TAX MANAGEMENT

INCOME-SOCIAL SECURITY-REAL ESTATE

INCOME, SOCIAL SECURITY
and REAL ESTATE TAXES

THE INCOME TAX

It may be an understatement to say that our tax law is complex; in fact, it is almost laughable when you consider the enormous mass of instructions, regulations and contradictions which make up the Internal Revenue Code (IRC) which affects the life of every citizen in one way or another. In 1983 there were 2,350 pages of Internal Revenue Code, 5,600 pages of official Regulations, 24,500 Revenue Rulings, 37,000 Tax Court and Board of Tax Appeals Rulings, 35,000 Federal Court decisions and pending rulings, regulations and propose new legislation as well. Twenty-three years later, according to the US Government Printing Office, the IRC was 13,458 pages not including the more than 3,000 pages written by members of Congress that make up the full text of Title 26 of the United States Code (IRC). The main thing to remember is that the people with the greatest understanding of our tax laws generally end up paying the least taxes.

INCOME

Do you know what income is? If you're tax-wise, before answering you'll ask: Do you mean gross income, adjusted gross income, ordinary income, earned income or taxable income?"

Congress defines gross income as "all income from whatever source derived." That doesn't seem to leave much to the imagination; salary, dividends and earned interest, proceeds from sales, services, barter proceeds, alimony payments, pension and other retirement plan payments, winnings (dollars and other prizes), anything you find, canceled debt (you may not get money but you get relief from no longer having to pay it), and so on and so on. Now that you're convinced that everything you can think of is income, we'll tackle the exceptions.

GROSS INCOME

Wherever specific amounts are mentioned check the IRS web site for changes effective in the current year.

Not included in gross income are life insurance proceeds which are though to indemnify a beneficiary for the loss of a loved one and perhaps someone who was also a means of support.

Damages received because of personal injury settlements are excluded from gross income for the same reason; they are viewed as indemnity for pain and suffering; also excluded are medical expense payments made by your life insurance company. An added bonus here is the amazing fact that the lost earnings which would have been taxed if received as wages are free of all taxation when obtained because you can't work!

The first $5,000 of death benefits from a deceased spouse's employer is excluded from your gross income.

Disability payments from insurance you purchase yourself are not included in gross income but if your employer paid for the contract and you did not report those employer-paid premiums as income then generally the disability payments will be considered taxable income to you.

Workmen's Compensation benefits are not included in figuring your gross income.

Salaries of enlisted men in combat zones are not taxed, and officers get the first $500/month excluded.

The values of gifts are also excluded. The rationale seems to be that the gift-givers are the ones with the money so tax them. An exception to this rule is the case where the gift you are given consists of the income from real estate or the right to receive interest or dividends from bonds or stock while the donor continues to hold the property. Since the rents, interest or dividends are new income they haven't been taxed already (in this case the donor hasn't paid the tax) so the IRS comes after you, the donee.

Meals and lodging are excludable if essential to your job. .

The value of ministers' living quarters are also excluded..

Scholarship and fellowship grants are also excludable when applied toward study and research as opposed to teaching. The rationale here is gifts are untaxed and compensation (wages form teaching) is taxed.

The first $100 of dividend income is excluded from gross income each year. After all, the corporation has paid taxes on it once already.

Living expenses paid under a homeowner's policy if your house was damaged and you have to live somewhere else for a while are also excluded from gross income.

Social security benefits and mustering-out payments from the armed forces are both excluded from gross income.

The whole subject of fringe benefits and barter are in limbo. The IRS wants to include them in gross income but by their nature they are hard to trace.

Term life insurance premiums paid by an employer are not included in an employee's gross income unless and to the extent that the face value of the policy exceeds an amount stipulated.

Unemployment compensation is taxable only if and when your total income exceeds the amount stipulated by the IRS.

Since an annuity is purchased with dollars which have already been taxed, when you get those dollars back they won't be taxed again but what they earned will be. You'd think the politicians would let you recoup your capital before they begin taxing the interest you are earning; after all, you could die without having gotten back the original amount you paid for that annuity so it can't really be clear just what they are taxing. Since they can't wait for the real earnings to begin, they use actuarial tables to determine what you will or would have made if you live the amount of years you're supposed to. The insurance company will provide the actuarial information you need for your tax return.

You’re even taxed on interest from Treasury bills and bonds of the United States Government. You lend the government money, they give you a modest interest and then have the nerve to tax you on it! They figure your risk is zero but it still doesn't bring out one's patriotic feelings, does it? On the other hand, interest paid to citizens who loan money to state and local governments by purchasing bonds, is excluded from gross income.

Workers who have low-paying jobs generally recoup fifteen percent of their payroll tax through the earned-income tax credit (EITC).

Contrary to normal perceptions, recent polls show that over half of all Americans own stock either directly or through their pension plans. This means they benefit when taxes on dividends and capital gains are lowered.

At this point the IRS can see what you've got (gross income established) and its appetite is controlled while you proceed to take some deductions.

DEDUCTIONS, EXCLUSIONS AND CREDITS

Before you get confused, let me arm you with three helpful definitions:

Deductions reduce income.

Exclusions erase all memory of the transaction.

Credit reduces the amount of tax due.

We spoke of exclusions above in determining gross income. Now we will consider the role certain deductions play in establishing adjusted-gross income.

BUSINESS DEDUCTIONS

Adjusted-gross income is really your *net income*—everything you make—minus what you spent to make it. The later are business deductions.

You may deduct from your gross income, with exceptions and explanations of course, all ordinary and necessary expenses connected with making a living. Commuting expenses are not deductible, but all transportation expenses incurred while on the job are, including meals, lodging, transportation costs, tips, laundry, phone calls, and anything else you can prove is necessary to your employment. If you are an employee, these expenses must have been incurred while away form home. The IRS (Internal Revenue Service) defines *away from home* as requiring you to sleep or rest before completing your work. If you stay overnight you can then deduct meals and so forth, but not otherwise. (Could the hotel lobbyists have anything to do with the sleep and rest requirement?} *Home* under this regulation refers to your principal place of business, not your residence. You can readily see why it is important for a traveling salesman to establish an IRS defined *home* somewhere so he can be away from it in order to qualify for travel deductions.

There is a great deal of litigation surrounding transportation and travel deductions so if you have such deductions in the normal course of your business be sure to check the IRS web site for its substantiation requirements in this area as well as those surrounding entertainment.

Entertainment expenses can only be deducted if you are a business owner or are an outside salesman unless you are reimbursed by your employer and can substantiate the expenses. The burden of proof is on you. You must keep an account book and provide receipts or other documentation.

Education expenses related to your trade or business are also deductible but not if the education qualifies you for a *new* job or career.

Moving, if made due to a new principal place of work is a cost of earning money. Once moved you must stay put pursuing a full-time occupation for a minimum of 39 weeks. The business must be at least 35 miles farther from your residence than was your old place of business. There is no ceiling to the moving expenses you can deduct as long as they are legitimate, but there is a $1,500 limit for searching for new quarters. It deters looking forever while deducting your living in some fancy hotel. Expenses incurred in both buying and selling a home are also included here up to $3,000 but remember your searching expenses come out of this $3,000.

Also deductible, but not really business-connected, are alimony payments, an IRA and other retirement contributions.

PERSONAL LIVING DEDUCTIONS

In order to determine your taxable income the adjusted-gross income is reduced one step further by personal living deductions referred to as itemized deductions. These itemized deductions are: the *interest deduction* (whatever you have to pay for the use of someone else's money); the *casualty deductions* (losses of property caused by theft, fire, flood or other disasters); the *charitable contribution deduction*; the *medical expense deduction*: and the *state and local tax deduction*. People in a high tax-bracket usually choose to itemize; they often have large interest payments, more charitable contributions and they save more on every dollar than would an itemizer in a lower bracket. Under our progressive tax system as your income increases you get taxed at a progressively higher rate.

The majority of taxpayers choose the easy way to reduce their adjusted-gross income; that is by using the *zero bracket amount*, known as the standard deduction. The zero bracket amount lets you automatically, no questions asked, reduce your adjusted-gross income by $2,300 if you're single and $3,400 for a married couple. You don't really subtract this amount from adjusted-gross income because it is figured out for you in the tax table as a built-in-deduction. Therefore, if you itemized you must immediately subtract $3,400 on a joint return and $2,300 on a single return from your itemized deductions.

EXEMPTION

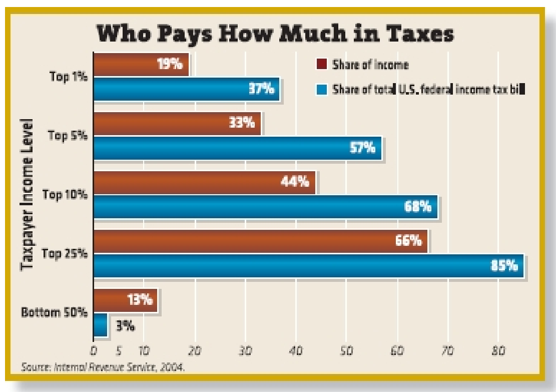
Exemptions are another form of deduction; a people deduction. You reduce your income by $1,000 for each mouth you have to feed—even your own. A mouth is considered yours to feed if you provide more than half the support, thereby making that individual your dependent. Dependents include children under nineteen years; over nineteen if full item students (in school five months out of the year), or if they make less than $1,000/year; relatives who can live anywhere as long as half their support comes from you and they earn less than $1,000/year; non-relatives who must live in your house to be considered dependents but even so if your relationship is against the law they cannot be claimed as dependents (so far no live-in lovers, just spouses). As a rule the parent who has custody for the greater part of the year claims the child of a divorce as a dependent unless another arrangement has been reached.

SO AGAIN—WHAT IS INCOME TAX ?

We started with the idea that income tax is a tax on everything. Then we erased a good portion of that income with a whole list of exclusions; that gave us our *gross income*. In order to arrive at our *taxable income* we had to go through three sets of deductions; business (things that help you make your living), personal (zero bracket or itemized deductions), and people (exemptions). After the first stage of deductions, when business oriented expenses were deducted from gross income we arrived at what the IRS calls adjusted-gross income (net income). But it is only after the personal and people deductions are applied that your taxable income can be determined by referring to the tax tables.

WHAT IS A *FAIR* SHARE?

The graph below is based on 2004 IRS figures and a 2007 article written by Stephen Moore that I urge you to read.



You might not be surprised to find that one percent of the population earns nineteen percent of the income. What might surprise you is that same top one percent pay *thirty-seven percent* of the taxes and that those just below the medial income level earning 13 percent of the nation's income pay only three percent of the nation's taxes. That leaves the middle 39 percent of the population holding the bag for 29 percent of the taxes.

2004

Percent of population	Percent of taxes paid
Top 11	68
Mid 39	29
Low 50	03

SOCIAL SECURITY

The Social Security Act was legislated in 1935 when there were fifty workers for every retiree. The tax was originally a mere one percent of an employee's salary matched by one percent from the employer. If these funds had been invested, as are the funds in all other regulated retirement plans, our social security system would not be in the financial straits it is today. In fact, one study showed if those finds had been managed and invested properly citizens could be receiving, with no strain, over triple the benefits the social security system is struggling to provide currently.

Unbelievably, Social Security is an unfunded program; FICA taxes (Federal Insurance Contribution Act) have co-mingled with other funds for years instead of multiplying off by themselves as most believe. Retirement benefits were simply paid out of current taxes, which was not too bad even in the 1950s when there were sixteen workers paying-in current taxes for every retiree taking-out. Today there are two workers paying-in for every retiree withdrawing benefits and the tax is no longer one percent for employer-employee but over six and a half percent each on employees making up to $102,000 with raises anticipated in the future.

Young workers are justifiably bitter about the large bite social security is taking out of their pay checks. Although social security makes up the largest portion of the payroll tax Medicare adds 1.4 percent and the various states add their own tax to the payroll tax. There are four taxes in California that vary in amount each year: The unemployment insurance, the ETT, employment training tax, the state disability insurance and the personal income tax. They come into the work place on the low end of the pay scale and find the payroll taxes take more from their generally meager wages than do income taxes.

The social security system is acquiring obligations faster than it is accumulating funds. That's not surprising when you realize the retired vote is the largest voting bloc in the United States and politicians have long realized the surest way to stay in office is to increase benefits for their constituents. Problems naturally arise when one Congress makes promises that a future Congress must keep. Over the years, benefits have spread to dependents and survivors so that barely half the beneficiaries of social security are retired workers who actually paid into the system. On top of that, other taxes will have to increase to keep up with spiraling benefits to retired state, local and federal government employees as well as retired military personnel.

Because social security trust funds are only allowed to invest in federal bonds, notes and Treasury bills, large amounts of money are being drained form the private marketplace. Business, finding its after-tax earnings are insufficient to meet demands for expansion, is forced to borrow. Unfortunately most of the potential savings from Untied States citizens, which should be available for such borrowing, is removed from the system by the requirements of social security. From this scenario follows increased business obsolescence, unemployment and cries for protectionism.

Social security is an example of government's attempt to accomplish worthy goals from a sense of compassion by adding Medicare in 1965 and overreaching to the extent that society may end up in a worse situation. High taxes encourage both unemployment and inflation because employers tend to react to an increasing tax burden by either hiring fewer employees or passing his inflated expenses on to the consumer.

Recent focus has been on the possibility that our social security system might go broke. That won’t happen because the federal government has the power to print money. However, a handful of analysts have had the courage to point out what I believe to be the real problem that our politicians refuse to face; not that social security may go broke, but that social security may end up breaking our nation.

In September, 2008 the dollar sign on the National Debt Clock in New York was needed to record $10, trillion for the first time. By the end of 2008 the national debt had increased more than another $300 billion and the order was in for a new clock with two more spaces for digits. Even without the huge anticipated increase in the national debt, every family in America is currently burdened with close to $90,000 of that debt which has been figured at $38,000 per person.

REAL ESTATE

STATE AND LOCAL TAXES

There is no uniformity in the various state and local laws governing the collection of taxes on real estate. Assessments vary greatly from one locality to another. Judging solely on the basis of the amount of taxes residents are required to pay, it is obvious that some localities are far more expensive to live in than others. The fact that California is our most populous state and Alaska the least is proof (as if proof were needed) that people are not apt to base their decision on where to live on tax information.

On the other hand, most people don't bother to obtain such information and if they had it perhaps their decisions *would be* influenced. Corporations make it their business to know which jurisdictions have the lowest taxes and factor that into the decisions. A large percentage of all corporations are based in Delaware for that reason.

CALIFORNIA AS AN EXAMPLE

Proposition 13, the controversial measure passed by California voters in 1978, rolled back assessed valuations to 1975-76 levels and imposed a one percent ceiling on property taxes and also limited assessment increases to a maximum of two percent a year or the annual increase in the California consumer price index, whichever should be lower. In 1983 the sharp reduction in inflation was responsible fro the drop in California's property taxes to one percent. In addition to reforming California's real estate tax, Proposition 13 provided that non-property related taxes could only be imposed by approval of two thirds of the voters. Although the United States Supreme Court held the proposition was unconstitutional over a challenge for ambiguities, it is these same ambiguities which are currently undermining Proposition 13's effectiveness as a buttress against higher taxation. The reference to special districts, special assessments and special taxes is at the heart of the problem.

In 1982 a suit was brought by the City of Los Angeles Transit Commission against George Richmond, its own executive director, for the specific purpose of clarifying Proposition 13's meaning regarding non-property taxes. The Commission levied a half-cent sales tax to raise revenue which the Board of Equalization (Board) refused to collect on the grounds that it was invalid under Proposition 13's two-thirds vote requirement. This half-cent tax was to generate approximately $225 million annually. Finally the Board agreed to collect the tax if the Commission guaranteed to refund the money in case the tax was later judged invalid. Since neither the Commission nor the Board was in a position to distribute refunds to millions of people the suit was brought by the Commission against its own director ostentatiously for a small infringement but purposefully to test the validity of the tax. The California Supreme Court evaded the question of whether the sales tax was a special tax by deciding instead whether the Commission was a special district. The court found that the special districts alluded to in Proposition 13 meant districts that have the power to levy property taxes. Because the Commission did not have such a power it was not a special district and was not governed by the restrictions imposed by Proposition 13.

The two-third vote issue which the parties to the Los Angeles case had anticipated the court would tackle was actually decided late in the year in San Francisco. A suit was contrived by the City suing its own controller to get a quick ruling form the courts on the interpretation of special taxes as used in Proposition 13. The supervisors of San Francisco County extended a one-and-a-half percent payroll and gross receipts tax which should have expired in June of 1980. The controller argued *special* means extra or additional and that any new tax requires a two-thirds vote. The City, on the other hand, argued successfully that *special* refers to special purpose and since the payroll and gross receipt tax went directly into the City's general fund it was not *special* and therefore was not subject to the two-thirds requirement of Proposition 13.

The special assessment clarification was given by the courts in a suit involving a taxpayer in the City of San Gabriel, California, who fought a raise in his property taxes above the Proposition 13 limits. The increase was necessitated by the City's obligation to its employee pension fund which the court ruled was a contractual obligation which the City must be allowed to fulfill. According to California's Supreme Court Justice Frank Newman, if Proposition 13 had not provided for the fulfillment of prior contract obligations, such as the City's obligation to its employees, the entire proposition would have been judged unconstitutional by the Untied States Supreme Court.

It would appear that the California Court's interpretation of Proposition 13's ambiguous special districts, special taxes, and special assessments only served to open further the floodgate of higher and more taxes. More than thirty years after enactment various citizen groups within the state continue to work on proposals to amend the controversial proposition.

Worksheet

1. Review the list of exclusions. Are you excluding all the following when you report your income?

- life insurance proceeds
- court - awarded damages
- medical payments via insurance
- lost earnings via insurance
- 1st $5,000 employee death benefits
- living expenses via insurance if home is damaged
- unemployment compensation (if total income is under $20,000)
- gifts
- grants for study & research
- annuity payments minus interest
- 1st $100 of dividend income
- social security benefits
- workmen's compensation
- disability payments from personally paid insurance

2. Which of the following deductions are you eligible to take?
Do they exceed the zero bracket limits??

- related to employment
- transportation
- meals
- lodging
- tips
- laundry
- phone calls
- education
- entertainment
- moving
- buy/sell home expenses
- alimony
- IRA (similar) contributions
- interest paid
- casualty losses
- charitable contributions
- medical expenses
- state and local taxes

3. Exemptions -- are you including everyone eligible?

- minor children?
- elderly parents?
- those to whom you contribute half their support?
- no pets please!

Recommended

The Complete List of IRS Tax Deductions, by Rosalie and Howard Minkow
Creative Tax Benefits, by Rosalie Minkow
You Can Profit from the New Tax Law, by Wiltsee and Sammons
State Tax Handbook (all states) Commerce Clearing House
http://www.irs.gov/