William M West Certified Public Accountant

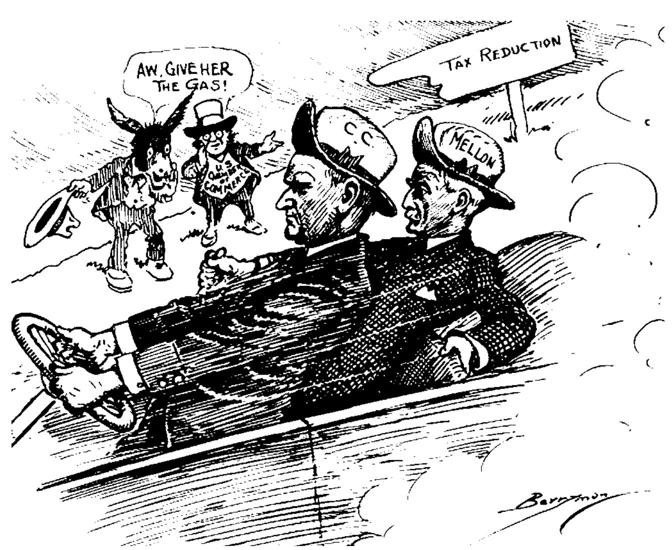
Wisdom to build Wealth

Tax Newsletter 2004

George W Bush, with a Republican majority in Congress, has **reduced taxes** more than any other president. Bush's tax cuts, war against terrorism, and high spending, have combined with the economic downturn to turn a big Federal surplus into a big **Federal deficit**. This year's big tax law is JGTRRA, the Jobs and Growth Tax Relief and Reconciliation Act of 2003. It encourages **investment**, and **accelerates** many of the Republicans' favorite tax cuts from their first big tax act, EGTRRA, the Economic Growth and Tax Relief and Reconciliation Act of 2001, the biggest tax law in decades.

JGTRRA reduces taxes **$350 billion**. It **sunsets** in just a few years, because Republicans do not have the super majority in Congress under the Bird Act to make these laws permanent. JGTRRA would reduce taxes by about **$1 trillion**, if it were permanent. The economy cannot grow fast enough to save future Congresses and Presidents from facing the deficit again, or to *raise* taxes. Economists say that JGTRRA moves the tax code one step closer to a **consumption** based tax. Many of my clients pay **AMT** (Alternative Minimum Tax), and will not get all the benefit (see page 2). JGTRRA's $350 billion tax cuts are:

- $148 billion — 15% dividend & capital gains rate reductions
- $ 74 billion — Reduction in all tax brackets (EGTRRA acceleration)
- $ 47 billion — Reduction in 10% and 15% tax brackets (EGTRRA acceleration)
- $ 32 billion — Child credit reductions to $1,000 per child, up from $600 (EGTRRA acceleration)
- $ 20 billion — State subsidies
- $ 18 billion — AMT exemption (EGTRRA acceleration)
- $ 10 billion — Business investment incentives.



Will the Brakes Hold?

Tax Tips

Invest in **dividend** paying corporations and realize long term capital gains to get the new **15%** rate (**5%** for those in the lowest 10% and 15% regular tax brackets). This is the biggest new Republican initiative by far. There are quite a few **planning opportunities** in these complex rules, that discourage wrongly converting income to these lower rates. Only dividends previously taxed to the paying corporation qualify. You must own stock at least 60 days. Mutual fund dividends are really interest. One unintended consequence is that charitable contributions of appreciated property (the deduction for which is usually at fair market value) may decrease.

Split income with your family members who are in the lower **10% and 15% brackets**. But watch the **kiddie tax** that makes children under 14 years pay tax at your higher rate on their unearned income. One trick is for them to own stocks that pay no dividends, but promise capital gains. Better yet, give them low basis stock (or any other asset, such as real estate) you already own. They sell after they turn 14, and pay tax at their lower rate. **Hire** your children, even children less than 14 years, to work in your business for **earned** income. They not only pay tax at their lower rate, they also can contribute to a **Roth IRA**, which offers tax free earnings forever.

Business investment incentives include two expanded first year depreciation rules: 50% section 168 bonus (up from 30%) on new equipment placed in service, and $100,000 (up from $25,000) section 179 on new and used equipment (thru 2004). Vehicles used over 50% for business qualify. If you buy a vehicle at least 6,001 lbs gross vehicle weight, you also escape the listed property limitations, so you can deduct the full $100,000 under section 179.

IRS liberalized its **home sale** exclusion rules substantially. The 2 of 5 year occupancy rule now has more exceptions. You now get the full exclusion on the portion of your home that you use for business. You can move back into rental property, like an old home, to get the exclusion, and may still get the section 1031 capital gain deferral on the balance.

The **Estate tax** exclusion rises to $1.5 million (from $1 million) in 2004. EGTRRA raises the exclusion to $3.5 million, then by 2010 eliminates the Estate tax. In 2011 the Estate tax returns, because Republicans did not have the votes to make the changes permanent. The confusion over Estate taxes creates major opportunities for the next few years, for wealthy families to save Estate tax. Income taxes, on the other hand, are much harder to save, because Congress has created so many restrictions over the decades, as AMT (see page 2). California residents may get a break, as we have a constitutional provision that prohibits estate tax.

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AMT is a *disaster in the making*. National Taxpayer Advocate Nina E Olsen.

The **complexity** of the income tax code is a **cancer**. It destroys IRS' ability to manage the income tax system. It encourages everyone to cheat, even the IRS, in order to get his **fair share**.

Cheating has reduced **voluntary compliance** for years. IRS does not have the resources to audit everybody, and the income tax is slowly dying of its own weight. Washington will have to turn to an easier method to collect tax, unfettered by the porkbarrel baggage of the income tax. Europe has turned for many years to a **value added** tax.

Alternate Minimum Tax

Alternative Minimum Tax (AMT) is perhaps the biggest and most egregious single complexity in the internal revenue code. AMT is a **complex patchwork of odd preferences and limitations**. AMT sets normal tax planning on its **head**. AMT is a **surprise** to most who pay it. Most people find AMT to be grossly **unfair**.

*The AMT is providing **nightmares** to taxpayers and practitioners*, says Enrolled Agent Claudia Hill to a Congressional hearing. Pay the **higher** of regular tax, or AMT, a **second tax system**. Politicians created AMT quietly many decades ago to correct the perceived political problem of a few high income taxpayers who legally reduce their tax to **zero**. Instead of simply removing the legal loopholes, Washington created the AMT. It affects only a few high income taxpayers, and most taxpayers have never known it exists. Washington **raised** AMT slowly over the years. It cut the regular tax, added more and more AMT tax preferences, and failed to index for inflation the AMT exemption.

*I think you will have a **revolt** on your hands*, says House Budget member John Spratt (D-SC), because the number of taxpayers paying AMT will **skyrocket tenfold** in ten years. 30% (up from 3%) of taxpayers will pay their higher AMT. 10% (up from 1%) of individual income tax receipts will come from returns that pay the higher AMT. *We assume that the AMT will be fixed. Both parties are supporting the idea*, says Spratt.

Washington is **hoisted by its own petard**. Elimination of AMT is extremely expensive, at 10% of individual tax receipts. More likely, Washington will fiddle with the AMT exemption, and modify the more egregious AMT preferences. In effect, they will raise the regular tax a little.

This is not your father's AMT, says Douglas Holtz-Eakin, Director of the Congressional Budget Office. *At the current pace, it is on track to **replace** the ordinary income tax for many Americans*. The first to pay AMT are those with specific AMT preferences, and those whose income exceeds the **exemption** of $150,000 married joint, $112,500 single and head of household, and $75,000 married separate. Common AMT **preferences** are personal exemptions, incentive stock options, depreciation, and many Schedule A itemized deductions (taxes, mortgage interest payments related to non-acquisition mortgages, and miscellaneous expenses, such as for investment and employee business).

California's high taxes make us more likely to pay AMT. Get current AMT information from a special interest reform group, http://www.reformamt.org

Inside the IRS

The news has been full of normal inefficiency and misconduct. Then there are the **frauds**, **cheats**, and **scams**.

The internal revenue code is so complex that IRS' answers to taxpayers' questions are **wrong 57% of the time**, according to a recent Treasury Department test.

IRS wants legislation to allow it to hire **private bill collectors**, for 25% commission. IRS estimates that 2.6 million new tax deadbeats per year have generated $78 billion of overdue taxes. IRS is a terrible tax collector. IRS too often **seizes** money and records real property **liens** against people who do not really owe tax. *I want to stress in the strongest possible terms that [private collectors] would be prohibited from threatening or intimidating taxpayers*. IRS Commissioner Mark Everson

IRS' troubled management structure wasted **$4 Billion** in the early 1990s on a failed modernization of its **antiquated** computer systems. IRS' software databases cannot communicate with each other, and uses equipment designed and first built in the 1950s, equipment that should be in the **Smithsonian**. Recently departed IRS Commissioner Charles Rosotti, IRS' first high tech manager, not a tax lawyer, restarted IRS modernization efforts. IRS just announced that his $433 million modernization program, has been delayed another year, at least.

Congress has a hard time managing IRS' inbred, secretive, bureaucracy. Congress created an **Oversight Board** in 1998, which is now filled with IRS apologizers and hangers-on. *Inbreeding is not what we want. I worry that the Board, particularly under its current leadership, forgets its mission. I worry that the Board forgets that its role is not to echo IRS management, not to obscure, obfuscate, or otherwise provide cover for IRS actions, but to keep a watchful eye on a very powerful and very important Federal agency.* Senate Finance Committee Chair Robert E Grassley (R-IA).

Congress also strengthened the **Taxpayer Advocate**. But the improvements are spotty, and less effective in many parts of the country, says the American Institute of Certified Public Accountants. No organization can investigate itself. We need a truly **independent** tax auditor.

The art of taxation is to pluck the maximum amount of feathers from the goose with the least amount of hissing.

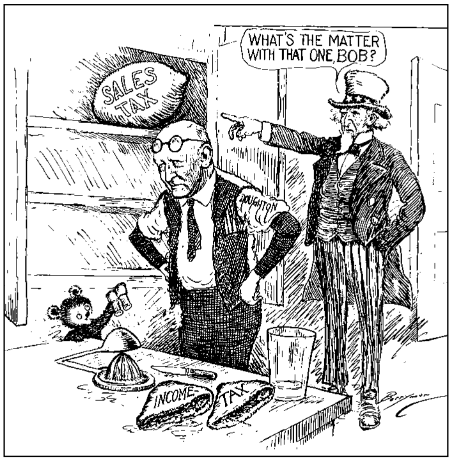
Jean-Baptiste Colbert, Louis XIV's finance minister

Frauds, Cheats & Scams

If it sounds too good to be true, it may be a **tax scam**. Usually the frauds target IRS, as in abusive tax shelters, below. Sometimes the frauds target you, as when scammers pretend to be from IRS to steal your money or your identity. See IRS' tax scam web site, http://www.irs.gov/newsroom/article/0,,id=98269,00.html.

IRS tried and failed last year to establish widespread, **free online filing**. IRS trumpeted that **60%** of all taxpayers would qualify. IRS partnered with the private online tax preparers, who **scammed** IRS. The private preparers used free filing as the **bait**, and **switched** people to paid services. IRS failed to realize that the private tax preparers would not easily give up 60% of their customer base. IRS has not yet announced changes in this year's free online filing program.

H&R Block is the biggest private tax preparer, and has made some big mistakes. It paid $3.3 million to settle a legal class action last year, for **misleading** customers to buy *peace of mind* insurance against audits. In another case, Ivy Johnson, one of its managers, allegedly stole customer information to commit **identity theft**. *We're as much of a victim here as our clients are*, says Block.



Obviously, I lost, says National Taxpayer Advocate Nina E Olson. She wanted IRS not to allow **refund anticipation loans** with the free online filing program. Tax preparers commonly charge extremely high fees to **loan** customers their refunds, for just a week or two. A few **lie** that the refund anticipation loan is **required**.

IRS cannot control the refundable **low earned income tax credit** scams. Some low income taxpayers commit **fraud** in wrongly claiming this credit. Worse, some paid preparers create **false returns** with big refunds, for kickbacks or so they can charge more for the refund anticipation loans. IRS wrongly refunds **billions** of dollars every year to low income taxpayers, which it can hardly recover. Congress deters IRS from common sense steps, such as prequalifying the recipients, or delaying refunds to ensure they are correct. IRS National Taxpayer Advocate Nina E Olson has recommended that the **paid tax preparer be jointly liable** to repay an incorrect refund.

I say to the hucksters, it's time to find an honest living says Senate Finance Committee Chair Robert E Grassley (R-IA) on opening Senate hearings on **abusive tax shelters**. A few of the big accountants, lawyers, and stock brokers should be forced out of business, and go to **jail** for **fraud**. Instead, IRS offers **amnesty**, as it did last year for offshore credit card abusers. Other frauds use tax exempt entities, such as leasing parts of the subway systems of Washington, Boston, and Chicago, and the water mains of New York City. IRS has **sued** many of these big money hucksters to get details on the scams. Investors have sued the hucksters for fraud. *Abusive tax avoidance transactions have a corrosive influence on our tax administration system and the rule of law itself. IRS will enforce the law across all sectors, but with particular* ***vigor*** *in the corporate arena and for high income individuals who enter into abusive shelters to* ***game the system***. IRS Commissioner Mark W Everson

One lesson that you learn from this case is ***you don't want to get crosswise with the California Franchise Tax Board***, says US Supreme Court Chief Justice William H Renquist. The Supreme Court ruled that Gilbert Hyatt can sue California in Nevada court for **abusive** collection practices. California wants to tax Hyatt as a California resident on $40 million royalties he collected, right after moving to Nevada. California's **normal** collection practices appear to include entering his Nevada home, rummaging thru his garbage, and disclosing his private records.

Even IRS gets caught **cheating.** The circuit court held that *[IRS] lawyers intentionally* ***defrauded the Tax Court*** when they withheld a secret settlement with test defendants. The Court ordered all members of the much larger group to get the same favorable settlement terms. IRS had given **bonuses** to the attorneys who conducted the fraud. The Court noted that *IRS has done little to punish the misconduct and even less to dissuade future abuse*. (Dixon v IRS, US Ninth Circuit Court of Appeals, January 17, 2003)

California

Higher taxes and **fewer government services** seem inevitable with California's huge **multi-year deficits**. Franchise Tax Board has already announced 25% staff cuts in customer service, and mandatory efiling by most tax preparers. Mandatory efiling may save the Franchise Tax Board $1.5 million, but cost you and me $5-10 million for the extra work. You can opt out of efiling, if you want.

California requires a **2/3 super-majority vote** to raise taxes, which is one of the **systemic** reasons for the deficit. So California now imposes more **fees**. The difference between fees and taxes is not well defined. Likely tax and fee increases include:

- Sins, such as alcohol and tobacco.
- The **maximum rate,** currently 9.3%. Taxing the wealthy is acceptable.
- **Sales** tax. See below.
- **Commercial** property tax, which rates are currently limited by Proposition 13. Taxing business is acceptable.
- **Energy** rates, to pay for the energy crisis.
- **Vehicle license** fee. Governor Schwarzenegger just reinstated the lower fee. The cities, the primary recipients, say they will sue.
- **Net Operating Loss** carryforwards for business, which have already been suspended for two years.

California now allows you to elect to pay **sales tax** with your individual tax return. This is California's **first** major effort to collect from all the individuals who owe **use tax** on property purchased for use in California, when the seller has not already collected the sales tax. Sellers often do not collect sales tax over the **internet**, which has grown like topsy. California loses major revenue, but does not have the resources to audit every individual. California is trying desperately to find ways to collect the sales and use tax. I expect that California will one year soon make the income tax reporting for individuals **mandatory**.

California has expanded its NetFile program for **free online filing**. They spent $550,000 last year to allow the simplest Form 540EZ filing. Next year they will allow online filing for the more complicated Forms 540A, and some Forms 540. The **private tax preparers** threaten to discontinue their free California filing. California has learned a lesson from the way they treated IRS. The private preparers used free filing as the **bait**, then **switched** people to paid services. The private tax preparers will not easily give up paying customers.

Tax Tips

(from page 1)

Health Savings Accounts (HSAs) are new in 2004 for people not covered by regular health insurance. Deduct contributions up to $2,250 single and $4,450 family, increased if you are over 55 years. Earnings are never taxable, so long as you use the proceeds for qualified health expenditures. You can also withdraw from the HSA account after you become 65 years. You can still have a high deductible health plan. This seems at first glance to be great for wealthier and younger taxpayers, who can afford the higher deductible payments, and can accumulate this nontaxable savings account, similar to a Roth IRA.

Military benefits include tax free death payments, suspension of time requirements for many filing and election purposes, and above the line travel deductions. Even part time national guard and reservists qualify for many of these benefits.

Maximize your **employee benefit plan** at work. Washington subsidizes health, pension, child care, education, public transportation, and more. These employer plans are almost always better than any income tax benefits you get directly on your Form 1040, when there is a tradeoff, as for health insurance and child care. Many employers subsidize the benefit packages, too.

Education earnings are **tax free**, so long as someone in your family uses the distributions for education. Schools can now compete with state governments to offer Section 529 Tuition Trusts. Contribute $110,000 at once, and more in future years, depending on the plan you choose. **Coverdale Education Savings Accounts** allow you to contribute $2,000 per year; direct your own investments; and spend the funds on K-12, vocational schools, equipment, room & board, and supplies. Other recent education deductions include $250 above the line for teachers' school supplies, $3,000 for college tuition, unlimited student interest (which used to be limited to 60 months), and permanent employee benefit plans, up to $5,250.

Retirement plans are bigger and better, even a little simpler. **IRA** contributions increase to $3,000. Business pension plan contributions increase in many ways, for example 401Ks to $12,000, and profit sharing plans to 25% or $40,000. Taxpayers over **50 years of age** can make additional **catch up contributions** in some of the plans. Required Minimum Distributions are much simpler.

As always, **phase outs** and **AMT** prevent higher income taxpayers from using many of these tax benefits. Please call me to discuss your individual situation.

William M West prepares tax returns and plans to save tax for business, investors, and individuals.