A Collection of News and Views

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"The best computer is man, and it's the only one that can be mass-produced by unskilled labor."

Phony Emails

The use of emails for fraudulent means has increased tremendously. After all, it's easier to steal personal information while sitting home at your computer than sifting through garbage for credit card slips, stealing credit card applications from your mail, etc. So these crooks don't just use fake IRS notices to get all your personal information, but every kind of important-looking notice you can imagine! In fact, many of them actually appear to be from credit card companies themselves.

Here are the overall cautions to keep in mind, regardless of from whom the email appears to be:

- Be wary of *any* email request for your personal information.
- Phishers typically depict a serious problem that requires your immediate attention.
- Then they ask for your account number, username, password, pin number or social security number — in order to "correct the problem."
- *Never* reply directly to an email (or click on a link that directs you to a web page) that asks you for any of the above-listed personal information "for verification purposes."
- Report suspicious emails to: reportphishing@antiphishing.org. If you *do* want to verify an important but possibly suspicious email, we suggest you verify by telephone.

  EXAMPLE: if you get an email from American Express and you *do* have an account with them — simply call the phone number *on the back of your card* (and *not* any number in the email itself) and verify if they indeed sent you an email, and why.

Winnings and Losses

Gambling winnings are fully taxable and must be reported on your tax return. Gambling income includes, but is not limited to, winnings from lotteries, raffles, horse and dog races, casinos — as well as the fair market value of such prizes as cars, houses, vacation trips and other non-cash items.

Depending on the type and amount of your winnings, you might be given a Form W-2G and there may be federal

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income taxes withheld from the payment. Whether or not you get that form, here are the reporting rules:

- **Winnings.** The *full* amount of your gambling winnings for the year must be reported on Line 21, Form 1040.
- **Losses.** If you itemize your deductions, you can deduct your gambling losses for the year on Line 27, Schedule A, Form 1040. *You cannot deduct gambling losses that are more than your winnings!* Also, if you do not itemize your tax deductions — you cannot claim *any* gambling losses.

True Story: One of our clients is a rich widow who lives in Las Vegas. She spends the majority of her free time gambling in one casino. Some years ago she won some major jackpots playing the slots, and she reported to us that her total gambling winnings (Forms W-2G) for the year were $95,000. She also advised that her losses were well over $100,000. I prepared her return on that basis, reported $95,000 in winnings, and also claimed a loss deduction for the same $95,000 (the loss limit, as explained above).

About 20 minutes later (so it seemed) she got a letter from the IRS questioning her gambling loss deduction and arranging for an "office audit." I contacted her for *any* evidence of her losses and to my pleasant surprise she sent me a book maintained by the casino that detailed all her gambling activities (dates and amounts). The book did in fact confirm both her winnings and losses as reported.

In I marched to the local IRS office, promptly at 8:00 a.m. The nice IRS lady looked over the book, ran a few tapes and at 8:15 a.m., I was out of their office with a "no change" report. As I was leaving, she said to me, "If you hadn't had that book, I would have disallowed your *entire* $95,000 loss deduction. Without proper records, we won't allow *any* loss deduction. Have a nice day."

To quote the IRS: "It is important to keep an accurate diary or similar record of your gambling winnings and losses. To deduct your losses, you *must be able to provide* receipts, tickets, statements or other records that show the amount of both your winnings and losses." Yea, verily!

Another Gambling Story

In another issue we wrote about a lawyer who lost over $3 million as a day trader in the stock market. Now comes the tax case of a doctor who lost over $2.5 million the same way. The Tax Court ruled that his losses could only be used to offset capital gains plus no more than $3,000 a year against ordinary income. At the $3,000 rate, he can deduct all of his losses in a little over 833 years! *(Jamie, Tax Court Memo 2007-22).* Of course he should have tried to make the Sec. 475(f) election that, if approved by the IRS, lets "traders" deduct their losses *in full* as "ordinary losses." Based on these stories, we suggest that the lawyers should litigate, the doctors should heal, and neither should try and beat the market.

Alimony

Reportedly, about 50% of the marriages in this country end in divorce. Therefore, the matter of alimony (also called "spousal support") should be of interest to many of our readers. There is not a month that goes by without reports of many divorce cases ending up in the Tax Court — *because of poorly drawn divorce or legal separation agreements.* The fights are usually over whether or not the alimony is tax-deductible by one party and taxable income to the other. The tax rules are rather clear, but apparently there is a class of lawyers that never read them.

These fights are exacerbated by the fact that many/most divorces end up in hard feelings (to put it mildly) on both sides. Of course the party paying the alimony thinks that any monthly payment of more than $100 is outrageous — while the other side is thinking of a "reasonable" payment of around $10,000 a month. As the saying goes: "the only winners in divorce cases are the lawyers." Usually, *both* parties feel they were the loser after it's all over.

Let's try to present a simplified summary of the main tax laws — and I beg you to only use this as a very basic summary — this isn't a comprehensive legal guide.

- For alimony to be deductible (and taxable) it must be required *in writing* by one of the following: (1) a decree of divorce or legal separation; (2) a separation agreement; or (3) a decree of support. Verbal agreements mean nothing.
- Voluntary payments in excess of required alimony are *not* deductible.
- Alimony payments are deductible from gross income, whether or not you itemize your tax deductions, but only in the year actually paid.
- The husband and wife must be separated and living apart.
- Cash payments are required. Cash payments to a third party for the spouse qualify *if made under the divorce or separation agreement* (e.g., insurance premiums, rent, mortgage payments, medical expenses, etc.).
- Transfers and divisions of property between the spouses incident to divorce are almost always tax-free, *regardless of the amount*. However, in the special case of splitting retirement plans, these should be made under a Qualified Domestic Relations Order (QUADRO) issued by the court, in order to avoid one of the parties having to pay tax on the *entire* split. We read about a lot of tax

cases involving this particular error and sometimes there is millions in taxable income at stake. Needless!

- Payments *must* stop at death or it *kills* the entire deductibility-taxability arrangement! (This key point is apparently missed in a surprising number of cases.) Just like the previous point — is this one too tough for some lawyers to understand?

- A fixed payment payable under the divorce or separation instrument *specifically* for child support is neither deductible nor taxable. (The spouse receiving such payments does *not* have to account for the spending of such funds to anyone — sometimes a major loophole and nice source of tax-free income.) In California a few years ago, one spouse requested child support payments of *$650,000 a month*, from a very, very wealthy husband, for one child (and the parentage was in doubt). In effect it would be a tax-free annuity to her for 18 years.

- If the decree calls for both alimony and child support and less than the required total payment is made, the payments apply first to child support.

- Payments made under an annulment decree qualify as both deductible and taxable.

- No taxes are withheld from alimony payments and the recipient usually must make estimated tax payments. Alimony paid or received can only be reported on regular Form 1040.

- Alimony income qualifies for contributions to a regular or Roth IRA. We *rarely* see anyone taking advantage of this rule.

- And some other more complicated and technical provisions. See IRS Publication 504, *Divorced or Separated Individuals*.

From reading some of the tax cases, many lawyers jumble alimony and child support into a one-lump amount/description — which creates lots of litigation over which is which and how much for each. Also, as stated, some draw up alimony agreements that do *not* end at death and negate the whole deal. We refer clients only to lawyers that specialize only in so-called "family law" and they are highly knowledgeable about all the tax laws in this area. As you can now see, this is not an easy subject or simple law, on top of all the traumas inflicted on all parties by the divorce itself.

I Hate to Say I Told You So — But…

By now everyone knows about the problem of "sub-prime mortgages" — how they are seriously affecting the economy, the loan companies, the stock market and individuals. At this writing about 20% of such mortgages are either delinquent or in foreclosure. As of this writing, one estimate is that as many as three million people (including 500,000 in California) could lose their homes because they are unable to make the payments, as their original low monthly sub-prime payments have now increased and increased. Nor could they refinance their mortgages to more favorable terms because: (1) under newer and stricter mortgage terms they could not qualify, and/or (2) their homes no longer were increasing in value or had dropped in value.

In April 2006 I wrote a vituperative part of an article about "sub-prime" lending. Unfortunately, at that time, my warnings were not available to MANA members. So here it is, uncut and as originally written:

In these days of "creative financing" for home buyers, it might be helpful to better understand some of the risks and downsides of what you are being offered. If a conventional 30-year mortgage of a given amount would require you to pay, say, $1,500 a month — the financial institution will decide how much to lend you, based on *that* monthly payment (plus your FICO credit score and the usual other factors). This, in turn, will control how expensive a house you can afford to buy. But along comes a mortgage broker who can get you a *larger* mortgage, but with the first one to five years requiring monthly payments of only $450!

Then, a mortgage lender considers your monthly mortgage payment of only $450 — and approves a much larger mortgage. This, in turn, allows you to buy a more expensive house. So now you have a larger house, a larger mortgage and easily affordable monthly payments of only $450. But what happens when those special one- five-year periods expire?

- **Beware of the option ARM!** With adjustable-rate mortgages (ARMs) and interest-only mortgages sweeping the country — the most dangerous choice is the *option* ARM. Many mortgages now give you (in the beginning) several payment choices each month: (a) regular ("conventional") principal and interest payment; or (b) interest-only payment of the full monthly amount of interest due; or (c) the *option ARM of a minimum interest payment*.

That last payment option is so low *it doesn't even cover the actual month's interest charge!* The unpaid interest is then *added* to the loan balance — and you will pay interest on *that* interest — as well as the original mortgage balance. Thus, the total mortgage principal you owe continues to *increase* — and you have what is called "negative amortization," a dreaded financial affliction most of you never heard about, or understand.

When this loan eventually converts to a regular *fixed* monthly payment mortgage (usually one to five years) — the payments could easily *double*

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(or more)! Because: (a) Now you have say 25 years to pay off the mortgage — not the original 30 years, and (b) the amount you owe is *more* than the original mortgage (because of that negative amortization), and (c) the *interest rate* has now returned to whatever the actual *current* rate may be at that future time (7%? 8%? 9%?) and (d) interest rates are predicted to rise over the next few years.

*"Nationwide, mortgage debt has ballooned by about 70% since 1999 to nearly $8 trillion as lenders have relaxed credit standards…. About **$1 trillion** in outstanding adjustable-rate mortgages could face payment increases in 2007."* (Los Angeles Times)

An adjustable-rate loan made to a family which can barely afford the initial monthly payments represents a ticking time bomb." (Stephen Brobeck, executive director of the Consumer Federation of America)

- Another provision that is slowly creeping back into these creative mortgages is the prepayment penalty. This usually provides that if the mortgage is paid off early (usually because the house is sold, or even refinanced), there is an *additional charge* of six months' interest on the *total unpaid* mortgage balance — that can be very costly.

- Many borrowers assume that when those highly increased mortgage payments hit, they will simply sell their (continually appreciating) house and still come out with a profit. Of course there is no guarantee that the price of homes will increase forever. Further, with tens of thousands of those creative mortgages all coming due at more or less the same time — there may be a flood of home sales that can also depress the market.

- Given all the above, some just plan to "walk away" from the house and the mortgage, when things get too costly and they are "upside down" financially. They forget they will then be hit by *(taxable)* "forgiveness of indebtedness income," *which the financial institution will report to the IRS*.

  EXAMPLE: If the mortgage balance is $500,000 and the foreclosed house is resold by the bank for $400,000 — that reported income would be $100,000. The former owner would then owe income taxes on $100,000 of additional income! And that unpaid mortgage balance might even be increased by a prepayment penalty, which, in turn, would further increase the amount of such forgiveness income — and the taxes he or she owes.

- Finally, in desperation, our poor borrower, who has lost his home, ruined his credit, and owes the IRS taxes on $100,000 — decides to file bankruptcy! First, he bumps up against the *new* bankruptcy law, which is *very* unfavorable to those filing (it was written with the help of credit card companies and other financial institutions). Under this new law (effective October 2005) in many cases the mortgage holder can *still* come after him, *even after he has filed for bankruptcy.*

- Then, to his horror, he finds out he *cannot* discharge his debt to the IRS! You see, taxes owed the IRS for the last three tax years (sometimes more), cannot be cancelled by a bankruptcy filing! Later on, the IRS files a tax lien against him — and ruins whatever was left of his credit! Now, with a FICO credit score of about 42, the poor guy could not obtain a mortgage large enough to finance the purchase of a dog house (which is where he may end up sleeping)."

And there you have it, as written, but apparently no one paid attention, until now.

Refinancing Your Home Mortgage

Almost everyone who still qualifies does it — particularly in Southern California — but almost no one understands how the refinancing charges are handled. Frequently there are substantial costs involved and most of them are *not* tax-deductible.

- "Points" or "loan fees" *may* be currently deductible for taxpayers who itemize, but usually not so.

- Points paid solely to refinance a home mortgage usually must be deducted in annual even increments *over the life of the loan*.

- However, if part of the refinanced proceeds were used to pay for new improvements to the home (and certain other requirements are met) — the points may be fully or partially deducted in the current year.

- When refinancing for the second time, the balance of points from the *first* refinance can be written off in full — and the second points for a third refinance, the third for a fourth, etc.

- Other closing costs such as appraisal fees, escrow charges, title insurance and other non-interest fees are generally not deductible. Those costs are simply added to

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the tax basis of your home and only come into play when you finally sell. (At which point you probably have *completely* lost track of those charges.)

- A minor exception: In some cases there may be a pro-rated charge for real estate taxes on your home — that can be claimed as a current tax deduction.

Business Friendly States

The Tax Foundation has published their 2007 list of the best "business friendly" states…and the worst. Here are the top 10 winners — and the bottom 10 losers:

Ten Best	Ten Worst
1. Wyoming *(best)*	41. Minnesota
2. South Dakota	42. Maine
3. Alaska	43. Iowa
4. Nevada	44. Nebraska
5. Florida	45. *California*
6. Texas	46. Vermont
7. New Hampshire	47. New York
8. Montana	48. New Jersey
9. Delaware	49. Ohio
10. Oregon	50. Rhode Island *(worst)*

All I can say about California is, *"Does Arnold know about this?"* asm

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