were unequal between spouses, the

“splitting” strategy could substantially increase the 3rd payment. In one case, a couple’s income consisted of $140,000 of wages, $20,000 of unemployment and a $20,000 pension, for a total AGI of $180,000. Filing joint, their unemployment was fully taxable, making them ineligible for the pre-payment of the 3rd “stimulus” payment. Split returns brought each of their incomes well under $150,000, which allowed us to exclude the unemployment in full, saving ($20,000 x 22% =) $4,400 of tax. Each spouse was deemed to have earned $70,000 in wages. The pension is not considered community income (odd, since in case of divorce it sure is seen as a community asset!), leaving the pension recipient with a ($70,000 wages + $20,000 pension =) $90,000 AGI and the other spouse with an AGI of $70,000. Because the lower-income spouse’s AGI was below the $75,000 threshold for pre-payment of the 3rd “stimulus,” the lower income spouse claimed their two dependents and became eligible for a ($1,400 x 3 =) $4,200 pre-payment. If their income is below the threshold in 2021, we can get the other $1,400 when we file next year. We were on high alert for such opportunities.

Add-on Tax Rates for the 3rd “Stimulus” Pre-Payments

		3rd “Stimulus” Amounts		
Income (AGI)	**Filing Status**	**Taxpayer(s)**	**One Dependent**	**Two Dependents**
$75,000	**Single**	**$1,400**	**$2,800**	**$4,200**
$80,000	**Single**	**$0**	**$0**	**$0**
Add’l Add-On Marginal Tax Rate **		**28%**	**56%**	**84%**
$112,500	**Head of Household**	**$1,400**	**$2,800**	**$4,200**
$120,000	**Head of Household**	**$0**	**$0**	**$0**
Add’l Add-On Marginal Tax Rate **		**18.7%**	**37.3%**	**56%**
$150,000	**Married Filing Joint**	**$2,800**	**$4,200**	**$5,600**
$160,000	**Married Filing Joint**	**$0**	**$0**	**$0**

We also used similar planning techniques to maximize the 1st and 2nd “stimulus” payments if the client did not qualify for 100% of those prepayments. There were a lot of moving parts.

The mid-March repeal of the federal Premium Tax Credit repayment (the subsidy for health coverage via the government plan) along with the brand new, and intended to be offsetting, California Premium Assistance Subsidy created a tangled web for several California taxpayers. In at least one instance we found the state would refund several thousand dollars more than the net payments; after hours of double- and triple-checking our work and the law, we realized this result was an unintended consequence of federal and state tax differences.

The extension of the filling season to May 17, 2021 created an unintended logistical nightmare for estimated tax filers when it was determined that overpayments and extensions from 2020 taxes could NOT be backdated to the unchanged 1st quarter 2021 estimate filing deadline of April 15, 2021. As a result, a number of clients were required to pay separate April estimates for 2021 before we were able to determine the balance due with the 2020 return extension. What a mess!

We also had to contend with planning for possible IRA repayments or deferring income over three years, a tax change made at the very end of 2020; changing interpretations and rules on the treatment of PPP loan forgiveness and the EIDL (both of which we view as payment to businesses for the taking of their livelihoods; we view the takings as a violation of the 5th amendment); and the ability to use 2019 income figures to calculate the refundable Advanced Child Tax Credit and Earned Income Tax credit.

With so many mid-Season changes, we had to be innovative and continuously alert to situations where such strategies could be employed. I would say the system can’t get any more complex, but Congress continues to surprise us.

* The fact the IRS ended up agreeing with the position we were ready to take saved us a whole lot of extra aggravation, because we may well have filed the returns taking the full exclusions where appropriate, with a disclosure, or filing amended returns later arguing for the community property treatment.

** This is the marginal rate on the additional “chunk” of income of $5,000, $7,500 or $10,000, depending on filing status and number of dependents. Add to these rates regular federal income tax, state income tax, FICA, SDI and possible phase-outs of tuition credits. There may be some hidden rates we have not thought of. Isn’t this absurd?

Tracking Home Improvements to Reduce Your Tax Bill on a Home Sale in an Age of Inflation

Nationwide, housing prices are increasing beyond the wildest dreams of the biggest housing bull. The mid-2000s bubble was mainly a coastal affair. Now, prices are skyrocketing everywhere, including the once reasonably priced midsection of the country. Median home prices across the U.S. increased by nearly 15% (11% more than the 5% reported inflation) in the year ending March 2021 and 21% (16% more than the 5% reported inflation) over the two-year period ending March 2021. There was a staggering year-over-year increase of nearly 25% through June 2021. In many areas, prices have increased by much more. This is not just a high-end bubble; housing prices are up more than 50% even in less "desirable" areas (for example, the upper desert of Southern California, which crashed by nearly 80% after the 2005-2006 peak).

Housing price increases in California have far exceeded the 2.10% average annual rate of *reported* inflation from 1997 through 2020. For example, a client's San Fernando Valley home increased in value from about $150,000 in 1997 to $760,000 today, for an annual average compound rate of about 7%. If the price gains were only inflationary, using government inflation statistics, we would expect to see a current value today of only $253,500. Annualized gains of 2.1% due to only inflation would have resulted in a ($103,500 / $150,000 =) 69% increase in value. Annualized gains of 7% resulted in a ($610,000 / $150,000 =) 406% increase, showing the power of compound growth. If my client had a reason to sell today, I would recommend they consider doing so because we are in a bubble. Prices often end up below the point at which bubbles begin, arguably 2019 or earlier in most areas. How long will these fantastic gains hold? That is a question for another piece and a better crystal ball than mine.

Such massive price increases up the odds of selling a home with a net profit, *after* the exclusion of gain—a rare occurrence in the past. Net taxable profit for a qualifying main home is calculated by subtracting the following from the gross sales price:

- Original purchase price (unless inherited, where this gets trickier)
- Costs of sale (one-time costs such as commissions, escrow fees, legal fees, etc.)
- Cost of improvements
- $250,000 exclusion (generally) per qualifying owner

Add to the net profit any depreciation if it was ever treated as a rental or a home office, as depreciation must be "recaptured" when sold (you saved tax when depreciating; now you get to pay that tax back).

The $250,000 exclusion of gain for a main home has not been adjusted for inflation since its inception in May 1997 (prior to which the gain from the sale could be deferred by purchasing another main home for as much or more than the one you sold). If the $250,000 figure had been adjusted for *reported* inflation, today's exclusion would be $410,000 per qualifying person, or $820,000 for a qualifying couple.

In the past, the cost of improvements was generally not essential because the gain was usually offset by the $250,000 per person exclusion. Even with these crazy price gains, *recent* buyers of homes costing less than $1 million are not likely to see net profits exceeding the exclusion amounts. Our concern is for those who have owned for many years or decades who have often seen huge gains in their home's value. These are the folks who risk paying taxes on inflationary gains, and for whom an excellent bookkeeping system tracking the costs of home improvements is vital.

What is considered an "improvement" for your home? Generally, any changes, updates or upgrades you make that will last many years and are not intended to fix or repair an item, such as a torn window screen, minor plumbing or electrical work and most painting jobs. However, plumbing, electrical or painting that is part of a "home improvement project" (such as a room renovation or add-on) becomes part of that improvement. Everything from faucets and flooring to curtains and wallpaper to decks and landscaping count towards improvements. For multiple improvements to the same item, count only the most recent iteration. For example, if you reroofed twice, do not count the first! The same idea applies to carpets, drapes and other replacements.

For those with rental properties, don't confuse costs of maintaining a rental with those for a main or 2nd home, as many rental property "improvements" are currently deductible as "repairs" due to a regulation change in 2013, while such costs are often deemed "improvements" for purposes of your main or 2nd home.

What is the best way to keep records of your home improvements? First, you should keep a summary report of all improvements, by category, that shows overall spending from the date of purchase. You can use a bookkeeping computer program (we use Quicken); Excel, if you know how to use it properly; or the old school way, by hand. Using bookkeeping software, you can easily print a "summary" report showing all your improvements from the purchase date. Beware, as there are exceptions if you ever rented the home to others or used it for a home office. If so, you should have deducted or depreciated improvements

during those periods; you cannot deduct such expenses a second time. If you inherited it, even from a spouse, only count costs post-inheritance if the home was deemed "community property" (if not, it gets complicated; ask us if this applies).

Second, keep annual backup files proving each improvement or expense: maintain folders with cancelled checks, bank statements, credit card receipts or slips and credit card statements. Because credit card receipts or slips may fade over time, make photocopies, or scan them before they become illegible.

Keeping detailed records is worth your time because little expenses add up. One client swore total improvements totaled only $10,000 and, upon review of his records (after we pushed a bit), found they were closer to $50,000, for an additional tax savings of nearly $9,000.

Sounds easy enough, right? Not quite. Even I, who knows this stuff well, have struggled with keeping well-organized records over decades. I purchased our home in 1994, but my accounting software crashed in 2005 so I have no records on my computer from before (my back-up somehow got corrupted; I am much more careful now). I have a properly categorized Quicken summary report showing spending on improvements from 2005-on and an Excel spreadsheet for improvements from 1994-2005, since the computer record is gone. In addition, I have annual "home improvements" folders containing all receipts (as discussed above).

I thought my system was pretty good, but one day I was trying to find the folder for a large home improvement project from 2003. I should have been more diligent, but never dreamed we would have a larger-than $500,000 profit on our home. After going into a near-panic state looking for the paperwork, unable to find the folder containing the receipts and contracts, I wondered whether our original contractor could supply us with the records—if he was still around, since contractors come and go. He was, and he came through in spades. (A big thank you to Roger Perron Design and Construction!)

There is no perfect system, so the best we can do is minimize the damage if you sell a home with a greater-than $250,000 gain per qualifying owner. Because there is no expectation that the exclusion will be increased, if inflation continues unabated good recordkeeping will increasingly become your most important tax "shelter" (my late colleague and dear friend Mel Kreger, Esq., EA used to quip that the best tax shelter was "good recordkeeping"). Do not shred or otherwise discard any of the perhaps decades of records that help prove the cost of improvements until at least *four years after the sale date.* If you keep records in multiple locations, be sure to list all the locations on your summary report so they are easy to find—someone else may need the records to report the sale of your home if you are unable due to illness or injury. If you gift the property be sure to give complete records to the recipient(s).

The chart included with this newsletter is a great resource for tracking home improvements. Compiling records as you go along could save gobs of tax in this new era of inflation-induced higher home prices.

Home Improvement Tracking is Not Just for Home Sales

There are several reasons for tracking home improvements other than to decrease the tax if you decide to sell. First, you may convert your home into a rental or business property. Second, while rarely advisable, you may gift your home before death. Third, you may bequeath your home and the heir(s) does not receive a full stepped-up basis.

Due to the potential loss of the exclusion of gain, we generally do not advise converting your home to a rental or other business property. If you do convert, good records of prior improvements are crucial to maximizing depreciation deductions (for which we have some seriously neat tricks). Should you eventually sell, these records are used to prove deductible costs that would reduce your tax bill.

If you decide to move back to your rental property and make it your main home again, your main home exclusion (that $250,000 per qualifying owner figure) is limited to a ratio determined by the number of days the home was your main home vs. the total number of days you owned it since 2009 (2008 and prior years don't count for this equation, as the law was changed effective January 1, 2009). For the sake of simplicity, we will use months rather than days in our example:

- You used as it as your main home from 2009 through 2011 (36 months)
- You rented it out from 2012 through 2018 (84 months)
- You used it as your main home again during 2019 and 2020 (24 months)
- You sold it January 1, 2021

The exclusion ratio is (lived in 36 plus 24 months =) 60 months, divided by (the full period of ownership) 144 months = 41.666667%; the per person exclusion is $250,000 maximum x 41.7% = $104,167 exclusion. Two qualifying owners can exclude up to $208,334 of profit.

How Much is Your Main Home Sale Exclusion: Example One

Usage Type	Period of Use	Time Counted for that Use	Time that Counts for Exclusion	Exclusion Calculation
Main Home	2009 – 2011	36 months	36 months	60 / 144 = 41.6667% x $250,000 = $104,167 maximum exclusion per qualifying owner
Rental	2012 – 2018	84 months	0	
Main Home	2019 – 2020	24 months	24 months	
Total time		144 months	60 months	

Let's take a more complex case:

- It was your 2nd home from 2009 through 2011 (36 months)
- You rented it out from 2012 through 2016 (60 months)
- It was your main home from 2017 through 2020 (48 months)
- You rented it out during 2021 and 2022 (24 months)
- It was your main home during 2023 and 2024 (24 months)
- You rented it out in 2025 (12 months)
- You sold it January 1, 2026

The period after you moved out (the 12 months in 2025) does not count towards either the numerator or denominator of the fraction that determines the exclusion ratio so long as you lived in it for two of the preceding five years—in other words, you could rent it to others AFTER you moved out for UP TO three years and it does not count against you. The ratio then, is (lived in 48 + 24 =) 72 months divided by (full period of ownership from 2008 through 2024) 192 months = 37.5%. The exclusion of profit available on the sale of this property would be the $250,000 maximum exclusion per person x 37.5% = $93,750, or $187,500 for a qualifying couple. (For more analysis of this issue please see pages 3-4 of issue # 56 *Wealth Creation Strategies* at www.DougThorburn.com).

How Much is Your Main Home Sale Exclusion: Example Two

Usage Type	Period of Use	Time Counted for that Use	Time that Counts for Exclusion	Exclusion Calculation
2nd Home	2009 – 2011	36 months	0	72 / 192 = 37.5% x $250,000 = $93,750 maximum exclusion per qualifying owner
Rental	2012 – 2016	60 months	0	
Main Home	2017 – 2020	48 months	48 months	
Rental	2021 – 2022	24 months	24 months	
Main Home	2023 – 2024	24 months	24 months	
Rental	2025	0	0	
Total Time		192 months	72 months	

For gifted property, the donor's cost or basis is transferred to the recipient of the gift. This generally comprises the original purchase price plus cost of improvements, but also minus any depreciation ever taken. Because the recipient must rely on frequently incomplete records provided by the donor to prove costs, and the fact the recipient does not receive a "stepped-up" basis, we generally recommend against gifting.

Under current law inherited property gets a "step-up" in basis to the fair market value as of date of death. This value becomes the new basis for the heir(s) of the inherited part, which allows them to sell and, if sold for the value as of date of death, report no gain and pay zero tax. In many cases the heir(s) may even benefit from a deductible loss due to selling costs on the sale of what has generally become, after death, property held for investment. Appraisals are recommended for such inheritances, especially if the property will be retained by the heir(s) for any period longer than six months, as the IRS generally accepts the sales price as date of death value for property sold within that time-frame. All those old receipts and other records? If 100% of the property was transferred by inheritance, as is the case when grown children inherit property from their deceased parents, the cost of improvements before death become irrelevant. Only the date of death value and post-death improvements matter.

When ownership of non-community owned property transfers after the death of one spouse to a surviving spouse, only half the property receives a step-up in basis to value as of date of death. The cost of the other half is determined by taking half of the original purchase price and half of the improvements made both before and after death.

In a new wrinkle, proposed legislation would do away with the step-up in basis altogether, instead using the decedent's original cost plus improvements as the beneficiary's basis (the same as gifting). While looking less likely, it illuminates the idea that Congress could change this long-standing law, on the books since 1921, at any time.

Tracking the cost of home improvements is important regardless of usage, now more than ever. We recommend you carefully track all home improvements regardless of what you expect to do with it later in life. We've seen plenty of clients who were certain they'd live out their final days in their home, only to sell for reasons of health, climate, moving to a state with greater perceived freedom, or moving closer to relatives and friends.

Home Offices are More Valuable than Ever

Home Offices are also Eligible for Employer Tax-Free Reimbursements

The increased standard deduction has substantially decreased the number of taxpayers who itemize. As a result, most homeowners now get little or no (federal) tax benefit from their mortgage interest and property tax deductions. However, the self-employed can deduct a home office and employees can get a tax-free reimbursement for such expenses under an employer's accountable plan if they qualify.

How do you qualify? First, you must be self-employed *or* eligible for reimbursement for home office expenses under an accountable plan by your own or someone else's business. Second, you must track allowable expenses. Such expenses include not only obvious ones, like utilities, insurance, property taxes and mortgage interest, but also less obvious ones such as painting the whole house (of which the home office is part) or patching a roof that covers both home office and non-home office parts of the home. (The "home office" section of the business expense worksheet, included in our tax prep package, can be used as a template.) In one recent instance, the cost of a home office's proportionate share of solar panels created an additional $3,200 deduction, on top of a 30% tax credit for the solar panels!

Third, oftentimes a home office can be legitimately increased in size relative to the entire home. The area that counts can be a *part* of a room, which may comprise a *part* of the overall home office. For example, you can use an entire room plus a part of another room for equipment storage and file cabinets. The home office may include closets, built-in bookcases and even a bathroom. Done right, the additional deductions may be worth thousands of dollars in yearly tax savings.

For the self-employed, the area claimed must be used exclusively for business (which, as you might guess, means you must use the area *only* for work-related functions) and generally cannot be comingled with a spouse's home office. For employees using this rule, the space must be exclusive for that employee.

You can get tax-free reimbursements for extra home and other expenses incurred due to the Virus, even though your use is non-exclusive

An obscure law promulgated after 9/11, Internal Revenue Code Section 139, allows tax-free reimbursements or payments for "reasonable and necessary personal, family, living or funeral expenses" due to an eligible "federally declared" disaster (deemed by the President to warrant assistance under the Robert T. Stafford Disaster Relief and Emergency Assistance Act). The Virus was declared as such by President Trump which, unlike previous disasters encompassing only areas affected by tornadoes, hurricanes, earthquakes and wildfires, encompasses the *entire* United States.

We mention this because lockdowns and subsequent office closures could happen again. You sit on your living room couch or at the dining room table. You would *not* qualify for the home office deduction under the "exclusive" use (self-employment) standard, but an employer may pay tax-free reimbursements for such home office expenses under Code Section 139.

Similar to reimbursements for home office use under the "exclusive use" standard, such reimbursements to and payments for qualifying expenses are tax-free to the recipient and deductible by the employer. "Reasonable and necessary personal, family, living or funeral expenses" may include childcare, tutoring and other special schooling for those not permitted to attend school during any lockdowns, medical expenses not paid by "insurance," over-the-counter medications and even hand sanitizer. Arguably, tax-free reimbursable expenses also include those resulting from being required to work from home, which we believe includes extra utility costs (possibly substantial for those cranking up the air conditioning during the day), cell phone and internet costs, extra toilet paper, cleaning supplies and janitorial services.

Employers that wish to provide tax-free reimbursements for their employees should create a written, accountable plan to document the start and end date for allowable reimbursements, a general list of expenses that will be paid for or reimbursed to employees and any maximum amount eligible for tax-free reimbursements and direct payments of qualifying expenses per employee and/or aggregate maximum for all employees.

Take Advantage of the Estate Tax Exemption by Gifting Now

The gift and estate tax exemption was increased under the 2017 Tax Cuts and Jobs Act (**TCJA**) to more than $11 million of assets owned at death ($22 million per couple), creating no federal estate tax on assets gifted or left to heirs that exceed the net worth of 99.75% of Americans. Because this exemption applies to gifted assets as well as inherited ones, and because the amount of the exemption may be reduced by current or future administrations (and is due to revert back to pre-2017 levels after 2025), the wealthy, who may or may not have high income, should consider gifting assets now. We suggest anyone with a net worth exceeding $3 million ($6 million for a couple) or so consider planning for a lower exemption amount in future years.

Gifting generally requires filing a gift tax return for non-spousal gifts exceeding $15,000 per person per year. All gifts over the $15,000 yearly allowance reduce the estate exclusion, which reduces the amount of the estate one can leave to heirs tax-free. This translates to $30,000 from a married couple gifting jointly held funds to a child or anyone else; $60,000 from a married couple to a child and spouse, or any other couple. No tax is due under the lifetime thresholds, and gifts made now that exceed lower future limitations will not trigger retroactive tax. For example, if you and your spouse gift $10 million to family members in 2020 and future legislation reduces the estate tax exemption to $3.5 million per person (as currently proposed), you would not owe gift tax retroactively. However, you would not be able to make additional gifts or leave additional assets to heirs without incurring such tax.

You may wonder how the very wealthy avoid the estate tax. They don't unless they have made gifts during their lifetime that are less than the estate exclusion and/or they have left assets that exceed the exclusion to qualified charities. The less wealthy can do that, too.

Great care should be taken as to what is gifted. This is not a DIY proposition. Property and other assets to be given must be carefully analyzed, with due consideration to possible future tax law changes, as well as to whom such assets are gifted. Gift and estate tax considerations require evaluating the financial situation and condition of the entire family.

The state in which you reside is relevant, because some states tax gifts, estates and/or inheritances at much lower levels. A few impose such taxes starting at a net worth of as little as $1 million. California has no such tax, but CT, DC, DE, HI, IA, IL, KY, MA, MD, ME, MN, NE, NJ, NY, OR, PA, RI, VT and WA all have gift, estate and/or inheritance taxes, further complicating long-term tax and estate planning.

Current Events

Current events have me concerned over the survival of Western Civilization, without which few of us would ever have been born, and those few born would have mostly led short and brutal lives. Eric Hoffer's ideas may shed light on our plight.

We recommend that you use your expanded Child Tax Credit to help fund an excellent private education. Perhaps your child will become the next Eric Hoffer, who appears to have been entirely self-educated (not to mention blind for seven years while a child). He became a longshoreman—and a philosopher. From *The True Believer: Thoughts on the Nature of Mass Movements*:

"Scratch an intellectual, and you find a would-be aristocrat who loathes the sight, the sound and the smell of common folk."

"A man is likely to mind his own business when it is worth minding. When it is not, he takes his mind off his own meaningless affairs by minding other people's business."

"Those who see their lives as spoiled and wasted crave equality and fraternity more than they do freedom. If they [claim to] clamor for freedom, it is but [for their] freedom to establish equality and uniformity. The passion for equality is partly a passion for anonymity: to be one thread of the many which make up a tunic; one thread not distinguishable from the others. No one can then point us out, measure us against others and expose our inferiority." [A lack of talent can lead to a lack of self-esteem which leads to a clamor for equity.]

"Passionate hatred can give meaning and purpose to an empty life. Thus people haunted by the purposelessness of their lives try to find a new content not only by dedicating themselves to a holy cause but also by nursing a fanatical grievance. A mass movement offers them unlimited opportunities for both."

Hatred can coalesce into mass movements, because "hatred is the most accessible and comprehensive of all the unifying agents. Mass movements can rise and spread without belief in a god, but never without a belief in a devil….The quality of ideas seems to play a minor role in mass movement leadership."

"…absolute power corrupts even when exercised for humane purposes. The benevolent despot who sees himself as a shepherd of the people still demands from others the submissiveness of sheep. The taint inherent in absolute power is not its inhumanity but its anti-humanity."

"The significant point is that people unfit for freedom—who cannot do much with it—are hungry for power."

Cost of Improvements for Your Main or Second Home

ITEM	$ SPENT	DATE (MONTH & YEAR)	ITEM	$ SPENT	DATE (MONTH & YEAR)
Air Conditioner			Hardware (Bath, Kitchen, etc.)		
Alarms/Locks			Heater		
Appliances			Insulation		
Assessments *			Landscaping **		
Awnings			Lighting (Exterior and Interior)		
Brick Work			Mail Box		
Buildings (Sheds, Pool Houses, etc.)			Patios & Patio Covers		
Built In Appliances			Plumbing Improvements		
Built In Furniture (Shelves, etc.)			Pools (Spa, Ponds, etc.)		
Carpets			Rain Gutters		
Cement Work			Remodeling, Room Additions		
Curtains/Rods			Roof Improvements		
Deck/Deck Fixtures			Solar Panels (Less Tax Credit Received)		
Driveways			Stucco		
Electrical Improvements			Walkways		
Fans (Attic and Indoors)			Wallpaper		
Fencing			Water Heater and/or Softener		
Fireplace			Windows/Shutters		
Fixtures			220 Volt Line		
Floor Improvements			Other Items (specify):		
Garage					
Garbage Disposal					

* Special homeowners' assessments for new roofs, etc. imposed by Homeowner's Associations; city assessments for sewers, street improvements, etc.

** Trees, sod, plants, sprinkler systems, etc.

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What is Considered an “Improvement” for Your Home?

What is considered an “improvement” for your home? Generally, any changes, updates or upgrades you make that add value and will last many years and are not intended to fix or repair an item that broke, such as a torn window screen, minor plumbing or electrical work and most painting jobs. However, plumbing, electrical or painting that is part of a “home improvement project” (such as a room renovation or add-on) becomes part of that improvement. Everything from faucets and flooring to curtains and wallpaper to decks and landscaping count towards improvements. For multiple improvements to the same item, count only the most recent iteration. For example, if you reroofed twice, do not count the first! The same idea applies to carpets, drapes and other replacements.

Think of improvements as an investment in your property that prolongs your homes’ life, rather than repairs that are a reaction to something that breaks. If you have permanently improved the value or the life of the property, it’s an improvement. This includes:

1. A “**betterment**,” which includes adding a room or curing a defect, such as anchoring a building frame to its foundation in earthquake-prone areas.
2. A “**restoration**,” which includes restoring a property to its original state after a casualty, such as hurricane, fire or earthquake (but only to the extent not reimbursed by insurance).
3. An “**adaptation**,” such as converting a garage to an office, or bathroom improvements to accommodate a disability.

Q: Can I deduct for tax purposes a repair or improvement on my home in the year made?

A: No! Maintaining your home is not deductible, even if related to selling your home (e.g., painting and other deferred maintenance). Improvements that increase the cost “basis” of your home are *generally* only deductible in the year of sale. They reduce your taxable profit. So keep those old records!

Q: I got a deduction for improvements done when my home was a rental. Can I deduct it again?

A: Nope! But, if you depreciated the improvement, you may still have “basis” in that improvement. Add that “basis” to your cost of improvements!

Q: I got a tax credit for solar panels in my home. Can I deduct the entire cost of the solar improvement?

A: Nope! You must deduct the credit received from the total cost of the solar panels. So, you still get the benefit of MOST of the cost! If you spent $40,000 but got the benefit of a $12,000 tax credit, the amount to add to your improvements is $28,000.

Q: I deducted medically-related home improvements years ago (special stairways, lap pool, and whirlpool). Can I include those improvements in my cost of improvements for purposes of determining the profit on the sale of my home?

A: Probably in part. You likely did not get the full tax benefit of the medical costs. First, you can only deduct costs that exceed 7.5% of your Adjusted Gross Income (AGI). Second, you must itemize deductions. To the extent your itemized deductions exceed the standard deduction, you got a tax benefit. To the extent you got a tax benefit, you cannot deduct those costs again. But you can deduct the rest of those improvements! (Ask us to calculate this for you if it applies.)

Q: Is inside or outside painting ever an improvement?

A: Maybe if you put gold flakes in the paint. Otherwise, only that which is part of a home renovation.

Q: I installed stucco where, previously, there was only paint. Is that an improvement?

A: Yes! Stucco lasts a whole lot longer than paint and extends the property’s life and value.

Q: Can repairs made necessary because of a casualty loss be counted as “improvements”?

A: These are the only repairs that, to the extent you were not reimbursed by insurance, can be added to your cost of improvements. See restoration rules (item 2), above.

If you are unsure whether to add something to your list, ask us!

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