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FROM THE RIGHT SIDE OF THE BRAIN—GREG ROHLER'S

SMALL BIZ NOTES

For Small Business Clients and Friends of Greg Rohler, Inc.

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On Fear of Failure…

It is common sense to take a method and try it. If it fails, admit it frankly and try another. But above all, try something.

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'Hot' Tax Break—Don't Just Burn Your House, Tear It Down!

For several decades, high bracket taxpayers received a sizable tax break for donating their old, dated house (only the structure—not the land) to the local fire department to burn down as part of training exercises. It was cheaper than a full demolition and a tax break besides! What's not to like about that? As it turns out, the IRS and courts no longer like this tax break and may have 'extinguished' any meaningful tax benefit. Two recent court decisions have essentially 'gutted' this opportunity for most people. (Forgive my puns—it's New Year's Day and I'm a bit silly.)

Now the 'hottest' tax strategy for those seeking to replace an outdated residence is deconstruction, that is disassembly and salvage of the old house, piece by piece. Deconstruction costs about twice what a standard demolition costs, but the donation of all the materials to a bevy of charities eager to receive the salvaged goods can often be up to several times what was permitted when donating the structure to the local fire department. (Not to mention that many people like deconstruction because it's considered 'greener.')

Of course not everyone is able to benefit from this strategy. The best candidates are those taxpayers who are 1) in high tax brackets, 2) with an outdated home due for replacement, and 3) whose house sits on valuable land which has appreciated considerably. For those who meet all three conditions, deconstruction could produce a significant tax break. [GR]

The Boomerang Complaint Department…

One day a frequent flyer took his seat on a plane with a major airline and noticed that a flight attendant was watching another passenger. The passenger, with obviously overloaded bags, tried unsuccessfully to stuff his belongings into the overhead bin of the plane. Finally, the flight attendant spoke up to inform the frustrated passenger that he would have to check the oversized luggage."When I fly other airlines, I don't have this problem," he complained. The flight attendant smiled and replied, "Sir, when you fly other airlines, I don't have this problem either."

Feeding The Paper Tiger

The Case of The $19 Million Paperwork Error

For many years I have told clients that the IRS is a Paper Tiger—not because it can't harm you—but because it is paper which the Tiger seeks, and you must feed it properly or it will bite you. More than once I've seen solid legitimate deductions lost because details of the paperwork were not properly handled.

"Feed the Tiger the paper that it craves, and most likely your deductions are safe."

A recent and rather spectacular case in point (Mohamed v. Commissioner, 2012-152): Joseph Mohamed, entrepreneur and successful real estate appraiser, donated six properties to a charitable trust over the course of 2003 and 2004. Mr. Mohamed, who is generally very bright, did something very foolish: he prepared his own tax return without consulting a tax expert. What Mr. Mohamed didn't realize is that IRS has some very detailed and explicit requirements to document donations of real estate. Included among them are some very stringent guidelines regarding the appraisal report and the appraiser who prepares it. Mr. Mohamed was a professional appraiser and used his own valuations in preparing his return—a major no-no. This was, as it as it turns out, his undoing.

In 2005 when IRS selected his 2003 tax return for review, they began asking questions about the appraisals for his donations. Initially, they contested the valuations he had used when filing the return. In response, Mr. Mohamed hired another qualified expert appraiser. This appraisal report indicated that the estimated values used at the time of filing were actually lower than a valid market appraisal. At this point the IRS conceded that the values were reasonable, but shifted their attack to the documentation. The basis of their argument rested entirely on the appraisals not being prepared timely and not in accordance with IRS regulations.

Eventually the IRS Tax Court agreed to review all documents and hear arguments from both sides. In May 2012, the Tax Court handed down its verdict. While conceding that it seemed 'extremely harsh,' the Tax Court struck down all of the $19 million in donations, leaving the taxpayer with no deduction for any of his donations of real estate—costing Mohamed about $6.5 million in taxes.

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What can we learn here? In my opinion there are two lessons: 1) Once more the IRS confirms it is a Paper Tiger: Feed the Tiger the paper that it craves, and most likely your deductions are safe. This is often true, even if the underlying transaction has a minor weakness. In contrast, rock solid transactions with poor or no paperwork will die almost every time. 2) It's best to hire a professional to assist you, even if only to review your work before filing your return with IRS. In this particular case the stakes were so high I can only wonder how such a smart guy could do something so dumb. [GR].

Heads I Predict, Tails You Lose?

Predictions are tricky business, yet we all love to read them. The Top Five Trends to Watch for in 2013. Seven Careers That Will Outpace the Economy Over the Next 10 Years. Five Stocks Set to Explode in Value as the Economy Recovers. And on and on. How often are these predictions fulfilled? Generally, not very often—so, how should we view them?

"… one subtle, but often overlooked trap is 'The Track Record' fallacy."

While there are several traps to avoid in trying to evaluate experts and their predictions, one subtle, but often overlooked trap is 'The Track Record' fallacy. Some years ago, a financial advisor I work with from time to time shared some of his brokerage house's best research on the fund managers they monitor and hire. After studying their data a while, I noticed something interesting: the longer the run of above average returns for a manager, the greater the chance of a subpar year following the string of successes. Warren Buffet refers to this phenomenon as 'reversion to mean.'

To better understand this trap, let us try a mental experiment proposed by Nassim Nicholas Taleb, author of *Fooled by Randomness*. Imagine that we have a pool of investment advisors numbering 8000. In year one, half of them predict a rising stock market and the other half predict a falling market. At the end of year one, 4000 new up-and-coming market wizards will have been born. Assuming that these 4000 wizards are ready to try their hand again and that roughly half predict an up market and half a down market, at the end of year two we will have 2000 'experts' who have successfully predicted the direction of the market two years in a row. And so it goes. At the end of year three—1000 will continue without error; year four—500; year five—250; and year six—125. At the end of year seven there will be about 62 or five dozen prognosticators who have a perfect seven year record of calling market direction.

Applying this experiment to a completely random event, we could recreate the same results by flipping coins and produce "expert coins" that will call the market direction without error. This is Telab's point: we infer order and meaning from random events because that is how we are wired. That doesn't mean that these events have real significance. An expert's track record could be solely the result of randomness. Not very comforting, is it? Especially if you happen to be one of the experts.

"…we could recreate the same results by flipping coins and produce "expert coins" that will call the market direction without error."

How then should we treat experts and their predictions? In the final analysis, we are the ones who must live with the wisdom or folly of our reliance on some expert and their predictions. What Taleb is telling us is that we must be shrewd enough epistemologically to discern when someone's track record could possibly be the product of pure chance, not skill. A lengthy track record of success in an area where there are few experts is much more meaningful than the same record pulled from a big pool of 'experts,' some of whom could survive for a long time thru the attrition of others. [GR]

Words of Wisdom Department

"Be more concerned with your character than your reputation, because your character is what you really are, while your reputation is merely what others think you are."

JOHN WOODEN