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Certified Public Accountants

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Here's the Tax Beat broadcast for October 14

Subject Line: The Great Pumpkin Interrogation

Back in 2007, the Iowa Department of Revenue noticed a problem. Iowa, like most states, charges sales tax on retail goods but exempts groceries. Pumpkins are groceries. But nobody in Des Moines was eating them. They were carving them into jack-o'-lanterns, which made them decorations, which made them taxable. Millions of dollars' worth of pumpkins were slipping through the cracks with googly eyes.

So the department sent retailers a bulletin. From now on, cashiers had to ask every pumpkin buyer a simple question: are you going to eat this, or carve it? Eat it, no tax. Carve it, pay up. (Presumably, lying to the pumpkin police carried its own penalty.) The bulletin lasted about a week. Once the internet got hold of it, Iowa was a national punchline, and on November 1 the state quietly smashed the pumpkin tax.

Iowa was just the one that got caught. New York's tax department has also ruled that pie pumpkins are exempt as food, while "decorative and carving pumpkins" are taxable property. Massachusetts exempts pumpkins whether you bake them or carve them – but if you paint a face on one before you sell it, the tax man wants his cut. And the pumpkin's just the gateway gourd. A couple dozen states define "candy" as sweets made without flour, so a Hershey bar is taxable candy, but a Kit Kat is a tax-free cookie. (So is a Twix. So is licorice. Plan your trick-or-treat bowl accordingly.) In Pennsylvania, a Superman costume is taxable, but ordinary clothing isn't, so you can dodge the tax by buying a suit and going as a CPA. (Terrifying.) In Vermont, the costume is exempt, but the mask isn't. And in New Jersey, the pumpkin you pick is a tax-free farm product, but the hayride out to the patch is a "place of entertainment," taxed like a carnival ride.

Here's why we're talking about Halloween in a tax column. It's still the same pumpkin. The same candy bar. The same guy in a suit. Nothing about the object changed. The only thing that changed is what we call it. The government doesn't actually tax *things*. It taxes *labels*.

And that, in one sentence, is what tax planning is all about. It's not a treasure hunt for secret deductions. It's deciding, on purpose and in advance, what to call things, then papering it so the label sticks. A dollar coming out of your S corporation is either wages (taxed at up to 15.3% for Social Security and Medicare) or a distribution (taxed at zero for those purposes). Your house is just your residence or, under Section 280A(g), a rental you can lease to your own business for up to 14 days a year, tax-free. A trip to Scottsdale is a vacation, or a board meeting with a vacation attached. A teenager is a dependent eating your groceries or an employee of the family business earning nearly \$16,000 at a 0% rate. (He'll still eat your groceries. Some things even the tax code can't fix.) A medical bill is a non-deductible personal expense or, with the right reimbursement plan, a business expense.

Other than getting called out on it, Iowa's critical mistake wasn't just asking the question. It was letting the customer answer it at the register with no paperwork. Done right, characterization is the most powerful tool in the code. The IRS cares about facts, and facts are made of documents: minutes, agreements, timesheets, appraisals, reimbursement plans. Give them the right label and the right paper, and the same pumpkin that cost you tax last year sails through tax-free this year.

Most tax preparers treat your income like a jack-o'-lantern: carve it up, light a candle, and watch it rot on the porch. We'd rather make pie. Call us before the cashier asks what you're planning to do with it.

Kevin

