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Wisdom to build Wealth

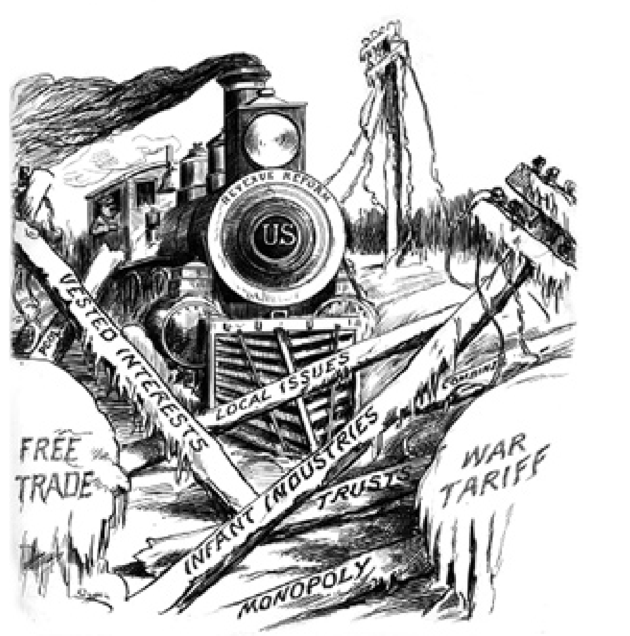
Tax Newsletter 2007

Tax Reform follows the political wind, which shifted dramatically in the November, 2006, elections. The republicans lost their majorities in both houses of the 109th Congress, after 12 years. Bush is now a lame duck, overshadowed by the 2008 elections. The democrats will now have simple majorities in the 110th Congress. Bush must sign any bill, and the democrats' simple majority cannot override his veto. Political **compromise** is in the wind.

Tax Tips

There are quite a few new tax laws this year, which I describe more fully on pages 2-3. Briefly:

• Get **charitable receipts** for **all** contributions, starting 2007.
• Limit your **noncash** charitable contributions to items in at least **good condition**, after August 17, 2006.
• **§529 tuition trusts** are now **permanent**.
• IRS' 2006 forms are **wrong.** They do not include the new rules in the Tax Relief and Health Care Act, such as the sales tax deduction. IRS had already sent its forms to the printer when Congress passed this Act in December, 2006.
• **Contribute** up to **$100,000** to an eligible charitable organization **directly from your IRA**, if you are over 70½ years, in 2006 and 2007. Keep your adjusted gross income low, and avoid Schedule A limitations.
• **Convert** to a **Roth IRA** without the $100,000 income limitation in 2010. Prepare with nondeductible IRA contributions now.
• The **kiddie tax** applies in 2006 to children until they reach 18yrs, up from 14 years. Children pay tax on their investment income at their parents' higher tax rate.



Revenue Reform by George Yost Coffin
c1890, Library of Congress

• Minimal **Energy** tax credits and other incentives can make you feel good about buying a hybrid car, installing insulation, new windows, or a furnace, if you were going to do it anyway. You may have to carry the credit forward, for example if you pay AMT, have other credits, or have no taxable income.
• IRS will **refund** about 3 years' **telephone excise tax** in 2006. The refund is quite small, compared to the work to calculate it. Individuals and small businesses can save the work with a standard amount. Large businesses have no standard, but can make an estimate with April and September, 2006, bills. If you are a client, please ask for my worksheet.
• California **Registered Domestic Partners** (RDPs) should plan to use **married** filing status, but not for IRS, starting for the 2007 tax year. (See page 4)
• The **foreign income exclusion** is limited, effective 2006. You may pay more tax if you use this exclusion, as a US citizen or permanent resident working overseas.

AMT

Congress will finally allow partial **AMT carryover credit refunds.** Many people in silicon valley paid AMT on the built in gain from exercising incentive stock options. The stock sank, sometimes to zero, before they sold. They have carried forward their AMT credits all these years. Now, they can apply 20% of the old carryover credit to their regular tax, every year from 2007 through 2012. But this credit phases out for married joint incomes above $150,000.

Alternative Minimum Tax (AMT) is our second tax system, a **stealth** tax, a **surprise** to most people who pay it. You pay the higher of AMT, or regular tax. AMT preferences include state and local taxes, incentive stock option exercises, depreciation, miscellaneous itemized deductions, dependency exemptions, and much more. I find that my silicon valley clients paid AMT in 2005 on adjusted gross income between about $175,000 and $500,000, depending greatly on the mix of taxable income. The lower limit will fall in 2007, unless Washington raises the AMT exemption, which they have done year by year recently. The democrats, who now control Congress, say they want to limit AMT for one more year.

Washington should **eliminate** AMT. But, elimination is not feasible, unless the regular tax increases to offset the lost revenue. AMT is so pervasive, after almost four decades, that it would cost $1Trillion to eliminate. AMT will raise more revenue than the regular tax in about five years. I predict, as I have for a number of years, that Washington will slowly **merge** these two tax systems.

The big AMT **planning** opportunity is to identify in advance that you will change from paying regular tax to AMT, or vice versa. When you identify this year to year change, then you can arrange to pay expenses in the year you pay regular tax, to get the deduction. Typical expenses are property tax and California income taxes.

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The single greatest thing that Congress can do…is to simplify the tax code. IRS Commissioner Mark Everson

New Tax Acts

Washington passed many new tax rules in three major tax acts, two early in the year while the republicans controlled Congress, and one after the election changes, in the lame duck session.

TIPRA 2005

Washington argued for over six months, and finally, in May, 2006, cut 2005 and 2006 taxes $70Billion with the **Tax Increase Prevention and Reconciliation Act of 2005**. In waiting so long, and enacting so many retroactive changes, they cost IRS and taxpayers $millions.

Bush and the republicans insisted on extending the **15% investment incentives** for two more years, until 2010, and to benefit large financial service and energy companies. The only way to overcome strong democratic objections was to use the liberal, annual, *reconciliation* process, which requires only a simple majority vote. To keep within the $70Billion tax cut limit, Congress did not have room for extensions of many popular tax breaks, such as the state and local tax deduction, 2007 AMT relief, and many business incentives. They finally did enact some of these extenders in December, 2006. See TRHCA, below.

Higher income taxpayers generally benefit from the 15% capital gains and dividend rates, and extending AMT relief for just one year, 2006. Voters who pay little state income tax, mostly in the red states, benefited, by extension of the sales tax deduction, just for 2005.

As usual, politicians promised to **prevent** tax increases in the title of this Act, yet they **increased** some taxes:

• The **kiddie tax** on investment income increases retroactively to 2006. Children pay tax at their parents' higher tax bracket until they reach 18 years of age, up from 14 years.

• The **foreign income exclusion** for US taxpayers working overseas is much more limited, effective 2006. You may pay much more US tax. All US citizens and permanent residents must pay US tax on their foreign income, subject to this exclusion, which they must elect each year on their tax return. ***No other civilized country in the world taxes earned income of citizens abroad***, says Nicholas de Boursac, Executive Director of the American Chamber of Commerce in Singapore.

• The government will **withhold** income taxes when they pay **independent contractors**, who get a Form 1099. Many in Washington want to extend this withholding to all 1099 payments.

• Stockbrokers will report your **tax exempt** income on **Form 1099**. IRS will match this income against your tax return, as it does with other 1099 income, for 2007 reporting in early 2008. Some brokers have reported this information to clients for many years in a section marked *not reported to IRS*. Tax exempt income is sometimes taxable for **AMT**, and indirectly increases other taxes which are based on total income, such as social security and the new medicare surcharge.

PPA 2006

The **Pension Protection Act** (PPA) of August, 2006, is the first overall **pension reform** in 30 years. It reigns in tax exempt organizations, a few of which have committed tax and other types of fraud.

PPA continues to tighten **charitable contribution** rules, due to widespread abuse. Last year, Congress tightened auto contribution rules. The Polly Klaas Foundation notes a 35-40% reduction in auto contributions. This year, PPA requires that you:

• **Substantiate all charitable gifts**. Get a **receipt** from the charity, or be prepared to show IRS a bank record, such as a cancelled check. This receipt rule used to apply only to gifts over $250. Starting 2007, this receipt rule applies to small gifts such as cash to a church collection plate, or a salvation army sidewalk kettle.

• Deduct only **noncash** gifts that are in at least **good condition**, after August 17, 2006. Congress specifically identified overvaluations of ***used socks and undergarments***. Keep detailed records of noncash gifts, since charities give you only a general receipt. You have the option to get an independent appraisal for items, such as collectibles, that are in less than good condition.

PPA expands pension deductions:

• Give up to $100,000 to an eligible charitable organization **directly from your IRA**, if you are over 70½ years, in 2006 and 2007. The contribution counts as part of your **required minimum distribution**. You get the deduction *above the line*, avoiding Schedule A and charitable contribution limitations. Your AGI stays low for indirect taxes, such as on passive losses, social security and the medicare surcharge.

• **Convert** to a **Roth IRA** without the $100,000 income limitation, in 2010. Save tax by converting in a low income year. Roth IRAs save income tax and estate tax.

• **Catchup** contribution limits increase if you are over 50 years of age, to $5,000 (from $4,000) for IRAs, and $20,000 (from $15,000) for 401k plans.

• Transfer an **inherited** IRA or 401K into your own name. This benefit has only been available to spouses. Use your own longer life to calculate required minimum distributions over many more years, starting 2007.

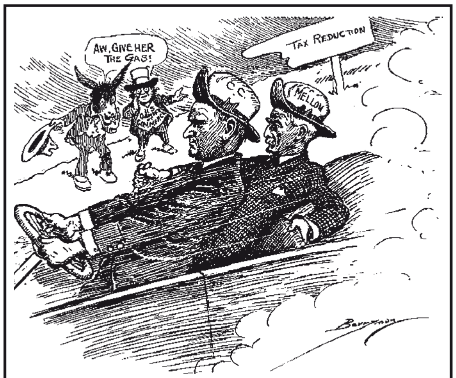
PPA makes **§529 tuition trusts permanent**. These are gold, in the right circumstances. You can change beneficiaries, even to yourself, if you go back to school, even for a part time hobby, like cooking. You can withdraw the money yourself to use for any purpose, if you pay the penalty. You do not pay estate tax on the trust. California's trust has lowered fees and increased the number of low cost index fund investments.

Complexity begats more complexity. This cycle can only be broken by true tax simplification.
National Taxpayer Advocate Nina Olson

TRHCA 2006

The **Tax Relief and Health Care Act** (TRHCA) of December, 2006, was the republican's last hurrah, passed in the lame duck session as the republicans ended their 12 year majority control of both houses of Congress. TRHCA has dozens of big tax breaks. Many of the minor tax breaks are very limited, to Congress' friends and donors.

TRHCA cut taxes by $45Billion, mostly by **extending** a bevy of expired tax breaks for one more year. Most of these tax cuts were retroactive to January, 2006. Washington has a long history of extending tax breaks retroactively, as they did with TIPRA, in May, 2006. The traditional *extenders* include the **sales tax** deduction (second largest component, $6Billion), higher **education** (hope & lifetime learning) credits, **teachers' classroom expense** deductions, and business **research and development** tax credits (the largest component, $16Billion). Newer extenders include energy conservation incentives, corporate deductions for donating computer & scientific equipment, work opportunity and welfare to work credits, 15 year depreciation of leasehold & restaurant improvements, and brownfields remediation costs. The act permanently enhances **health savings accounts**, and subsidizes **energy** producers.



Will the Brakes Hold?
by Clifford Kennedy Berryman
1925, Library of Congress

Taxpayers may be confused, says IRS Commissioner Everson, because IRS' forms and instructions and publications are now **wrong.** IRS had already finalized them for printing, when Congress passed TRHCA. IRS asks that you track down its **new instructions** to get the worksheets and tables you will need, and to make special notes on the old forms. IRS promotes its web site and efiling to make sure you use the new forms and instructions. Everson says: ***Some may delay filing their returns. Some may file incorrect returns due to the confusion, which could lead to an increase in the number of amended returns***.

Hardship, tax compliance problems, and confusion, is what Charles Grassley (R-IA), outgoing chair of the Senate Finance Committee, promises. Max Baucus (D-MT), incoming chair of the Senate Finance Committee, says IRS will need ***at least six weeks to reprogram its systems to reflect the changes. This means delays in starting to process and issue refunds. And it means money. It may cost the IRS millions in additional costs because of our delay. And the cost to taxpayers could be even greater***.

TRHCA increases the **tipster reward** to 30% (maximum) from 10% of IRS' recovery. You may have to be a **whistle blower** with **inside information** to collect a reward. IRS has found most tips to be worth very little, sometimes petty bickering between families and neighbors. IRS has historically paid rewards to only 8% of the tipsters who apply, and then only 3% of its collections. IRS will likely look at your return to see if you were part of the tax problem. You will wait many years for IRS to examine and to collect. You may never learn the result, unless there is a public court proceeding.

Free File

IRS negotiates free tax filing with the for profit tax preparation firms every year. Your income must be below about $52,000 in the 2007 filing season. 93 million, or 70% of all taxpayers, will qualify. I **recommend Free File** for your children and others who do qualify. You must start at www.irs.gov to link to the software firms' web sites.

Free Filing decreased 23% in the 2006 filing season, as IRS allowed the firms to limit their free filing services, and to badger filers to buy pricey services. Nina Olson, Taxpayer Advocate, condemned refund anticipation loans, that bear ***a hefty price for almost immediate access to cash.*** She condemned Free File generally as a ***Wild Wild West of differing eligibility requirements, differing capabilities, differing availability of and fees for add-on products, and many sites that are difficult to use. There is little justification to continue with Free File and every justification for the IRS to develop a tax preparation template and to provide free efiling for all taxpayers, just as it does for paper filers.***

Charles Grassley (R-IA) and Max Baucus (D-MT), ranking members of the Senate Finance Committee, wrote a joint letter to IRS, saying ***The industry appears to be using the Free File program as an opportunity to bolster its revenue through the sale of ancillary products at taxpayer expense. Perhaps it is time to consider having IRS provide a direct filing portal to enable all taxpayers to file electronically without cost.***

This year, IRS negotiated with the firms to give up their hard sell of pricey services, including refund anticipation loans. IRS Commissioner Mark W. Everson says: ***This is a constructive step. We heard many legitimate concerns about the marketing of ancillary products during the last filing season***.

California has tested an even better alternative, **Ready Return**. 96% of users liked it. Ready Return prepares simple returns with information California already has, such as W2 wages. But the software firms are upset. Intuit, maker of TurboTax® gave $1Million to the 2006 republican state controller candidate who opposed Ready Return. He lost. So Ready Return will return. Tom Campbell, republican member of the Franchise Tax Board, and Dean of the Haas School of Business at UC Berkeley, says: ***In all my years as a state senator, a US Congressman and state finance director, I never saw as clear a case of lobbying power putting private interests first over public benefit.***

IRS Outsourcing

I, and other economists, applaud **outsourcing** tasks to the private sector, whenever possible. IRS' outsourcing, however, may not be possible. IRS is terrible at managing any programs, its own or outsourced. Tax administration is highly **confidential**, and historically difficult. Jean-Baptiste Colbert, 17th century French finance minister, observed: ***The art of taxation consists in so plucking the goose as to obtain the largest amount of feathers with the least amount of hissing.***

Bank Fraud

One IRS **outsourcing failure** is the **Mellon Bank fraud.** IRS **criminally indicted** six Mellon Bank employees for shredding 77,000 tax returns in 2001. Mellon paid a **$18.1Million fine** to avoid criminal prosecution itself. IRS had outsourced check cashing to Mellon via a *lockbox*. Banks receive mail at a lockbox, negotiate enclosed checks immediately, and forward accompanying documents, in this case tax returns, for processing. Mellon's staff apparently fell behind, and shredded their work backlog, in order to get their performance bonuses.

Bogus Refunds

IRS paid **$318Million** in **bogus refunds**, according to the Treasury Inspector General. ***It is one of the more significant disappointments of my tenure***, says IRS Commissioner Everson. IRS will not even penalize Computer Sciences Corp in this **outsourcing failure**. IRS hired them to write data mining software to identify bogus refund claims for the 2006 filing season. But the software wasn't ready on time. IRS cannot usually recover these refunds from the low income recipients. IRS delayed some refunds, without notifying people. Computer Sciences is still not finished, so IRS will restart a ten year old software program to try to catch bogus refunds in the 2007 filing season. Everson says the blame ***lies both within the IRS and at the*** contractor, because both ***totally misjudged the complexity and the difficulty of this system.***

Private Collectors

IRS started in late 2006 a test program to **outsource collections** of 50,000 simple, overdue, accounts. Congress will not give IRS the budget to hire more employees. IRS, and its employee union, complain that it pays only 3% of collections to its own employees, versus 25% using private contractors. The Government Accountability Office criticizes this program for failing to create results oriented goals and measures, failing to determine program costs, and failing to establish an evaluation procedure. Nina Olson, Taxpayer Advocate, says this program is ***extremely misguided and harmful,*** and ***vastly more expensive than we ever imagined.***

IRS warns of **scams**, and institutes safeguards. IRS, then the private collector, will write you letters, before calling. The private collector will never take money, but direct you to pay IRS; never ask for a password or PIN; never contact third parties, such as banks, neighbors, or employers. Most people opt out of the private collection process, choosing instead to work with IRS.

California

California imposes a substantial **nonconformity burden** on its citizens. California does not conform to most of the new tax rules in last year's tax acts, TIPRA, PPA, and TRHCA (see pp 2-3). It will take the California legislature many years to conform to many of these Federal rules. California never will conform to some rules, as a matter of public policy.

Registered Domestic Partners (RDPs) should plan to use married filing status for California tax returns, but not IRS returns, starting in 2008, for the 2007 tax year. California now treats RDPs as **married for all purposes**, such as community property, participation in employee benefit plans, inheritance, divorce, health care, privacy disclosure, child support, alimony, etc. But Washington does not recognize RDPs for any purpose.

RDPs can be **same sex** partners, or **opposite sex** partners over 61 years. Two earner RDPs with similar income may pay the **marriage penalty**. Other RDPs may save tax. All RDPs will pay much more to professional preparers to calculate their tax, using two very different sets of rules.

RDP treatment will be **litigated** for years. The California Franchise Tax Board is trying to determine how to handle all the tax issues. They will post updates throughout 2007 on their web site, www.ftb.gov. One attorney wrote to Franchise Tax Board that he found the tax rules so onerous that he and his partner would **deregister** by December 31, 2007.

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