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- **How to deduct cat food**
- **Be prepared for tax season, extensions, IRAs and 1099s!**
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Wealth Creation Strategies

Tax and Financial Strategies

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"So, What's Deductible?" Cat Food?

Clients starting a new business often ask, "What's deductible?" We tell our budding new entrepreneurs that, generally, any expense relating to the production of or the attempt to produce income may be an allowable deduction. When asked to be more specific, we enumerate some of the more obvious expenses such as rent, supplies, telephone costs, advertising and professional fees. However, a recent case sheds some light on the reason the best answer is a nebulous one.

The case involved the owner of an auto salvage business who leaves cat food in his salvage yard. We all know that cat food is usually not deductible. However, the owner's goal was to attract wild cats in an attempt to deter snakes and rats from infesting his business area. The IRS conceded that a business benefit resulted. Therefore, the $300 spent on cat food became a deductible expense.

Many taxpayers think, "If the tax professional doesn't know my business, he can't possibly know what's deductible." However, since every entrepreneur runs his business in his own style, it's essential that we dispense with formulaic approaches to deductions. Instead, the top professionals are curious and have minds that are capable of both integrating seemingly disparate ideas and connecting the law to specific situations. If asked whether a specific expense is deductible, we ask, "What was your intent in spending the money?" If the purpose was to produce income and not forbidden by law, it's probably deductible.

Deductions can vary tremendously within businesses. One entrepreneur may never think of spending money on something that another in the same profession regularly splurges on. Amounts, too, can be dramatically different. For example, one actor spends only $5,000 per year on his craft, while another spends $50,000. We find similar spreads among real estate brokers, other sales persons and even computer software programmers.

Many believe that income tax preparation is boring. If worked with accountants' blinders, it would be. However, we take a scientific approach, often asking, "Why?" and, ultimately, "Why not?" So don't be surprised if the next time you ask what's deductible, we respond, "Cat food, if you're in the right business and using it for the right purpose!"

Don't Send the Kitchen Sink!

Occasionally, clients who drop off or mail their tax information give us far more than we need. While we don't want to discourage you from providing us with details that may shed light on your situation, excess unnecessarily adds to postage. More important, it can lead to errors.

Except for purchases of vehicles and other expensive business equipment, we generally don't need receipts. They are for you to keep in the event of an IRS inquiry. While some provide a year's worth of auto receipts, all we really want are total costs of repairs by business-use vehicle, along with odometer readings, found on repair bills, from near the beginning and end of the year. (These can be close to the end of the preceding and beginning of the subsequent year.)

A few give us all of their phone or other receipts. Rather then sending these, we simply need total costs for 100% business phones, with separate amounts for partial business phones and percentage of business use. The same goes for repairs, purchases and other expenses for both businesses and rental properties. If you do send such bills, please be sure to include why you are providing these, or else you may only confuse us.

The riskiest items to provide are year-end statements from IRAs and other retirement plans. On rare occasion, we have inadvertently included the interest and dividends from such investments and even buy/sell information on stocks sold, catching our error just before the return was completed. Since earnings from such plans are non-taxable until withdrawn, whatever transpires inside the plan is, from a tax point of view, totally irrelevant. You'll receive a 1099 reporting the taxable amount when you withdraw funds, which is all that matters when preparing an income tax return.

On the other hand, we need year-end Keogh retirement plan statements for filing forms 5500, or to determine whether we need to file these forms. It helps if such statements are clearly marked. It's ok to share with us the non-Keogh retirement plan information if you have questions, but please attach a note distinguishing these from your regular taxable accounts.

It's a good idea to give us year-end 1099s for children's accounts, since a return may need to be filed even though no tax is due. For example, the government doesn't know that there was a $25,000 loss on $5,000 of securities sales until we inform them. They just see $5,000 of income subject to tax. In addition, stocks sold at a loss may yield a capital loss carry forward that can yield tax savings years later. You can help us help you by noting and separating such accounts from yours.

While we're pretty good at reading minds, every now and then we err. To reduce the odds of a mistake, please clearly note anything different or unusual in the material you provide us.

Should We Just Put You on Extension?

If you don't call before April 10 as we begin to prepare extensions, we are put into a quandary. Many figure we will mail your extension even without calling. While not our policy, we have done this for some. We telephone others, many of whom respond with a resounding, "Yes! Thanks for the call!"

The longer you have been with us, the greater the likelihood we will extend without a request. However, this is not always safe for us. Years ago, we did this for a client who had been with us about a dozen years. When we called him near the end of the extension period in late July, he screamed, "How dare you put me on extension without asking. I went elsewhere!" Every year we earn new clients while losing some old ones. While we don't miss someone like this, his angry response made us more cautious about putting people on extension without asking. We'd prefer that you send us pertinent "official-looking" documents such as W-2s and 1099s, requested elsewhere in this issue, along with your request. Besides, the IRS could conceivably disallow any extension on which reasonable estimates as to tax liability are not made (even if the tax is not paid). Without the documents, it is impossible to make such an estimate.

Extensions and First Quarterly Estimates

We generally suggest that you include the estimated tax due for the prior year with any extension, along with the first (and often second) quarterly installment for the upcoming year. Some have asked why we don't recommend sending a separate check for the estimates. The reason has to do with an inadvertent underestimate for the prior year. Let's clarify this.

Assume we think you owe $10,000 for the prior year and $5,000 for the first two quarterlies of the upcoming year. We later find that last year's tax due was actually $15,000. If we sent the estimate payments separately from the extension, you'll owe interest and late filing penalty in the one per cent per month range (with a first month 5% kicker to the state of California) on the $5,000. If instead we had sent the entire amount with the extension, we simply apply it to the prior year. The late payment penalty for current year quarterlies is currently half of one per cent per month. We saved 4% plus 1/2% per month on any state tax due along with 1/2% per month on the federal tax owed. These penalties can add up. On the other hand, if our expectations of tax for the previous year are correct, we simply apply the refund to the first (and subsequent) quarterlies, thereby saving postage if nothing else.

We can't prepare accurate extensions without your help. Please do us a big favor—send us your documents with an extension request by early February, even if you've promised yourself to file on time. Those of you going on extension are consistently almost all the same people. We have no problem with this; let's just be realistic about the odds of changing behaviors. I know I will go on extension every year. I plan accordingly. You can do the same.

Last Minute Extensions and IRAs

Cajole as we do, there are always those who provide us with tax information on or near April 15. There are several reasons why I don't expect this to change, even though you read this article.

First, some are simply procrastinators. I understand the creative mindset that is often at the root of this behavior.

Others have emergencies or other life problems, resulting in tax preparation being put at the end of the line. Some are simply too busy with work; I can be included in this category. I haven't filed a return before April 15 in over 20 years.

Since September 11, 2001 too, many have re-prioritized life, holding the opinion that the government can wait. This is not a problem as long as the appropriate tax is paid with the extension and desired investments in IRAs have been made.

This is where our job is made challenging. While we can closely estimate the tax for some clients, it is difficult when there are large numbers of such estimates in April or when the situation is complex. Last year in particular, very few sent their information in January (even though we strongly encourage it) and an inordinately large number waited until the last minute. While irrelevant for those who have no funds with which to pay tax or invest in IRAs, it's important for clients who do have such reserves.

The trouble lies in accurately calculating the taxable income with incomplete information and when, after ten 70 to 80-hour work-weeks, your trusted adviser (along with hard-working staff) may be more prone to error. The selection of optimal IRA (traditional or Roth) is in large part a function of taxable income and filing status (single, head of household or married). This makes the decision particularly difficult for those straddling the 15% and 27% tax brackets. If $1,200 is taxed at the higher rate, we generally recommend that an eligible taxpayer invest that amount into a traditional IRA and the balance of allowable contributions ($1,800 for 2002, or $2,300 if age 50 or over) into a Roth.

Such determinations are also challenging for those whose incomes are near or within the IRA contribution phase-outs ($95,000 to $110,000 single and $150,000 to $160,000 married). Take a married couple whose adjusted gross income is estimated at $154,500. If accurate, they will each be allowed to invest up to $1,650 into year 2002 IRAs. If we later find (or an IRS auditor belatedly determines) the income to be $157,000, the allowable contributions are reduced to $900 each, subjecting each $750 excess to over-contribution penalties. If the income turns out to be under $150,000, our clients missed the opportunity to invest up to $3,000 each ($3,500 if age 50 or over) into these tax-favored vehicles. To make precise determinations, we need to have the return virtually completed (even if not filed) without error by April 15.

Tax law changes effective for 2002 promise to increase the cost of any errors as well as lost opportunities. Precise calculations are required to determine the savings of the new low-income saver's tax credit. Forgetting to include even $1 in income may increase or decrease the prospective tax savings of a $2,000 contribution by $300. We don't like to make such errors, miss potentially large tax savings, or see clients hit with penalties.

What can you do to help us help you?

We delivered our exclusive "By Mail" package with folder in December. As soon as the "official looking" tax documents (W-2s, etc.) begin arriving, simply slip them into the folder. Send the package to us on February 5, even if you are still waiting for additional documents. Be sure to complete the sheet that asks if you'd like to be put on extension, along with the amount you'd like to invest in IRAs. You can always respond, "I don't know yet if I'm going on Extension—but prepare for it." Inform us of any major changes to your situation so that we can incorporate these into our mental estimate of taxable income. In addition, tell us how much you'd like to invest in IRAs. If we receive your initial "mini" package by February 7, we'll be able to give you an idea by mid-February of where you're at tax-wise, which IRA would be right for you and how much tax an IRA contribution will save. If you appear to be "straddling" tax brackets or are at or near the phase-outs for allowable contributions, we'll let you know that you would be best served by re-prioritizing your tasks, to make tax preparation first.

Our greatest desire is to continue offering you unparalleled service and apply innovative ideas to your situation that you won't find anywhere else. We need your help to be able to maximize the income producing and tax savings opportunities available to you.

1099 Filings for Business and Income Property Owners

Most of you regularly file 1099s when required. Non-employees' names, addresses, Social Security numbers and amounts paid in the course of operating a business or rental property are reported on these forms. The government matches these reports against the returns of the recipient. Those who don't report the income are virtually guaranteed a letter, if not a full-blown audit, proposing additional tax. Despite the fact that the reporting requirements have been in place for decades, confusion exists even among those who regularly file. Since they're due in January, it's a good time to review the basics.

There are almost as many kinds of 1099s as there are types of income. Even those not owning a business/ rental property or working for people who do, are familiar with at least a few varieties. Owners of accounts earning interest income receive 1099-INTs, while persons who own dividend-paying securities are sent 1099-DIVs. Taxpayers who sell stocks are issued 1099-Bs (for Broker transacted sales) and retirees receive 1099-Rs for retirement income. With the exception of clients who pay interest to private lenders to finance their business or rental, few small businesses are obligated to issue these 1099s.

The most common ones issued by small business or rental property owners are 1099-MISCs, or "miscellaneous" income. These are, most commonly, for non-employees paid over $600 during a calendar year and rents paid in the course of business. They are not required if the payment is non-deductible (i.e., personal in nature), or if the payee is a corporation other than legal or medical. Nor are 1099s required if the payment was for goods subject to sales tax law.

The penalties for not issuing 1099s when required are $15 per 1099 for filings up to 30 days late, $30 for those filed more than 30 days late but by August 1, and $50 for filing them after August 1. If not filed at all, the penalties may apply and the deduction may be completely disallowed in audit. Since this usually results in a cost far greater than $50, we strongly encourage our clients to file the reports late rather than not at all. Further, until recently penalties for filing late were being automatically abated, or easily removed with a letter of explanation. The IRS has become far more resistant to eliminating these penalties, but it's still possible, especially for first-time filers who just didn't know any better until informed of the rules when having their income tax return prepared on a timely basis.

We may have a few clients who appear to have flaunted the law in this area for some time. There is a risk that the client could be construed as purposely evading the law, which could be viewed either as fraud or collusion with the payee, which is just as bad. We don't want to be caught in the crossfire between a client and the IRS on this issue. Therefore, we expect to hear from you in January if 1099s need to be filed. You will find our 1099 worksheet in our By Mail package, which can easily be faxed to us.

Reporting New Subcontractors During the Year

California business or rental property owners who pay independent contractors are subject to more than just the 1099-filing requirements. Payees must be reported to the state within 20 days of making payments or, if earlier, entering into a contract for $600 or more within a calendar year. In an obvious act of legislative overkill, this must be done every year, even if the same persons continue to be paid. Unless informed otherwise, we assume payees continue in subsequent years and, therefore, automatically report to the state all payees for whom we file 1099s. While we have a real problem with the rule (the state is trying to collect past due child support from "deadbeat dads" whose average income is less than $12,000 a year) we encourage all of you to comply with the law, which we take care of for you when informed. This may be a challenge with new payees. It's just too easy to forget when going about your normal business in the middle of the year. Unfortunately, those who forget are at risk of incurring a $24 per payee penalty for non-compliance and a $495 penalty if suspected of conspiring with the payee.

1099s and state reports are required for many payees that may not be obvious. In the case of rental properties, these could include gardeners, electricians, plumbers, other non-incorporated sub-contractors and handymen. For businesses, consider web masters, consultants, persons to whom the business owner pays commissions or finders' fees, and attorneys (incorporated or not).

Our general rule is to present a form W-9 to payees before we hit the $600 mark. The recipient fills in name, address and Social Security number, and signs the form. This takes you off the hook for any sort of fraudulent claim, unless you "should have" known better. This may include a W-9 that clearly reports a false Social Security number—for example, a number with more or fewer than nine digits. If the payee refuses to sign, the payer is required to withhold 30% of the payment and remit to the IRS, along with 7% for the State of California. Needless to say, once a W-9 is presented to a payee, compliance is very high. If you fax the completed form to us, we will be happy to send the required information to the state.

Letters to Doug

Dear Doug,

In the November-December, 2002 issue, you made a good case for selling a portion of one's real estate holdings as a hedge against today's overvalued market. I wonder how this affects someone like me, who owns only a home that I plan to continue living in, along with one rental property.

My investment real estate has rocketed in value from $200,000 to $600,000 over the last decade. Depreciating the property has reduced what you have informed me is my "cost basis," or cost for purposes of calculating my taxable gain, to $150,000. Subtracting expected selling costs of $42,000 and this "basis" of $150,000 from the $600,000 selling price would net a taxable gain of $408,000. You have also explained that because I'm subject to the Alternative Minimum Tax and deduction phase-outs, my real tax rate is not the advertised 20% but instead 23%, plus California state income tax of about 10% (again, not the 9.3% advertised rate due to phase-outs). My expected tax, then, is almost $135,000.

Since I own the property free and clear, I would net $423,000 ($600k - $135K tax- $42k selling costs = $423k). I am, then, better off selling only if the property plummets by $177,000 to $423,000, and if I do a better job investing the $423k than by simply holding the existing property. The decline represents an almost unfathomable 30% collapse in price. I wonder if we'll really see a decline of that magnitude and whether I will invest the proceeds wisely enough.

In the meantime, my net rental income is $25,000 per year after deducting maintenance, a realistic reserve set-aside for long-term replacements (roof, central air and the like), property tax and insurance. This doesn't seem a bad return considering the alternatives in this low-interest rate environment in which stocks have been a disaster. Taking everything into account, it seems to me I should hold. Am I missing anything?
--Feeling Locked In

Dear Locked In,

Your moniker is very appropriate. Investors with large gains often feel "locked in" to a stock or property due to a potentially enormous tax burden. However, we have on many occasions been reminded by our clients' real-life situations that Mr. Market can take away far more than Mr. Government.

Your situation raises several great issues. How far does the price of your investment have to fall before you do better by having sold? Can you earn a higher return on investment elsewhere? The answers require that we know the approximate tax consequences and transaction costs, which represent something referred to as "equity dilution."

My answer would be very different if you were considering a sale of securities inside an IRA or other retirement plan. The transactions cost for any sizeable stock sale is now close to zero, which is far from true for real estate. Furthermore, the tax is zero. The only question is whether you expect the price of the stock to fall by an amount greater than the cost of selling.

While there are tax consequences for asset sales outside of retirement plans, securities prices have been far more volatile than real estate prices. We have seen many clients who refused to sell a stock in which they had large gains, because the tax cost was perceived as too great. Unfortunately, many $10,000 investments have made the round-trip to $100,000 and back to $10,000. This is far worse than any possible tax consequence and is the reason we suggest that clients who won't sell 100% of an overvalued stock should at least hedge and sell half.

While real estate investors have rarely experienced volatility of this magnitude, they need instead to consider a relatively illiquid market that can make such investments far more difficult to unload.

To better understand your situation, let's compare it with someone who paid $550,000 for the same property and has, therefore, a far lower tax to consider. The cost basis would be around $475,000*, and taxes would run about $30,000**. Taking into account both selling and tax costs, compare net equity on the "net proceeds" line (line 5) in the chart below, and "equity dilution," or reduction in net worth from having sold, just below it (line 6):

1. Original Cost	$200,000	$550,000
2. Selling Price	$600,000	$600,000
3. Less Selling Costs	($42,000)	($42,000)
4. Less Tax Costs	($135,000)	($30,000)
5. Net Proceeds (equity)	$423,000	$528,000
6. Equity Dilution (total costs)	$177,000	$72,000
7. % Drop From FMV	29.50%	12%
8. % Return on FMV	4.17%	4.17%
9. % Return on Net Equity	5.91%	4.74%

5. = 2 less 3 less 4
6. = 2 less 5
Equity dilution: taxes and transaction costs
7. = 6 divided by 2
8. = $25,000 (net rent) divided by $600,000 (fair value)
9. = $25,000 divided by line 5 (net equity after costs and taxes)

While we have seen many corrections of 12% in real estate, we have seen few in which holders have suffered losses of almost 30%. Oddly then, it is easier for an investor with a small gain to sell than for someone like you, with a large profit. In other words, the price drop needed before you are better off having sold is far greater than for the investor with a smaller profit. You are a victim of a potentially large "equity dilution," which creates the "lock-in" effect. The higher the potential tax and transaction costs, the greater the equity dilution and the more an investor may feel locked-in.

There is another important consideration for which I gave a hint, when I stated in the article to which you responded, "the higher the tax the lower the dividend one might accept." I should have added, "on one's existing investment." This is related to equity dilution.

Take a look at the last line in the chart above, "% Rent Return on Net Equity." This is the return after tax and transaction costs, or "dividend." (You can perform the same calculation on the return from any other investment, including stocks.) Note that this is quite a bit greater than the return on Fair Market Value in the line above. This tells us how much harder our money must work for us if we sell. Our net return on gross value is 4.167% ($25,000 net rental income divided by FMV of $600,000). After selling your property, you need to earn 41.8% more, or 5.91%, to provide an identical $25,000 yield. In other words, you have to be 41.8% more right in the replacement investment than in the one you currently own. Our friend with the smaller profit needs to earn only 4.74%, or 13.6% more, to achieve the same net income. Therefore, the greater the tax and selling costs relative to value, the higher the return we need in the replacement assets to stay even. Conversely, this means you may accept a lower return on your existing investment than does someone who incurs lower overall transaction costs.

On the other hand, there are several other options and considerations.

1. You own only one investment property. If you owned several, it would seem more reasonable to hedge your bets and sell at least one of them.
2. You might consider a tax-deferred exchange into a property with a higher net yield, while achieving greater diversification. For example, you could exchange your equity into several $200,000 properties or units totaling $600,000 or more.
3. A tax-deferred exchange could be utilized to build liquidity despite paying some tax, while continuing to defer tax on some of your profit. For example, if you exchanged into $400,000 worth of property, you'd pay tax on just the $158,000 ($600k less $42k selling costs, minus the $400k replacements) in cash received, continuing to defer the tax on $250,000 of profit.
4. Even though an exchange will defer income tax, in California your Proposition 13-based property tax will increase to 1% plus voter-approved

bonded indebtedness of the purchase price of the property into which you exchange. Because the property tax is based on the price you paid (plus 2% per year), not current value, this could reduce your net return by several thousand dollars.

5. You are at great risk for an economic downturn if your property consists of only one or two units. You could suffer vacancies, refusal to pay on the part of tenants, or a collapse in rental values, any of which could decimate your net return.

6. An installment sale could be utilized, although you would still be at risk for a sharp downturn in real estate (you might, at some point, have to foreclose on the buyer). This would, however, allow you to collect interest income on the loan undiluted for income tax costs. Collecting 7% on owner-carried financing on, say $400,000 yields a substantially greater return than 7% (or likely less) on the cash less applicable income taxes, which continues for the duration of the installment agreement.

7. Investors should be averse to buying new properties in an environment in which the return is less than 5%. They should hesitate at net expected returns of between, in my opinion, 5% and 8%. Assuming no decreases in the net rental income, buyers could "hesitate" until the value of your property has dropped by almost half.

The problem with exchanging is finding another investment that has greater income and/or potential than the property you are selling. There is a possibility that real estate in some areas may suffer price drops as catastrophic as those experienced by stocks, which may make finding property worth holding on to challenging. This could still be dangerous, since there is some risk of a complete and total collapse in real estate values nationwide.

If the recent gains in single family homes were supported by similar increases in household incomes, there would be less cause for concern. The trouble arises when we compare increases in prices with that of incomes. The historical precedent in the late ‘80s, when there were huge price gains in, for example, Boston and Los Angeles, is disconcerting. According to The Wall Street Journal (October 3, 2002), home prices rose 73% over a five-year period in Boston while incomes grew only 42%, leading to an 11% price drop and a flat market for an additional five years. Prices increased by 89% in Los Angeles over a six-year period, while incomes increased by 37%. That imbalance led to a 24% price drop in the early ‘90s.

The disparity is far greater this time. Home prices have almost doubled in Boston, while incomes have grown only 22%. Similarly, home prices have shot up 81% in New York’s Long Island suburbs, while incomes have increased by barely 16%. Similar statistics can be found across the country, including, no doubt, California.

Interest rates are far lower than just a few years ago and may account for some of the disparity. However, it is hard to justify price increases such as these when mortgage delinquencies are near their highest level since the early ‘90s, and a record number of mortgages (1.23%) are in foreclosure. Considering the fact that unemployment is nowhere near the peak levels of past economic downturns, something doesn’t seem quite right.

Humility is essential when making investment decisions. Since we don’t have crystal balls, we can only make rational, informed and educated guesses. Asking, "What if prices collapse?" is essential. You must be able to respond with some degree of certainty in regards to both your emotional reaction and financial survival.

* The higher cost basis yielded greater depreciation deductions, accounting for the greater drop in basis.

** A 35% rate due to "depreciation recapture," which subjects the depreciation previously taken to a higher tax rate than the rest of the capital gain.

Dear Doug,

In your November-December, 2002 letter, you described 529 plans and Educational Savings Accounts. You pointed out that the donor can exercise some control over the funds in these accounts. Since alcoholism runs in my family and money is the biggest enabler, I’m very concerned about restricting access to funds. My children are toddlers, so it will be impossible to determine if they have inherited alcoholism until it’s too late. You mentioned the funds could be redirected to another beneficiary in 529 plans and in some ESAs, if the right trustee is selected. How much additional control can I exercise?

--Uncompromising Disenabler

Dear Disenabler,

Your tacit acknowledgement that your children may have an inherited a predisposition to addiction and desire to never allow money to protect them from the consequences of misbehaviors is commendable. Fortunately, in an amazing act of clarity (or, perhaps, a wonderful mistake) Congress saw fit to allow the donors of 529 plans full control over expenditures. The donor remains, for all intents and purposes, the owner, even though the funds are not considered part of the donor’s estate.

The donor/owner not only authorizes all expenses, but can even veto paying for USC when he’s a UCLA alumnus. (Families in which one spouse graduated from USC and the other from UCLA might consider having two such plans.) The owner can withdraw the funds for his own use (paying the appropriate tax and penalties), or re-designate anyone else as beneficiary including himself. If he wants to get his Masters or Doctorate, this may be a terrific way to fund a "back-to-school" sabbatical. There is apparently no age restriction in most 529 plans (although it appears there is an age 45 maximum for California plans).

Section 529 is a fairly new Internal Revenue Code section. It sometimes takes years for professionals, the IRS and the courts to digest and agree what new laws intend. We’ll keep you informed as our understanding of these powerful investment vehicles increases.