



We'll reform our outdated tax code, said George W Bush the day after he won reelection to a second term. He talks of a **mandate**, with higher turnout than in decades giving him a 51% majority vote. His father in 1988 was the last president to win by over 50%. The Republicans performed the first incumbent hat trick since Franklin D Roosevelt, reelecting the president and increasing their majority in both houses of Congress. As a second term President, Bush now has a surprisingly short time to promote his programs. His historical legacy will increasingly divert his attention. His lame duck status will increasingly divert everyone else's attention. The Republicans will learn how to use their increased power against the Democrats, who will fight with all their Constitutional minority powers.

At **19.6%**, the overall 2004 income tax rate is the lowest in years, says the Government Accounting Office. Bush and the Republicans have promised to extend these low rates, to privatize Social Security, and to reform the income tax, despite the biggest deficit in decades (see p2). Bush may follow the Reagan Presidency, which talked tax reform throughout the first term, consolidated support in the first two years of the second term, then enacted the last major Tax Reform Act of 1986.

Bush and the Republicans sacrificed simplification with two major tax acts. The **Working Families Tax Relief Act of 2004** (Work2004) cut individual taxes by \$146Billion over 10 years. It extended many of Bush's more popular 2001-2002 temporary tax cuts, including the \$1,000 child credit, 15% maximum capital gains and dividend rate investment incentive, expansion of the lower (10% and 15%) tax brackets, \$250 educator deduction, and a very little relief for the marriage penalty and

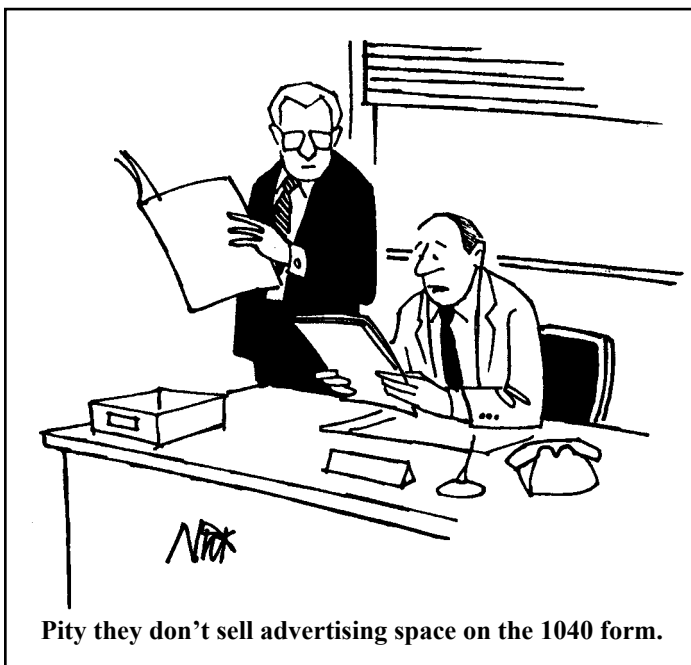
the Alternative Minimum Tax (AMT). Bush has promised to make these 2001-2002 tax cuts permanent. Otherwise they expire irregularly between now and 2010.

The **American Jobs Creation Act of 2004** (Jobs2004) cut corporate and international business taxes more than any other tax act in a generation. It heavily subsidizes US manufacturers, ostensibly to encourage (but not require) increasing US Jobs. It is revenue neutral, offset by tightening tax loopholes. It is a pandora's box of pork barrel patronage that Sen John McCain, R-Ariz, calls the **worst example of the influence of the special interests I have ever seen.**

Tax Tips

There are many law changes this year with Work2004, Jobs2004, and California's attempts to deal with its huge budget deficits. I can only mention a few new laws, so please call if you have questions.

- Apply for **California tax amnesty** by March 31 to save penalty and fees. California more than doubles the penalties, if you could have used the amnesty, but did not. (see p4)
- **Donate** your **car** in 2004, to deduct the high bluebook. Thereafter, deduct only the charity's actual sale price. (Jobs2004) (see p3)
- Deduct **sales tax** or income tax, whichever is greater, on Schedule A, beginning in 2004. Deduct either the actual sales tax you paid, or a standard amount based on your income. Low/no income tax states get this benefit. California income taxes are so high; that only a few who buy **big ticket** items will save tax. (Jobs2004)
- Sell losing stocks to deduct the maximum \$3,000 capital loss from ordinary income.
- Pay your 2004 California tax in 2004. If you underpay or overpay, **AMT** may (or may not) cost you extra tax. Call me to estimate your AMT.
- Beware your **IRA's** Required Mandatory Distribution (RMD), when you pass 70 years of age. IRA trustees will now report the RMD to you and to IRS. The penalty is a heart stopping 50%.
- **Depreciate** business and investment property faster, including bonus first year depreciation. But depreciate your business **SUV** more slowly, limited to \$25,000 first year bonus depreciation. (Jobs2004)
- Insure your own health with a **Health Savings Accounts** (HSA). IRS is slowly issuing the rules, which have made these high deductible plans a great deal for a few people. But California does not conform.
- Plan to take advantage of **expiring** tax breaks. 50% bonus first year depreciation expires Dec 31, 2004. \$100k bonus first year depreciation reverts to \$25k on Jan 1, 2006. (Work2004) The 15% maximum rate for capital gains and dividends expires Dec 31, 2008, under existing law.
- Disclose potential **abusive tax shelters** on your tax return, or pay a huge, mandatory, penalty. (Jobs2004)



See *Tax Tips*, page 4



President Bush has a clear mandate to make the tax code flatter and fairer. That's what the president wants and what taxpayers deserve. When he succeeds, he'll have turned a mandate into a legacy.

ex House Majority Leader Dick Armey, R-TX

Tax Reform

Major tax reform is unlikely, as politicians talk big but vote for only incremental changes. The road to reelection includes doling out political patronage, and alienating the fewest voters. The US income tax does not so much raise revenue as it redistributes wealth, often to political contributors. Pam Olsen, Assistant Treasury Secretary for Tax Policy, says that *any reform is likely to have vocal losers and largely silent winners.*

The income tax system is a *kafkaesque maze of complexity*, says Steny H Hoyer, D-MD, House minority whip. It becomes even more complex and more **unfair**, as Washington incessantly twists and tweaks, with temporary and retroactive rules. You can buy justice, if you can afford to pay part of the \$135Billion per year, over 10% of tax receipts, that it costs just to administer and to comply with the income tax.

The income tax is in a **death spiral**. It is hard to pay one's fair share, seeing so many people so obviously evade tax. Treasury's Taxpayer Advocate finds \$331Billion per year that IRS fails to collect, not including the huge underground economy. More people scam the voluntary system, and drop out altogether. Fewer honest taxpayers are left holding the bag.

AMT

AMT (Alternative Minimum Tax) is a *perfect storm* that will *devour the tax system*, says Fred T Goldberg, former IRS Commissioner. Politicians promise to eliminate AMT permanently, but Washington cannot afford the \$Trillions. I speculate that Washington will reform the regular income tax by merging it with AMT. AMT already meets one goal as a **flatter** tax, with just two brackets – 26% and 28%. Merging the regular tax into AMT, creating one tax system, would produce a **simpler** tax.

AMT is a *time bomb on a short fuse*, that operates *randomly, no longer with any logical basis in sound tax administration or any connection with its original purpose of taxing the very wealthy who escape taxation*, says Nina Olson, Treasury's National Taxpayer Advocate. 35% of taxpayers will pay AMT in ten years, up from 2% now. AMT may raise 50% of US' total income tax receipts, up from 1% now.

AMT is a **stealth** tax, a surprise to most. It is an add-on second tax system, including all the complexities of the regular tax. It is no longer just a headache for the wealthy. It inflicts unintended harm on the middle and lower classes. Washington tried to dodge news reports in 1969 that just 155 wealthy people had taken advantage of legal tax deductions to pay no income tax in 1966. So Washington created AMT. It has grown like topsy. Politicians loudly crowed over the years as they lowered regular tax rates. But they did not lower AMT rates. They did not index AMT for inflation.

Nearly **everyone loses**, as you pay the higher of regular tax or AMT. AMT makes you abandon the logic and common sense of the regular tax. Some of the AMT differences include:

- Families lose all their personal exemptions.
- Low income families lose their earned income tax credit.
- California residents lose their high property and income/sales taxes, all mortgage interest over \$1Million, and mortgage interest over \$100,000 not incurred to acquire their residence.
- Middle and high income taxpayers lose the basic AMT exemption as they exceed adjusted gross income of \$150,000 married joint, \$112,500 single and head of household, and \$75,000 married separate.
- Investors and businesses lose the fastest depreciation schedules.

- Employees and investors lose Schedule A miscellaneous deductions.
- Everyone loses the standard deduction, forcing use of Schedule A.
- Silicon Valley workers lose the income exclusion on the built in gain upon the exercise of incentive stock options.

If you want to find out more information about AMT, and possibly to lobby Washington, see a special interest reform group, ReformAMT.org

Social Security

Bush's plan to **privatize** social security is economically **absurd**, says William C Dudley, chief US economist at Goldman Sachs. Bush should get credit for grabbing this third rail of politics with both hands. Washington cannot possibly raise taxes high enough for the Trust Fund to pay all the promised benefits. Beginning about 2018, the Trust Fund will pay out more than it collects as baby boomers retire, and collect big pension and even bigger health benefits.

The Social Security Trust Fund does not really exist. It is a **pay-as-you-go** system, and Washington has always spent the Trust Fund's excess payroll tax collections elsewhere.

Bush should not take away people's most secure retirement benefit, in exchange for private accounts. Higher returns from common stock investments are not **free**. *You are getting these returns precisely because you are taking on risk*, says Dudley. As some will inevitably mismanage their private accounts, Washington will still be the retirement protector of last resort.

Sales Tax

A **national sales tax** is economic magic. It encourages **saving** by taxing consumption. It is **simplification** personified. It is easier to collect at the time of each sale, from the business

Our priority...is to put the IRS out of business. I have no sympathy and I don't shed tears for the IRS

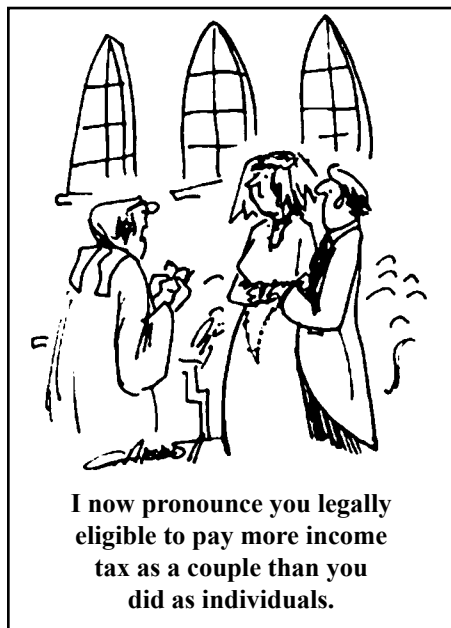
House Majority Leader Tom DeLay, R-TX

source. It prevents tax evasion. The European Union has long successfully used a variant, their value added tax. But Washington has long declined to implement a national sales tax.

The **internet** is the current catalyst for a national sales tax. The states lose big revenue from buyers who click to buy from a seller in another state, and to evade sales tax. The states have an unwieldy maze of over 7,500 separate tax rates and exemptions. The states must overcome their fear of Federal control of this substantial revenue source.

IRS' Strategic Plan

New IRS Commissioner Mark Everson CPA combined with Jobs2004 to make IRS' current 5 year Strategic Plan. Everson started his career at Arthur Anderson, worked in private industry, and knows where the bodies are buried. The Plan calls for improved taxpayer **service**, technology **modernization**, and enhanced **enforcement**.



IRS' taxpayer **service failed 83%** in 2003, when the Treasury Inspector General for Tax Administration sent mystery taxpayers to test IRS' tax preparation help. IRS **failed 100%** when Treasury repeated the test in 2004. Treasury faulted IRS helpers for modifying the test facts, and for failing to use IRS' instructions and publications. Treasury found systemic IRS training and computer software failures. Senator Byron Dorgan (D, ND) decries **too many wrong or incomplete answers. This is unacceptable.**

We've got '60s and '70s technology, says immediate past Commissioner Charles Rosotti, IRS' first high tech manager, not a tax lawyer. When Rosotti took over, he scrapped a **modernization** plan, after IRS had wasted \$4Billion. He designed IRS' new *Customer Account Data Engine*, which begins production tests in 2005, and is already 40% over budget. New IRS Commissioner Everson admits to **major setbacks**. Larry Levitan, Chair of Congress' IRS Oversight Board, says **every single major project under way experienced a significant delay in time and overrun in budget....a five year track record of absolute consistency of cost overruns and delayed deliveries.**

IRS' enforcement

Congressional hearings and civil suits have revealed details of the big business **frauds** and barely legal **scams**. IRS now threatens tax shelter promoters with **criminal** prosecution. Jobs2004 requires more disclosure, as these scams often use **secret** agreements and misleading tax returns. One popular tax shelter relies on transferring taxable income to partners who pay no tax, such as

municipalities, charities, and offshore entities. For example, purchase and lease back a city's bus system. Moving overseas is another popular tax shelter. Now, Jobs2004 requires you to pay more tax on your past and future US based earnings. Everson decries that **business decisions were taken by some of our finest firms as to whether they would comply with the law. That's shocking and unacceptable.**

Jobs2004 allows IRS to contract with **private debt collectors**. IRS collects overdue tax very poorly, partly because Congress prohibits IRS from managing and rewarding collectors based on successful collections. Now, IRS will pay the private firms up to 25% of collections, plus performance bonuses. But IRS' uncollected debts, \$120Billion, dwarf private industry's total collections. IRS will have difficulty supervising the private collectors to recognize legitimate tax problems, to be fair and equitable, to promote **voluntary compliance**.

Charities

Jobs2004 and IRS have targeted **charities** for special enforcement. Charities are inherently more vulnerable than profit making firms, because everyone thinks they are somehow less susceptible. But scammers and fraudsters hide behind real charities, start phony charities, steal charity's funds, and wildly exaggerate the value of their gifts.

You can only deduct the **fair market value (FMV)** of your charitable gifts. Jobs2004 closed many loopholes, the most common of which is for **cars**. The Government Accounting Office says that IRS did not enforce its own rules, allowing you to estimate FMV of your

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own car, up to \$5,000. The California Attorney General found that charities received only 37% of the actual sale price, on average. The Government Accounting Office found that most charities received less than 10% of the actual sale price. After Dec 31, 2004, charities must report their actual sale price, which usually limits your deduction.

Tax Tips

(from page 1)

- Beware high fees on §529 Tuition Trusts. Tax free earnings make these Trusts great in the right circumstances. But more than 80 state and private plans have separate rules and fees. The National Association of Securities Dealers warns of their brokers who take advantage of you (see nasd.com). **It's not getting easier**, says Joseph Hurley, founder of savingforcollege.com. **Some investors don't want to take the time to wade through it all, and others don't have the ability to do it.**
- Deduct **attorney fees** and avoid AMT in job related discrimination cases that settle after Oct 22, 2004. (Jobs2004) The US Supreme Court will rule on old cases and non discrimination cases. Your attorney fee deduction depends on when and why you settle.
- **Exchange** rental property tax free, convert it to your home, then exclude up to \$500,000 capital gain on sale. But you must wait five years, up from two years. (Jobs2004)
- Plan to pay California a **1% surtax** on taxable income over \$1M in 2005. This is a marriage penalty, since single people use the same \$1Million limit. You cannot offset this surcharge with tax credits. This is a tax by initiative earmarked for a specific purpose (health care), and is a dangerous precedent. (Prop 63)
- Beware of new **child** definitions in 2005 that unify the rules for the dependency exemption and care credit, child credit, earned income credit, and head of household status. There are many exceptions. (Work2004) Hopefully California will conform next year.

WmWest.com

My website has back issues of this Newsletter, links to interesting tax sites, and articles on investment and tax topics. Last year I wrote on **Record Retention**. Income taxes are just one consideration. Other adversarial legal proceedings have their own requirements, including common ones such as death and divorce.

Identity Theft is this year's article. Request free copies of your credit reports under the Fair and Accurate Credit Transactions Act of 2004. Beware of the email phishing scam. Beware of fraudsters who pose as IRS agents. The Check Clearing for the 21st Century Act allows banks to scan then to destroy paper checks. Fraudsters can more easily digitally drain your bank account.

California

California last **conformed** to the Internal Revenue Code as of Jan 1, 2001. California does not conform to Work2004, Jobs2004, or Bush's other tax acts, with a few exceptions. California drags its heels, because it is expensive to conform. It is **unconscionable** that California makes all of us suffer the extra trouble and expense to deal with different tax laws. Please, **write or email** Governor Schwarzenegger and your legislators.

Real estate withholding uses a broad brush, and can be very unfair. California withholds 3.3% of the sale price on most non-residential real estate with a taxable gain. Withholding is a big surprise for most people, who do not sell real estate very often. In 2005, California expands withholding to non residents and to entities, including corporations, partnerships, and limited liability companies.

The **Domestic Partners** Rights and Responsibilities Act of 2003 allows community property and other marriage type benefits, effective January 1, 2005. But Washington does not allow

any benefit relating to same sex marriage. Last year there were small tax differences, such as the taxability of health benefits. It looks like the differences will increase.

Tax Amnesty

Save penalties and fees, but not interest or tax, with California's **income and sales tax amnesty**. Apply Feb 1 to Mar 31, 2005, for any tax issue prior to 2003. File by May 31, 2005. Pay in installments by May 31, 2006. California more than **doubles penalties**, if you could have used the amnesty, but did not.

Plan to pay IRS, too. California will notify them under their information sharing agreement. IRS will probably give you the benefit of having voluntarily paid your Federal tax, which will probably protect you from larger penalties and criminal prosecution.

California hopes to collect an extra \$200Million with this year's income and sales tax amnesty. California collected \$1.4Billion in last year's amnesty for abusive tax shelters, after hoping to collect \$90Million! Abusive tax shelters are a much bigger problem than they imagined. They have high hopes for this year's amnesty.

Contact me immediately if income and sales tax **amnesty** might help you or someone you know, Your situation might include bankruptcy, an IRS audit or assessment that will lead to California tax, nonresidency, nonfiling, revival of a suspended entity (corporation, LLC, limited partnership, etc), filed tax returns that were too aggressive, or outstanding California tax debt.

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