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Wisdom to build Wealth

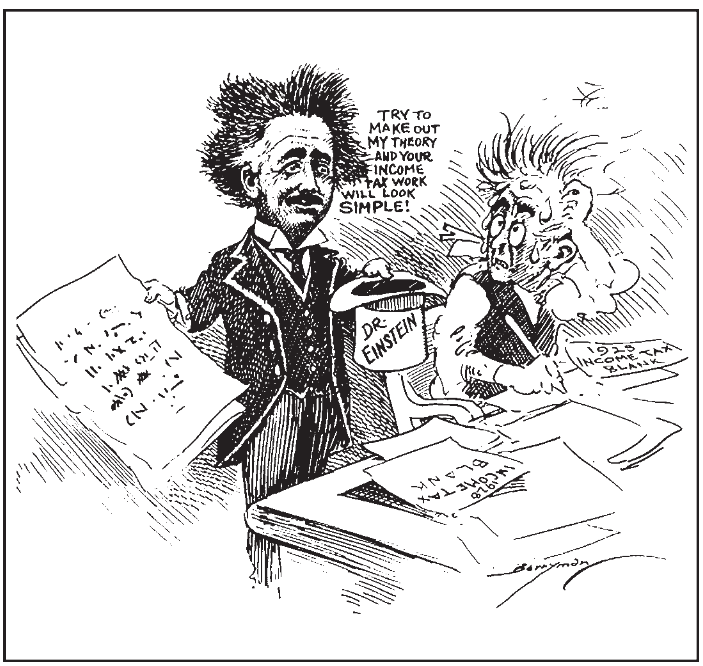
Tax Newsletter 2006

We'll reform our outdated tax code, promised President George W Bush the day after his November, 2004, reelection. Bush also promised to extend his pro-growth tax cuts, and to reform Social Security. Bush did try this year to reform Social Security, and failed quite dramatically. He still hopes to extend his tax cuts permanently, though the overall tax rate, **19.6%**, is already extremely low by historical standards. And the Federal deficit is extremely high.

Bush appointed a **Tax Reform Panel** of Republican loyalists upon his reelection in January, 2005. The Panel reported back in November, 2005, with the usual Republican recommendations. (see p3)

Bush has lost the **political capital** to promote major tax reform, as I write this in December, 2005. Some top republicans are enmeshed in scandals, perhaps inevitably, after so many years that the Republicans have controlled the Presidency and both houses of Congress. Congress is in no hurry to pursue major tax reform, either. 2006 is an election year, for most members of Congress. Some Republicans have already distanced themselves from Bush, to improve their chances of reelection.

Congress has delayed the 2005 tax bill. They will likely make some 2005 changes when they reconvene on January 31, 2006. Congress' delay, until tax season is already underway, is a major tax problem. They may retroactively reenact some tax provisions that expire December 31, 2005. It is too late for some other tax provisions, which cannot be completely reenacted, retroactively. Year end planning, and tax preparation itself, are much more difficult, as everybody tries to figure out last minute, retroactive, changes. Changes under discussion include reducing Alternative Minimum Tax (AMT), possibly for 2005, extending the 15% rate on capital gains and dividends beyond 2008, and extending the state/local sales tax deduction to 2005. The hated **stealth AMT** is the most immediate provision, as 10-20M taxpayers may pay more, or less, AMT. (see p3)



Washington did include many tax subsidies in the Katrina and Energy Acts (see p4). These Acts add much political pork to the income tax system, which long ago turned from merely raising revenue to redistributing wealth, and subsidizing politically correct activities.

Tax Tips

• IRS expects to raise taxes overall with a new **unified child definition**, effective Jan 1, 2005, affecting the basic exemption, dependent care credit, child credit, earned income credit, and head of household status. There are many exceptions. Non-traditional families, such as divorce situations, will see the most changes, especially if the parents do not agree on the tax issues. Living with your dependent is more important now. The dependent's income and source of support is less important now. Dependency exemptions are more likely for the disabled; and less likely for relatives living in Mexico and Canada.

• **Domestic production activities** get new tax **deductions** of 3% in 2005, rising to 9% in 2010. Qualifying activities include tangible personal property, software, farming and wholesale food processing, film and sound recordings, and real estate construction. You must pay some **wages**.
• The Estate tax exclusion rises to $2Million in 2006. The annual gift tax exclusion rises to $12,000. The lifetime gift tax exclusion remains $1Million.
• Plan for AMT, which is growing like topsy. Paying California tax and other preferences in the better year may help, as you move into or out of AMT.
• Deduct only the charity's selling price, when you **donate a car, boat, or airplane** valued over $500. Congress limited the deductions to stop wildly overvalued donations. There are a few exceptions, such as if the charity uses your vehicle in its tax exempt activities.
• Sell and pay the 15% long term capital gain tax, before the rate goes back up to 20% on Dec 31, 2008. The qualified dividend 15% limitation also expires at this time. Bush wants to extend these rates, which are as low as they have been in generations.
• Buy business assets that qualify for §179 first year depreciation up to $100,000 by Dec 31, 2007. Thereafter, the deduction reverts to $25,000, unless Washington extends it. The 50% bonus depreciation has already expired, at Dec 31, 2004.
• Sell losing capital assets, such as stocks, to deduct the maximum $3,000 capital loss from ordinary income.
• Insure your own health with a **Health Savings Account** (HSA). IRS is slowly issuing the rules for these deferred tax savings accounts, which combines with a high deductible health plan. HSAs are a great deal for many people. But California does not conform.

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The US income tax is a grotesquely complicated system that distorts the allocation of resources and violates common sense notions of fairness.
former IRS Commissioner Fred T. Goldberg.

Tax Reform

*You need a **precipitating event** to force big policy changes in Washington*, says Mark Weinberger, former Treasury assistant secretary for tax policy. **AMT** may be that event for the normal tax reform we get every generation, most recently in 1986. The growing tax gap will be the event for the major tax reform we get every few generations. US taxpayers increasingly hide their income, leaving fewer honest taxpayers **holding the bag**. *Tax evasion is a big problem because it undermines the fairness of the tax system, and it makes some people who voluntarily comply feel like **suckers***, says Joel Slemrod, U Michigan economist. Major tax reform must make the system seem fair and equitable, and be much easier to collect.

*It's **one step forward, two steps back** when it comes to dealing with the tax gap*, says Senate Finance Committee Chair Chuck Grassley, R-Iowa. Washington estimates the known tax gap, ie, uncollected taxes, to be $353Billion, and growing. Then there is the unknown tax gap. Many people never file returns. Many file but hide income, especially from unreported and complex transactions. Many do not report cash and barter transactions. No government official will admit that the emperor has no clothes. I speculate that the total tax gap is $Trillions.

The **tipping point** approaches, as voluntarily compliance declines. Even if IRS became a model of efficiency, it could only enforce the tax laws with the cooperation of the vast majority of taxpayers to voluntarily file and pay what they owe. IRS' major internal problems contribute to the feelings that the tax system allows others to cheat, so one must cheat just to stay even. The tax system has grown very complex, with tax subsidies to favored political constituencies and wealth redistribution to the poor. It no longer merely raises revenue. Politicians' promises to simplify the income tax system have become a joke. Increasing complexity allows tax cheats more room to maneuver. Tax scams have increased dramatically.

Tax Scams

Tax cheating is the norm in most of the world. US is reverting to the norm. The news has been full of acronyms for big money, complex schemes: FLIP, OPIS, BLIP, BOSS, son of BOSS, SOS, etc.

Offshore entities and financial accounts hide assets and income. Multiple layers of **pass through entities**, such as trusts and partnerships, obfuscate some scams. The mere complexity of the tax code allows some scams to hide in **plain sight**.

IRS and CA now have lists of suspect transactions that must report in detail on special forms. They impose huge **penalties** for the mere failure to report.

There is no tax due on these detailed reporting forms, which follow the money to catch terrorists, drug dealers, and tax cheats. You must file if you own an entity or have signature authority on a financial account that does not report to the US, or if a foreigner owns a US entity.

KPMG

KPMG admitted in 2005 to the **largest criminal fraud** ever filed. IRS estimated that it has lost $2.5Billion, and collected $3.7Billion, from taxpayers who purchased KPMG's fraudulent schemes. The Justice Department threatened to indict KPMG for designing, marketing, and implementing fraudulent tax shelters. Justice instead allowed KPMG to pay $456Million in penalties. KPMG will identify others, including purchasers, who colluded in these fraudulent schemes. KPMG will help IRS prosecute at least nine individual accountants and attorneys, most of whom worked for KPMG. There are only four huge, international, accounting firms left, after Arthur Anderson **imploded** when it was indicted just a few years ago. KPMG was terrified of imploding, too.

*You have to start with the big guys, so [enforcement] resonates thru the system. [These] actions demonstrate our resolve to hold accountable those who play **fast and loose** with the tax code*, said IRS Commissioner Mark Everson. *At some point such conduct passes from clever accounting and lawyering to **theft** from the people. We simply can't tolerate **flagrant abuse** of the law and of professional obligations by tax practitioners, particularly those associated with so-called blue chip firms like KPMG, that by virtue of their prominence set the standard of conduct for others. Accountants and attorneys should be the pillars of our system of taxation, not the architects of its circumvention.*

KPMG was too big to fail. $456Million is just a **slap on the wrist** for criminal conduct by such a big firm. IRS is now trying to undo this KPMG precedent of relatively light punishment for criminal behavior. IRS attempts to convince other accountants and attorneys that they would be treated more harshly. IRS threatens penalties for normal planning activities, to pay the least tax required by the law.

EITC

Earned Income Tax Credit (EITC) errors and fraud cost IRS $10Billion per year. The EITC gives cash refunds of over $32Billion. It is the **biggest Federal welfare** program for low income working families, who get cash refunds up to $4,400. IRS can rarely recover the erroneous refunds, even in cases of fraud. So IRS makes even tighter rules, delays refunds, and examines 48% of all EITC returns. The EITC is so complex that some qualified families do not bother to claim their refunds. *EITC has been singled out for*

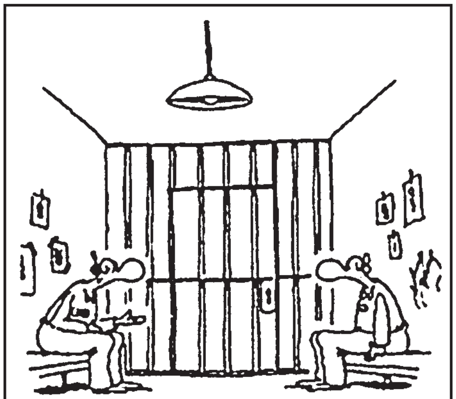
When it comes to the tax system, America is winning the battle but losing the war.
immediate past IRS Commissioner Charles O Rosotti.

disproportionate emphasis as compared to other areas of tax noncompliance, says Treasury's IRS Advisory Council. IRS Commissioner Everson challenges the Council to suggest a better solution. Perhaps the better solution is to subsidize these low income families outside the income tax system.

Tax Reform Panel

Bush appointed his Tax Panel right after he was reelected in 2004, to recommend a tax system that is simpler, fairer, more conducive to economic growth, at no net cost to the Treasury. The Panel largely agreed with Nina Olson, National Taxpayer Advocate, in recommending elimination of the stealth AMT, and simplification of tax subsidies for retirement, education, and health plans. Bush's Panel also recommended stimulating economic growth by extending permanently and enhancing Bush's 2001 dividend and capital gains tax cuts to 15%.

These expected recommendations followed the Republican party line, as Bush had filled the Panel with loyal Republicans. The Panel could make only very general recommendations, as it had to work in cumbersome public meetings in adherence to Federal sunshine laws. ***It is really a crummy way to work. It's just idiocy***, says Panel member Bill Frenzel (ex House member R-MN).



Let's Just say, with taxes, it's best to think inside the box.

AMT

Elimination of AMT is the Panel's most expensive recommendation by far; at $1Trillion. Bush's Panel chose two of the biggest deductions to offset this cost: elimination of state and local income taxes, and mortgage interest on high priced homes.

The stealth AMT is our second tax system, a surprise to most who pay it. You pay the higher of regular tax, or AMT. AMT has grown for more than three decades. In five years or so, AMT will raise about the same as the regular tax, about $1Trillion. I have written about AMT in detail for many years in my previous Tax Newsletters, which you can read at wmwest.com. There is even an advocacy site, reformamt.com.

*AMT is a **time bomb**, and it is set to detonate within the next five years. **Gotcha taxation** is not good for taxpayers or the tax system. If I were given the opportunity to make just one change to the Internal Revenue Code, I would use it to eliminate the individual AMT*, says Nina Olson, National Taxpayer Advocate.

*AMT is **unfair**, **complicated** and does **not promote growth**. It is a perfect example of everything that is wrong with our tax system. It has evolved from a targeted provision aimed at a handful of high-income taxpayers who were avoiding paying tax to become a significant **hardship** to millions of middle-class families*, says former Sen Connie Mack, Chair of Bush's Tax Panel.

*It's a **mess**, and we need to clean it up for good*, says Charles Grassley (Rep-IA), Chair of the Senate Finance Committee.

One of the experts who wants to **eliminate the regular tax**, instead of AMT, is Sheldon D Pollack, PhD, JD, of the University of Delaware. He says that eliminating the regular tax would leave AMT as *just **one** tax system that meets the criteria of tax reform agreed to during the historic compromise of 1986: **no tax preferences, a comprehensive tax base, and lower marginal rates***.

Washington must deal with the highly unpopular AMT. Washington has much invested in both the regular tax and AMT. Politicians rarely completely eliminate any substantial government program. Bush appears to have lost the political capital to promote any major initiative. I predict that Washington will muddle along, and slowly merge these two tax systems.

IRS Reform

Washington is **reforming IRS** from the inside, by giving it substantially more money. IRS is hiring more staff, training staff better, modernizing its archaic computer databases, examining more tax returns, and getting tougher with known tax scams. For many years, Congress had withheld funding, as punishment for perceived IRS abuses. Now, IRS Commissioner Mark Everson says ***service plus enforcement equals compliance***.

But the Government Accountability Office (GAO) says IRS wastes millions of dollars every year, as it fails to meet, even to measure, its own goals for accuracy and staff training. *None of the programs had long term accuracy goals, training goals, or measures* *suitable for an assessment of the impact of training on accuracy. Nor had [IRS] determined the relative importance of the various factors that impact accuracy, benchmarked the training practices of other organizations, or conducted assessments of long term skill needs*, says GAO.

It is ***unacceptable*** *that report after report demonstrates the IRS's inability to set goals and measure its performance. IRS cannot keep* ***blindly throwing money*** *at training without seeing the result. It must put a strategy in place that includes long term goals and performance measures for training and accuracy so it can make informed decisions about the use of its limited resources to improve customer service*, says ranking Senate Finance Committee member Max Baucus (D MT).

We've got '60s and '70s technology, said immediate past Commissioner Charles Rosotti, IRS' first high tech manager, not a tax lawyer. Rosotti scrapped a failed modernization plan, after IRS had wasted $4Billion. He designed IRS' new *Customer Account Data Engine*, which exceeded its budget by more than 40%. This new system will begin slowly in 2006 by processing just the simple Form 1040A. 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 will experiment with **private debt collectors** in 2006. Detractors fear that private firms may violate debtors' rights, in their efforts to earn commissions on the taxes they collect. The courts have finally allowed this test program to proceed. IRS will start the private collectors on $7.7Billion of its simpler debts. IRS hopes to expand the program in 2008, to include more of the total $120Billion in delinquent debts. *Quite frankly, this activity is geared for an inventory that* ***IRS currently cannot chase with existing resources***, says IRS Commissioner Everson.

2005 Tax Acts

Two major 2005 acts contained some tax provisions, and a great deal of political pork. So the income tax system is more complicated. Tax evaders will use this complication, this unfairness, as further excuse to widen the tax gap.

The 2005 **Katrina** Emergency Tax Relief Act has many liberal benefits for businesses, employees, and residents, in the disaster area. The most liberal income tax benefits are for charitable contributions that go to disaster victims; and for cash contributions made by Dec 31, 2005, whether or not they are disaster related. Californians will get a few benefits, such as extra exemptions for providing free housing to Katrina refugees.

The 2005 Energy Tax Incentives Act contains $15Billion of tax credits, mostly for 2006 and 2007, and other subsidies for most every energy segment of the economy. Subsidies are for energy research, building efficient homes and appliances, and a wide range of alternative energy sources, such as ethanol, biodiesel, natural gas, hydrogen, fuel cells, and solar (both hot water and photovoltaic collectors).

• **Drivers** get up to $3,400 tax credit for purchasing a hybrid or clean-diesel vehicle. CA allows hybrid vehicles in the multiple occupancy diamond lanes. San Jose allows free parking in downtown city lots and meters, if you purchased your hybrid in San Jose.

• **Homeowners** get up to 30% credit (max $2,000) for installing solar electricity or heating equipment; up to 10% credit (max $500) for energy-efficient furnaces, fans, windows, boilers, etc; and smaller credits for energy efficient appliances.

The Energy Act does not pretend to use basic research to attack long term energy issues, like global warming and dependence on foreign oil. It is *little more than a collection of old ideas that have never worked, new ideas unlikely to work, and a lot of* ***pork*** *for the energy industry*, says Ben Lieberman of the Heritage Foundation, a right wing think tank. *There has never been any reason to believe that the Tax Code can do a better job than markets in making the right energy choices for America. Yet, Washington keeps trying. The energy bill is the* ***same old failed policy*** *on an unprecedented scale. Its most egregious provision appears to be one inserted into the legislation after the House-Senate conference committee (so members had no chance to vote on it) steering $1Billion to a private consortium in Majority Leader Tom DeLay's district in Texas*, says David Sandalow of the Urban Institute, a left wing think tank.

California

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.

California advanced its conformity date to most Federal rules in effect on Jan 1, 2005. The lack of full conformity dramatically increases the cost of filing. Some of the Federal rules to which California does not conform are Health Savings Accounts, education loan interest deductions, first year bonus depreciation, $250 teacher's classroom expense deduction, and domestic production deductions.

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