William M West Certified Public Accountant

Wisdom to build Wealth

Tax Newsletter 2008

AMT

The most serious problem facing taxpayers today is the complexity of the Internal Revenue Code, and the poster child for tax-law complexity, is the Alternative Minimum Tax for individuals (AMT). The AMT is a parallel and complex tax structure that is imposed on top of the regular tax structure. While the AMT was originally designed to prevent wealthy taxpayers from escaping tax liability through use of tax-avoidance transactions, it now affects large groups of middle class taxpayers with no tax avoidance motives at all, says Nina Olson, National Taxpayer Advocate.

AMT is the battleground for **tax reform** in the next few years. Politicians universally denounce AMT, and promise relief. Washington has enacted yearly AMT relief, as the politicians have not been able to agree on permanent AMT relief, which costs about $1Trillion over 10 years. Washington still argues bitterly about this year's relief in the middle of December, but I must send this Newsletter to the printer. 23-50 million taxpayers who might pay AMT will be affected, depending on any 2007 relief Washington finally does enact (see p2).

The 2008 elections will reveal whether Democrats win the Presidency and a filibuster proof majority in the Senate, as they hope. In the meantime, Republicans fight to preserve their gains from the last 7 years with Bush in the White House.

Democrats hope that pay-as-you-go (PayGo) will win votes. ***Democrats are committed to ending years of irresponsible budget policies that have produced historic deficits. Instead of piling trillions of dollars of debt onto our children and grandchildren, we will restore pay-as-you-go budget discipline***, said Nancy Pelosi (D-CA), Speaker of the House.

It's a ***train wreck***, says Charles Rangel (D NY), Chair of the House Ways & Means Committee, as AMT expands without inflation adjustment. Rangel has waffled this year on PayGo. On February 15, Rangel said ***AMT is a phony revenue source, and should not be offset since the AMT collects revenues it was never meant to collect in the first place.*** But in November, Rangel introduced a bill to eliminate AMT permanently, with offsetting tax increases. He said this ***mother of all tax reform bills is not a tax increase***.

It is ***the mother of all tax hikes, the largest individual income tax increase in history***, responds Jim McCreary (R LA), ranking Republican on the House Ways & Means Committee. McCreary introduced a bill to eliminate AMT and to continue the 15% dividend and capital gains rates permanently, with no income tax offsets.

Republicans hope to win votes by ignoring PayGo, as they have for the last 7 Bush years. ***AMT is crazy; it was never meant to apply to middle-class taxpayers***, says McCreary. ***Why are we trying to collect it? This is the closing of a tax loophole, and you should be proud to participate in that.***

"Don't Spend Money… I don't have, eh! Always, a simple solution to a complex problem."

Tax Tips

The preferential **15%** rate on long term **capital gains** and qualified **dividends** expires on Dec 31, 2010. Plan to sell assets by then, if you were going to sell soon anyway, to capture the lower rate. If you pay AMT, you lose this preferential 15% rate. Very low income taxpayers pay 5% or even 0%, from 2008 through 2010.

You must have **written documentation for charitable contributions**, starting 2007. That usually means either a receipt from the charity, or a cancelled bank check. For large or unusual contributions, I suggest both.

More children are subject to the **kiddie tax**. In 2008, your dependents pay tax on investment income at your higher rate until they are 23 years, up from 17 years in 2007, and 13 years in 2006. There is a new exception in 2008 for your dependents who provide over **one half** of their own support.

Gift **appreciated stock** to charity. You get the full deduction at current value, subject to some limitations. The charity pays no tax on the gain, when it sells. Wealthy families who can escape the kiddie tax may also gift appreciated stock to lower income family members, who pay capital gains tax at their lower rates.

Mortgage insurance is deductible as home interest in 2007, but not in 2008. Mortgage companies typically require insurance if you borrow more than 80% on your home, or if your loan is **sub-prime** for some other reason.

Home foreclosures trigger **taxable income** for your cancelled debt. IRS requires lenders to send you a 1099C showing the income. Beware that many of these 1099Cs are **wrong**. There are some exceptions that allow you to avoid paying tax on the income, such as if you are already insolvent or bankrupt.

California **Registered Domestic Partners (RDPs)** have much more complicated returns, now that California requires them to file **married**. IRS requires **single** filing, as the Feds do not recognize same sex marriage for any purpose. (see p4)

AMT & 2007 Relief

Washington guarantees a **filing fiasco** for the 23 million taxpayers who may file incorrect tax returns, and not get their refunds timely. Politicians continue to promise that they will enact 2007 AMT relief, but they are **gridlocked**, as of mid December. February may be the earliest that IRS can process any return that may involve AMT, since IRS needs 7 weeks to change its computer systems. Some tax wags suggest extending the normal April 15 due date.

AMT is a significant problem for working families. It is a parallel and stealth tax system estimated to hit 23 million taxpayers this year. The impact on middle-income taxpayers defies logic. A family of four earning just $66,000 could be hit by the AMT this year if we do not act, says Richard Neal (D-MA), Chair of the House Select Revenue Measures Subcommittee of the Ways and Means Committee. ***By 2013, it will cost more to repeal AMT than the regular income tax. By the end of the decade, virtually all families earning between $75,000 and $100,000 with two children will be paying higher taxes due to the AMT. It is a family unfriendly tax designed to punish larger families and married couples***.

The IRS Oversight Board, Congress' watchdog, says it ***is gravely concerned about the serious risks to the 2008 filing season if legislation to change the AMT is delayed. A delay threatens the IRS's ability to process returns and issue refunds in a timely manner and imposes significant burden on taxpayers.***

A ***filing fiasco*** [is] ***fast approaching, thanks to Congress' failure to act.*** [The Board's] ***letter should be a splash of cold water for Congressional leaders that fixing the AMT should be the first item on*** [Congress'] ***agenda. The message is clear. Delay at taxpayers' peril***, says Charles E. Grassley (R-IA), ranking Republican on the Senate Finance Committee. ***AMT as a policy has completely failed to accomplish its original intentions, and actions taken so far have not been adequate in dealing with the problem in a meaningful way.***

The Tax Gap

The federal tax gap is one of the most serious problems facing taxpayers today, says National Taxpayer Advocate Nina Olson. IRS estimates that it fails to collect $300-400Billion per year. This includes only the **known** tax collection shortfalls, and, even then, is probably very conservative. The income tax system raises only about $1Trillion per year. I suspect that the **unknown** tax collection shortfalls may be another $1Trillion per year.

Instead of reducing income tax complexity, Washington concentrates on the major tax frauds and steps up **compliance** and **enforcement.** The kindler and gentler IRS of the 1990s is history. Congress has substantially increased IRS' budget. **Audits** are up. **Penalties** are up. IRS spends more time finding **underreported income**, such as in **offshore bank accounts** and **pass through entities.**

Some **small businesses** grossly underreport their income, sometimes working largely, even exclusively, in the **underground economy**. These fraudsters are hard to catch, as they use cash, and barter for services. They undercut law-abiding competitors who voluntarily pay their payroll and income taxes.

Big business tax avoidance is fostered by an army of promoters, appraisers, accountants, tax consultants, and attorneys, too many of whom IRS has accused of tax fraud. In 2007 Jenkins & Gilchrist, a large Dallas law firm, closed its doors and paid $76Million penalties to avoid prosecution for marketing abusive tax shelters.

In 2005, **KPMG**, the big accounting firm, admitted to the **largest criminal fraud** in history, paying $456Million in penalties, to avoid closing its doors, as Arthur Anderson just a few years ago. The Justice Department had threatened to indict KPMG for designing, marketing, and implementing fraudulent tax shelters. KPMG may yet be largely exonerated by the courts, as was Arthur Anderson.

A few **tax preparers**, mostly but not exclusively franchises, have been caught conspiring with their clients to falsify tax returns, and even defrauding their own clients. In 2007, Jackson Hewitt closed offices that were found to have committed tax fraud. Separately, Jackson Hewitt paid $1Million penalties plus $4Million restitution for deceptive marketing involving refund anticipation loans. H&R Block has paid many times to settle class action lawsuits regarding their refund anticipation loans and other business practices, including $40Million in 2006 for a case that started in 1998.

Charities and other tax exempt organizations owe about $1Billion, says the Government Accountability Office (GAO). The majority is payroll taxes, interest, and penalties. GAO identified some of the charities' activities as abusive, and potentially **criminal**, including self dealing by directors, and money laundering.

IRS is trying to collect $250Million from **government** units, according to the Treasury Inspector General for Tax Administration (TIGTA). 8,000 government units, out of 80,000, or 10%, owe payroll tax.

There is a big part of the tax gap we simply won't be able to reach without adding draconian and painful requirements on all taxpayers, says Treasury Secretary Henry Paulson.

Compliance

It is easy and cheap for IRS to send computer generated audit letters when their computer finds mismatches with your tax return. These letters are the most common type of IRS audit, and are also usually, at least partly, **wrong**.

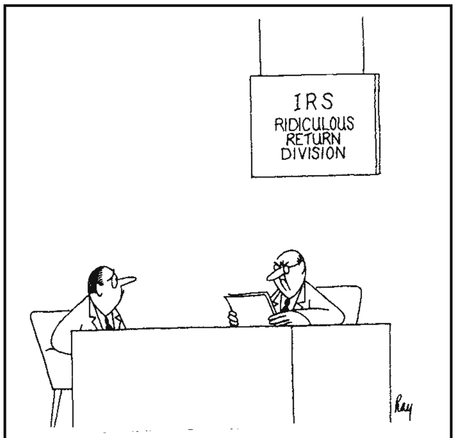
W2 matching has been around for generations. Congress is making more and more transactions reportable on Form **1099**. Many years ago IRS Congress required 1099 reporting of cancelled debt, which is now common in the **subprime home lending bust.** It is difficult to calculate cancelled debt correctly, and many, if not most, of these 1099s are wrong.

1099s increasingly report **investment** income, because too many investors fail to pay their tax. Congress required stock brokers to report **municipal bond** income for 2006. This so called tax exempt income is taxable for AMT, and in some other situations.

Congress is highly likely to require stock brokers to report the **basis** of securities you sell. They have long discussed requiring reporting of business deposits and transactions by banks and credit card processors. More recently, discussion has turned to **internet** transactions, such as eBay auctions and Paypal payments, and sales of game currency, especially when purchasers pay real dollars.

K1s report distributions from pass through entities, which fraudsters increasingly use to hide income. IRS recently made major changes to the K1 reporting system, to make computer matching easier.

Please ask if you want me to prepare and to efile 1099s for your business. 1099s are due January 31, for payments you make to nonemployee service providers over $600 in the calendar year.



IRS Ridiculous Returns Division

Corporations are exempt from getting 1099s. Attorneys always get 1099s. Use Form W9 to request the information from the service providers. Most of my small business clients buy 1099 forms at a stationery store. You can also use online services, and buy software, both of which also efile with the government.

Enforcement

The art of taxation consists in so plucking the goose as to obtain the largest amount of feathers with the least amount of hissing, observed Jean-Baptiste Colbert, 17th century French finance minister. IRS favors correspondence audits, which are cheap, easy, and often wrong. IRS uses many other methods to pluck the goose.

In person **audits** have increased substantially, as Congress has increased IRS' budget. IRS concentrates more on income underreporting now, and less on merely matching expense deductions against receipts.

Research audits are back. IRS says they will be a little easier because IRS will investigate you thoroughly before contacting you. Wags have compared the extremely detailed research audit to a proctoscopy without anesthesia, and to an autopsy without the benefit of dying. I have suggested for many years that IRS merely give you a **free pass** as to any interest and penalties, and maybe even underpaid tax, in return for cooperating with IRS' research.

Private debt collectors are so costly, invasive, and insecure, that Congress should **repeal** this program, says Nina Olson, National Taxpayer Advocate. These private firms collected $24Million in their first year, and will collect $2.2Billion during the next decade. Their commissions of about 25% are much more costly than using IRS' own employees, and give them the wrong incentives that may lead to disclosing taxpayers' private information. IRS is terrible at managing programs, especially with outside contractors.

CPAs, attorneys, and Enrolled Agents, are the traditional **paid tax preparers**, subject to IRS' stringent regulations. Congress now extends these regulations to employers such as H&R Block, and to any appraiser, promoter, or tax consultant, who works on your tax return. Congress will probably soon include all the other small tax preparers. California is one of only a few states to regulate them, requiring a bond and continuing education.

Congress created a **conflict** between paid tax preparers and their clients. The House-Senate Conference Committee surprised the entire tax community, including IRS, by increasing paid preparer penalties, and by increasing the standard which paid tax preparers must use to avoid penalties. The standard is now higher than what taxpayers must use on their own returns. As an individual preparing your own return, you must have a **realistic possibility of success**, about **33%**. But paid preparers must now be **more likely than not** correct.

It's a ***total mess***, said Cono Namorato, former director of the IRS' Office of Professional Responsibility. IRS is struggling to issue guidance to paid tax preparers regarding their higher standard and their conflict with their clients.

IRS Security & Privacy

One day IRS will get a lot of negative publicity for disclosing a lot of **taxpayers' private information**. It maybe a stolen laptop, a missing CD, or a compromised network computer, all of which are prominent in today's news. Some people will use these security problems as one more excuse to stop **voluntarily** filing their taxes.

The Treasury Inspector General for Tax Administration (TIGTA) has admonished IRS for taking ***relatively few disciplinary actions*** for **computer misuse**. IRS employees risk computer viruses, which could infect the entire IRS network. They surf **sex** oriented web sites. They abuse email. IRS' own security employees do not always follow security procedures, such as removing unneeded software services, changing default passwords, and installing software security updates. IRS employees encrypt sensitive data on only about half of their computers. IRS routinely allows many employees access to sensitive information, which they do not need to do their jobs. TIGTA found that IRS lost 490 computers with sensitive data on 2,359 individuals over about 3 years.

By not encrypting personally identifiable information on laptops and other electronic devices, the IRS is needlessly exposing the data to unauthorized access, theft, or loss, says TIGTA. ***Some IRS executives are not holding managers and employees accountable for carrying out their responsibilities and are not ensuring managers and employees are aware of the security risks associated with their positions***.

Phishing is a social engineering scam that uses an important sounding but phony email, like from IRS, to direct you to a fake web site. There, the fraudsters prompt you to reveal personal information, such as your account password. IRS failed TIGTA's social engineering test last year. 61% of IRS employees revealed their passwords when TIGTA investigators asked. Only 8% reported the phony TIGTA investigators to IRS management. ***This is especially disturbing***, says TIGTA.

Avoid phishing scams by going to web sites on your own, usually via your own bookmark. Never follow an email link to an important website, such as your bank. ***IRS does not send out unsolicited e-mails asking for personal information,*** says ex IRS Commissioner Mark Everson.

IRS **intentionally discloses** your confidential tax information in many cases. The biggest, and probably most secretive, is to **Homeland Security**. In the wake of 9/11, IRS and the Social Security Administration made 12,236 emergency disclosures. The Treasury Department started project **Reveal**, which combined data from at least 16 government databases, plus public credit aggregators such as ChoicePoint and LexisNexis.

The starting point of this kind of thing is going to be for terrorism and we all are going to be in favor of fighting terrorists, said Kim Harper of the libertarian Cato Institute. ***The finishing point of this is going to be for catching deadbeat dads and enforcing student loans and unpaid parking tickets.*** California, which has numerous, extensive, information sharing agreements with IRS, already withholds refunds from deadbeat dads.

The Government Accountability Office (GAO), Congress' investigation arm, last year gave IRS its eighth **unqualified** audit opinion. GAO criticizes IRS for its ***serious internal control and financial management systems deficiencies. IRS continues to lack accurate, useful, and timely financial information and sound controls with which to make informed decisions day-to-day to ensure ongoing accountability.***

California

Registered Domestic Partners (RDPs) are married for all purposes in California. But the Feds do not recognize same sex marriage for any purpose. So RDPs have to file **three income tax** returns: one California **married** joint return, based on an unfiled IRS return, and two **single** Federal returns.

California initiates its own **audit** programs when it can collect taxes that IRS is too busy to find. California has sent questionnaires for many years to people who use head of household filing status. California's letter audits collect so much tax, that they have just announced letter audits for alimony deductions, which they find to be wrong on 40% of all returns, and auto use, 80% wrong.

California tries to collect more **use tax** by extending the statute of limitations to 8 years. You owe use tax on tangible property you use in California, if the seller did not have to collect it. Internet purchases are increasingly common, and internet sellers are often not subject to California sales tax. Pay the use tax on your individual income tax return.

The Franchise Tax Board's **Hall of Shame** publicizes the top 250 delinquent income taxpayers. The Board of Equalization publicizes a similar list of delinquent sales and use taxpayers. Search on either web site for *delinquent taxpayers*.

California **conformity** continues to be **shameful**. Most individual taxpayers ignore the differences, unless their software forces them to report the difference. Paid preparers charge more to try do it right. Sacramento still conforms only to the internal revenue code as of Jan 1, 2005, three years ago! California will never conform to many IRS provisions, which are just too expensive, or against California policy, like depreciation, net operating losses, and the limited 15% investment rates. But California does not even conform to problems that are common sense, like health savings accounts, and those that would raise tax collections, like the stricter kiddie tax (see p1).

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