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The high cost of medical care is, in part, rooted in excess demand. Increasing employees' share of such insurance does not help reduce use of medical services. Only by increasing deductibles and co-payments—in other words, the consumers' direct costs—can we begin to reduce use and, therefore, overall medical costs.

Wealth Creation Strategies

Tax and Financial Strategies

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An Update on Record Keeping

I've previously authored two articles on something that tax attorney par excellence, Melvin Kreger, calls "tax shelter #1": good record keeping. In the first article, written for California Real Estate Magazine in 1988, a system of recording expenses as incurred was described. I showed that if done right, the time needed to tally the expenses in their proper categories at year-end would be minimal for all but the largest businesses. To review, annotate all checks *and* the checkbook register with the category of expense. Staple credit card slips and receipts to credit card statements on which the type of expense is noted. Then, tally up expenses by category, using only the check register and credit card statements as source documents, rounding everything to the nearest \$1. Because receipts tend to be terribly confusing, ignoring them (but saving them in the event of an audit) saves a tremendous amount of time. A separate cash receipt file is the only other source needed to compile the final records, with the goal of keeping cash expenses to a bare minimum.

In the second article (December 1997 newsletter, "The Art of Creating Files for Personal, Business and Investment Records") a method of filing receipts using color-coded files (thanks again Colleen!) was suggested listing various types of expenses by year. The number of years each file (or components in each file) should be retained was given. Both of these articles are available by request from our office. (We have not yet included articles written prior to 2002 on our web site.)

There are three new points worth mentioning. The first is that the use of a computer to add up business or rental expenses is not necessary unless the business expenses are so voluminous and varied that it becomes the only practical way to do so. We've seen some nasty messes resulting from attempts to computerize everything by people who are, unfortunately, not computer-savvy. Further, many are attempting to use QuickBooks, which is a far more powerful and complicated program than most need. (My apologies to those few to whom I suggested this program—if it's any consolation, we made the same mistake.) The far simpler Quicken is suitable for at least 95% of the businesses we serve. Just be sure to back up regularly!

We use the computer for tracking our tax and publishing business expenses. However, I record income and expenses solely by hand for the three vacation rental units that my wife and I own in Mammoth Lakes, California. I make detailed notes in my check register, from which all income and most expenses are transferred onto three sheets of paper at year-end. I use one charge card devoted exclusively to the vacation rental business and keep cash expenses to a minimum. It takes two to three hours per year to calculate everything. The key is in the approach: I don't need to think when recording and tallying the expenses—it's all in the register, credit card statements/slips and a (thin) cash receipt file.

The second idea is to include several months (or more) in checks for small

repetitive payments, if cash flow allows. Writing one \$300 check each year for telephone service takes far less time than twelve \$25 checks. Some companies debit the charge card, which I let the cable company do for all of our vacation rentals, also saving check writing and book keeping time. Of course, it's debited on the vacation rental-use only credit card, making it virtually impossible to forget the deduction.

The final point is that I occasionally see grossly misleading suggested-time-frames over which records should be kept. The most recent was a reprint from the Dallas Morning News in the Los Angeles Daily News, in which the "typical time to keep" real estate records was "as long as you own the property," and tax returns retention was listed as "6 years." These are seriously off base. Under these guidelines, you might toss the property records just before the IRS audits the sale of that property, putting you into one heck of a bind. Real estate records should be kept at least four years past the due date of the return on which the disposition of the property was reported, or the final property, if it was purchased pursuant to an exchange. Tax returns should be kept indefinitely. On a number of occasions, I've used returns from the early 1980s to reduce state income tax on IRA and Keogh distributions for which clients have "basis" (i.e., they never deducted the contribution for state tax purposes and the withdrawal is, therefore, a return of previously taxed capital). Recently, I used a return from 1993 to support a position taken on a 1999 return. Keep those tax

returns forever—and don't trust every- thing you read or hear, especially in regards to taxes!

Coping with the High Cost of Medical Care

Non-Prescription Drugs Eligible for Flexible Savings Accounts Reimbursements

Continuing the "kinder and gentler" approach in dealing with taxpayers (see September-October, 2003 issue, "A Gentler, Kinder Monolith"), the IRS has ruled that payments or reimbursements of non-prescription drugs via flexible savings accounts ("FSAs," or Section 125 plans) are tax-free.

The reasoning is that over-the-counter formulations, including antacids, allergy medicines and pain relievers, are intended to treat specific ailments. Items that promote only general health, such as vitamins and supplements, do not fall into this category and, therefore, remain non-reimbursable without a doctor's prescription.

A rational person might think this ruling would apply to Health Savings Accounts (HSAs, the new and expanded version of Medical Savings Accounts, which are available as of January, 2004), as well as to the deductibility of medical expenses on tax returns. However, rational thinking is often omitted from the tax code. FSAs are subject to special rules under which reimbursements are not limited to otherwise deductible expenses. However, in order to simplify policing such expenses, companies can restrict reimbursements to prescription drugs on their own.

HSAs Help Reduce Demand and Overall Cost of Medical Care

Health Savings Accounts hold the greatest promise in the quest to reduce demand for medical care, which would, in turn, help reduce costs. Under these plans, which anyone can set up by purchasing high-deductible insurance, a special account is established to which the employer and/or employee contribute. The contributions paid by the employer are not included in income,

while those paid by the employee are deductible. The first couple thousand dollars of medical expenses are paid out of the plan. Unused funds remain in the HSA for use in future years, which at age 65 become part of the owner's retirement. An incentive like this could go far in discouraging overuse of medical care, as well as more intelligent shopping by consumers.

One of the main causes for the high cost of medical care is extraordinary technology. Another is that Americans, unlike those in many countries with a more socialistic health care system than ours, are unwilling to wait in line for medical procedures. We need to focus on the two areas that can be controlled without causing pain to those who do not abuse the system: unnecessary use of medical resources and more intelligent shopping by people using those resources. After all, who is more likely to shop the \$300 Save-On prescription, which can be purchased for \$250 at Costco, a price that any Wal-Mart pharmacy will match—a fully covered employee or an HSA participant?

While those abusing a system allowing full payment for all medical costs are few, the increased demand for medical care by that minority puts a tremendous strain on the system. The best estimate among those working in emergency rooms with whom I have spoken is that a minimum of 50% (and as many as 90%) of patients are alcohol or other drug addicts. The 10% of the population, then, comprising addicts is likely responsible for 50% of ER admissions, just as they are the cause of almost that much road carnage.

By inference, we might surmise that these are the patients who overuse and abuse the system for minor problems as well as major ones. Reducing the demand for medical care by this small portion of the population may help free up a tremendous amount of scarce medical resources. Reduced use would

result in lower overall costs. One estimate of the overall use of medical resources by the addicted few is 25%, which is not an unreasonable estimate given the fact that alcoholism causes or exacerbates 350 secondary diseases and disorders. While the total elimination of such overuse is not in the cards, every per cent by which demand for a resource shrinks often results in overall costs dropping by more than one per cent.

What's the Solution?

Seemingly inconsequential initial events can lead to enormous repercussions. Two such events combined to create the system we have today: a little wrinkle created early on in the tax code, along with price controls over wages during WW2. Employers competing for valuable workers figured out they could offer medical insurance coverage to employees without violating wage controls. In addition, while deductible to the employer, the coverage would be tax-free to employees. This resulted in first-dollar coverage for a huge swath of the population. The problem was exacerbated by Medicare and Medicaid, under which most medical costs are borne by someone other than the user. It was made even worse as Americans began living far longer than the actuarial assumptions in the Medicare program allowed for, thereby dramatically increasing the number of qualifying recipients. With decreasing deductibility of medical costs at the personal level (only those expenses exceeding 7.5% of income, up from 2.5% as late as the early 1980s), the incentive to shift costs to third parties became relentless. As economist and mutual fund manager John P. Hussman puts it, this has resulted in an "all-you-can-eat health care system where prices fail to provide any effective constraint on demand."

While crossing picket lines at supermarkets, I've taken the opportunity to tell the picketers that their members

need to participate in HSAs, spending their own funds on deductibles and co-payments. I explain that reduced demand for medical care, along with more intelligent shopping by consumers, would initiate a drop in overall costs. I emphasize that unspent dollars would be theirs to keep. Every supermarket worker with whom I've discussed this has liked the idea (and agreed that there are addicts among them).

If we had a system under which steak and lobsters were free, there would be unlimited demand for these foods. We need to move toward a free market for medical care, in which prices are factored into consumers' decisions to buy

or not buy medical products. It works wonders in many other areas and would do so for medical care, if only we'd give it a chance. We need to rethink the purpose of insurance, as well: it is not meant to cover every possible cost. Insurance is a brilliant idea in which groups voluntarily pool resources to pay the costs of occasional unaffordable disasters that some experience. This is the reason we have deductibles—which should be suitably high. (In my opinion, deductibles and contributions allowed under the new HsAs are not high enough, but it's a start.) High deductible plans insurance plans combined with HSAs may be the most effective way to

resolve this contentious issue and create a real solution that goes to the heart of the problem of abuse and excessive demand.

In any big city, there are thousands of restaurants, each with dozens of items from which to choose. This is a wonderful example of the magnificence of free market capitalism. And this is the system we have chosen to abandon in the schools and, increasingly, medical care. Walk into any post office or government school and ask yourself, is this what we really want for medical care? Or do we really prefer the restaurant approach, with its almost unlimited supply of options?

Tough Love for California Government

While increases in California income and sales tax rates may have been put on hold for the time being, user fees and property taxes have not been so constrained. The electorate continues to vote to increase bonded indebtedness, which bypasses Proposition 13 limitations. Just take a look at your property tax bills. In Los Angeles County, the 2% Proposition 13 limit was surpassed by a factor of almost five, for a nearly 10% year-over-year increase. Still, this isn't enough for various government entities. The LAUSD will ask voters this March to pass yet another school bond, this one for \$3.8 billion, to build new campuses and modernize existing ones. If passed, property owners will pay an additional \$60 per \$100,000 of assessed valuation on their homes for the next thirty years, on top of the previously approved \$100 per year per \$100,000 in assessed value. Incredibly, \$1.65 billion of the \$3.8 billion would be dedicated to school repairs and finishing projects that were promised under previous Propositions but not completed because of mismanagement and poor estimates. The nerve of the public officials who added this to the ballot is breathtaking. At the same time, the state has placed a \$12.3 billion school construction bond on the ballot.

It's bad enough that parents have no

choice of schools unless they decide to pay twice—once through taxes and again by paying a private institution. Competition via vouchers would insure a reduction in costs with an increase in quality, just as competition does in almost every other area of life. It's doubly bad—and dangerous to our fiscal condition—that spending constraints are not in place that limit government expenditures to a fixed amount, adjusted for inflation and population growth. (The State of Colorado has such a constitutional limitation which, by all accounts, is forcing politicians to spend wisely.) Any such proposed checks should include those that voters, many of whom do not pay the taxes whose fate they decide, approve. In other words, set an overall state and local limit on government expenditures—and let the debate center purely over how the funds are raised and spent.

In constant (inflation-adjusted) dollars, the cost of California State government per person has skyrocketed from \$390 in 1950 to over \$2,200 today. It was barely over \$1,500 as recently as 1994. The number of state workers per 1,000 residents has increased 60% in the same period, from 5.7 to 9.1, with a 16% increase in total state workers during Gray Davis' tenure alone. California leads the nation's state government

employees in average compensation at almost \$57,000 per year, with 13 paid holidays (six more than in the most generous private firms) in addition to vacation periods. Worse for taxpayers, pension costs are slated to skyrocket due to changes made in 1999, during the bull market in stocks. This is the year CHP pensions were increased from 2 per cent per year of service with retirement as early as age 50 to 3 per cent per year of service, for a 50% increase in pension payments.

The cost of such an annuity requires an investment of almost 20% of salary each year for a newly hired employee, assuming a 7% long term rate of return on investment. This could be 33% of salary for someone who is already 15 years into his or her career, and far higher for someone close to retirement. Since these pensions are indexed for inflation, the costs may be far greater. If investments fail to perform—the return on CalPERS, the California Public Employees' Retirement System was negative over the three-year period ending June 2003—we've got bigger problems. This wouldn't be so objectionable were it not for the fact that while competent state workers may be underpaid, the less competent are often overpaid.

I was disgusted when Bustamante,

in a gross misuse of terms, suggested imposing "tough love" on Californians by raising their taxes. Tough love is

meant for addicts, not for the addict's victims. Those addicted to spending other people's money wantonly are the

ones on whom tough love must be imposed.

The Alternative Minimum Tax and You

Due to the complexity of the subject, this article has had a long gestation. However, because the Alternative Minimum Tax (AMT) is finally affecting more than just a few, it's time to explain what it means in simple terms. The number of taxpayers who can expect to pay higher taxes this year as a result of the AMT may be twice that of last year, and could quintuple over the next few years. It can theoretically affect anyone with total income over the exemption amounts, \$40,250 for single people and \$58,000 for married ones. In real life, it's beginning to hit those with incomes as low as \$80,000 and is often striking those with incomes in the mid-\$100,000's to the \$400,000's. It's sneaky, in that it can trap the unwary by (1) turning ordinarily deductible expenses into non-deductible ones, (2) rendering further decreases in regular income tax rates worthless (including those mandated by inflation indexing) and (3) creating an effective rate on capital gains, supposedly taxed at 15%, as high as 22%. It's a flat tax with almost no deductions other than the large exemption amount, and the tax rates (26% on up to \$175,000 taxable, 28% of the excess) are higher than or equal to most ordinary tax rates.

Most think of the Alternative Minimum Tax as an "add-on" or additional tax. This view is due to the way the form shows this levy added on top of the regular tax. However, this is a misconception. The AMT is actually a separately calculated tax, which is com-

pared with the regular one. The final levy is the greater of the two.

Although misunderstood, complex in all its intricacies and covert, the basics that affect most taxpayers are really quite simple. The AMT is calculated using a different set of allowable expenses, tax rates and standard deduction. There are a number of more esoteric aspects to the tax, which can be significant to those renting or selling depreciable real property, as well as to people exercising incentive stock options. The problem is, this tax is affecting many with seemingly simple tax situations.

A classic profile of those subjected to the AMT comprises taxpayers earning \$100,000 to \$200,000 per year, with children, California-sized state income taxes and property taxes, along with a modicum of deductible employee business and/or investment-related expenses. Another profile includes almost any taxpayer in this income range falling behind on property tax or state income tax and paying two years' worth of either (especially income tax) in one year. Still another encompasses such unincorporated upper-middle income taxpayers with large employee business expenses, including those working in the entertainment industry and outside salespeople (who don't qualify under the "statutory employee" rules).

The basic rule is that certain normally deductible expenses are non-deductible. The most common among these include:

- State income tax, SDI, property taxes and DMV fees
- Certain mortgage interest on loans not originally used to purchase or improve one's home or second home
- Otherwise allowable medical expenses to the extent they are less than 10% of Adjusted Gross Income
- All otherwise allowable employee business expenses and investment-related expenses
- Personal exemptions for self, spouse and dependents

Then, a large exemption is allowed: \$40,250 for unmarried people, \$58,000 for joint filers.* However, even this is subject to a phase-out at AMT incomes over \$112,500 for single people and \$150,000 for joint filers.* In addition, there is no 10%, 15%, or even 25% tax bracket. There is instead a 26% tax on AMT income up to \$175,000 and 28% above that. Because of the exemption phase-out, the real tax rate on AMT income is 35% from \$175,000 to \$273,500 (\$175,000 to \$382,000 for married couples)*. This is equal to the highest advertised ordinary income tax rate, which doesn't even begin until ordinary taxable income reaches \$311,950. You'd think members of Congress would be embarrassed to walk the streets.

*Note the marriage penalties embedded in the AMT rules, which Congress didn't even attempt to reduce in the recent tax act.

Tax Rate	On Up to Taxable Ordinary Income of:		Tax Rate	On Up to Taxable AMT Income of:	
	Single	Married		Single	Married
10%	\$7,000	\$14,000	26%	\$175,000	\$175,000
15%	\$28,400	\$56,800			
25%	\$68,800	\$114,650			
28%	\$143,500	\$174,700			
33%	\$311,950	\$311,950			
35%	\$311,950	Unlimited	28%	Unlimited	Unlimited

Here are some of the bizarre results:

	Couple #1		Couple #2	
	Married - Regular Tax	Married - Alternative Minimum Tax	Married - Regular Tax	Married - Alternative Minimum Tax
AGI	\$188,000	\$188,000	\$138,000	\$138,000
Less: allowed medical costs	(\$4,000)	\$0	\$0	\$0
Less: State income, SDI, property and DMV taxes	(\$15,000)	\$0	(\$13,000)	\$0
Less: Mtg Int on purchase	(\$20,000)	(\$20,000)	(\$16,000)	(\$16,000)
Less: Mtg Int on loans used for personal purposes	(\$2,000)	\$0	\$0	\$0
Less: Employee business and investment expenses	(\$5,000)	\$0	(\$15,000)	\$0
Less: Charitable donations	(\$2,000)	(\$2,000)	(\$1,500)	(\$1,500)
Plus/minus misc adjustments	\$2,000	\$0	\$0	\$0
Less: Personal exemption or AMT exemption	(\$12,000)	(\$54,000)	(\$6,000)	(\$58,000)
Taxable income =	\$130,000	\$112,000	\$86,500	\$62,500
Tax =	\$26,562	\$29,120	\$15,267	\$16,250
Extra tax due to AMT =		\$2,558		\$983

Couple number 1 above has excess medical costs, the usual state and local taxes, a bit of interest on a new increased mortgage loan out of which personal funds were used to pay off car loans, some employee business expenses and exemptions for a family of four. Any of these could be considered the "trigger" for the AMT. The fact is, the last \$9,800 of these deductions—whichever ones you want to count—save this couple nothing (the \$2,558 additional tax due to the AMT divided by the 26% AMT rate).

Couple number 2 has the usual state and local taxes along with outside sales person expenses, none of which are deductible for purposes of calculating the AMT. The taxpayer is paid on commission, which means that up to a point, the more he spends in an attempt to produce income, the more he actually earns and, therefore, pays in taxes. However, because he is taxed on any increase in earnings and unable to deduct additional expenses, he needs to view expenditures through AMT eyes. Careful consideration must be given to

the fact that such non-deductible expenses may create fully-taxable income. Also, if he purchases an SUV expecting to take advantage of the immediate expense allowance for cars in excess of 6,000 pounds, I get to explain that such a deduction saves nothing. Therefore, the opposite of what we would think is an optimal strategy is in order: we need to depreciate as little of the cost of the vehicle as possible in order to decrease the gain or increase the loss upon disposition.

Here are additional examples:

	Single - Regular Tax	Single - Alternative Minimum Tax	Head of Household - Regular Tax	Head of Household - Alternative Minimum Tax
AGI	\$80,000	\$80,000	\$194,000	\$194,000
Less: State income, SDI, property and DMV taxes	(\$6,000)	\$0	(\$27,000)	\$0
Less: Employee business and investment expenses	(\$23,000)	\$0	\$0	\$0
Less: Charitable donations	(\$1,000)	(\$1,000)	(\$7,000)	(\$7,000)
Plus/minus misc adjustments	\$0	\$0	\$2,000	\$1,000
Less: Personal exemption or AMT exemption	(\$3,000)	(\$40,250)	(\$8,000)	(\$21,500)
Taxable income =	\$47,000	\$38,750	\$154,000	\$166,500
Tax =	\$8,560	\$10,075	\$35,888	\$43,290
Extra tax due to AMT =		\$1,515		\$7,402

The single person in the example above, an actor, incurred business expenses of \$10,000. He also won a non-injury lawsuit, the proceeds from which were

included in the \$80,000 income (while damages from injuries are tax-free, all others are taxable). The attorney's fees of \$13,000 incurred to win the lawsuit

are deductible only as an employee business expense. [Caution: A different treatment may be allowed in some jurisdictions.] The last \$5,827 in deductions

saved no tax (the \$1,515 extra tax due to AMT divided by 26%, the AMT rate).

The Head of Household doubled-up on state income taxes by paying tax on a prior year gain in 2003, in addition to current year tax. But it didn't even matter: none of the deduction saved federal income tax.

It's crucial to grasp the idea that no matter how much larger the state income tax, property tax, employee business and/or investment expense, the federal tax remains the same. This is difficult to accept, because we all intuitively "know" that a rational system wouldn't tax income twice (accounting for the idea behind the deduction for state and local taxes) and allows deductions for expenses incurred to produce income (such as employee business and investment-related expenses). Yet, even if \$20,000 (or \$100,000) in additional state or local tax is paid, the federal income tax remains the same. Once the AMT hits, investing \$25,000 (or

\$100,000) in an effort to produce income as an employee or investor does nothing to decrease the tax.

What are the practical consequences of this lunacy?

1. We need to carefully plan payments of state income taxes. Generally (but watch out! There are exceptions!), we don't want to double-up by paying last year's and this year's state income tax this year, when the prior year tax is in the thousands of dollars. Yet, I see this time and again, because I am not informed that income has skyrocketed or deductions have collapsed until after the year is over.

2. Employees who pay large business expenses should either negotiate with their employer for reimbursements or consider incorporating. There are a number of negative considerations in this approach, not the least of which is that the taxpayer-owner becomes responsible for the employer's half of Social Security tax, which can add

\$5,000 to \$10,000 or more tax. On the other hand, the cost can be mitigated by a number of strategies and factors. The tax benefit of a pension plan can greatly exceed this cost.

3. Expenses that are not deductible under the AMT should be "averaged" or "smoothed" out whenever possible. If the single person above had been able to pay \$7,000 of the attorney's fees or business expenses in a prior or subsequent year, all else being the same, he would have avoided the AMT in both years.

4. We desperately need to have the law changed. The idea that expenses incurred to produce income may not be deductible is particularly irksome and irrational. If you are being clobbered by the AMT and are willing to send a note on the subject to your Congressperson, I will be happy to help draft the letter at no charge (something I have already done for some of you for 2002 returns).

Huge Percentage Increase in Tax Hits California

Hidden among the jargon of "no tax increases" is a monumental increase in two taxes that every California employee pays: state unemployment "insurance" and state disability insurance.

The state unemployment tax ("SUTA"), while nominally paid by employers, creates a downward bias on compensation (all employer taxes are ultimately borne by employees in the form of lower wages). SUTA has increased by an amount that doesn't suggest a large increase, but only because the numbers are seemingly trivial.

Here is a sampling of increases we have found among our clients:

2003 Tax Rate	2004 Tax Rate	% Increase
3.40%	4.50%	32.35%
2.50%	3.60%	44%
2.50%	3.80%	52%
1.70%	2.90%	70.60%

It's so easy to lie with statistics. A 1.1% increase in the rate doesn't seem like much until we analyze it (hence, the third column "increase"). A 52% increase is huge—especially when we consider that there are many large California

employers with thousands of relatively low-income employees. We'll see how much of a job-killer this becomes, which could exacerbate California employment problems resulting in a need to further increase the tax....

In the meantime, State Disability Insurance has increased from .9% of the first \$56,890 in wages to 1.18% of the first \$68,829. Hence, the maximum SDI increases from \$512 in 2003 to \$812 in 2004.

What's more astonishing is the increase over the last several years, which parallels the incredible increase in Workers' Compensation Insurance rates levied on employers over the same period:

Year	Rate	Max Wages	Max Cost	% Increase from 1999
1999	0.50%	\$31,767	\$159	
2000	.5/.7%*	\$46,327	\$324	104%
2001	0.90%	\$46,327	\$417	162%
2002	0.90%	\$46,327	\$417	162%
2003	0.90%	\$56,890	\$512	222%
2004	1.18%	\$68,829	\$812	411%

* .5% January-March; .7% April-December

NO ON PROPOSITION 56

If you want higher taxes, vote yes and you'll get them. Otherwise, vote no.