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Wisdom to build Wealth

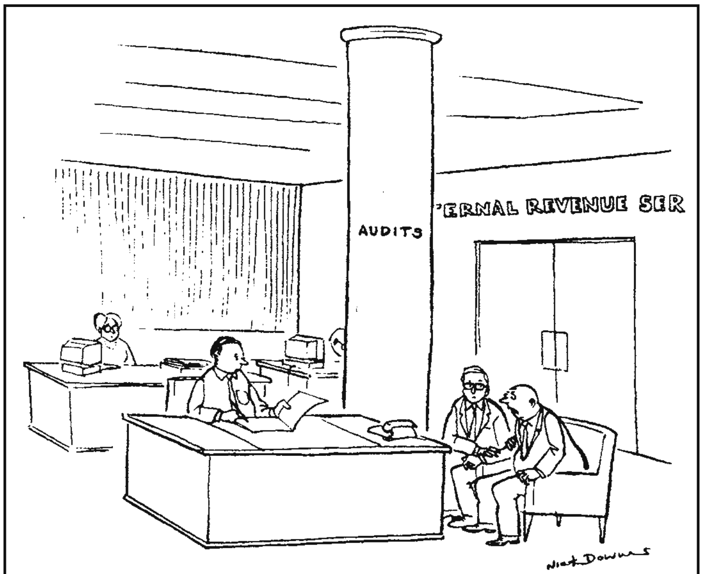
Tax Newsletter 2009

Tax planning is much more important than in generations. Between the **financial meltdown** and President **Obama's first 100 days**, there are dozens of major new tax laws, and hundreds to thousands of lesser changes, depending how you measure. Many of the new laws are tax breaks, loaded into 2008 and 2009, to bolster the economy.

The Democrats will control Washington tax policy for at least 2 years. President Obama won the November election by a **majority** of the popular vote. They control the Presidency and both houses of Congress, for the first time since 1994. They significantly strengthened their control of both houses of Congress, for the second election in a row. The Senate Republicans just barely having the required 40% margin to stall bills by the parliamentary action called a **filibuster**.

Fixing the **financial meltdown** is everyone's priority. Washington has already (as of this writing, in early December) authorized $1.5Trillion: $700Billion by Congress in October, and $800Billion by the Federal Reserve in November. Obama has announced more to come in his first 100 days.

Who gets this huge government **dole**? Washington originally talked of buying distressed assets such as mortgages from the failing finance industry. In November, Treasury Secretary Paulson upset Congress, saying that the financial industry was stabilized, and he would find other places to spend the money. Washington now talks of buying shares of investment banks, hedge funds, lenders, insurance companies, and companies which are **too big to fail**. So most big companies and industries, plus states and municipalities, argue that they are too big to fail. Bush and most Republicans should be mortified, to enact such **nationalization** on their watch.



"Are you saying that bribes and kickbacks I receive are taxable, yet the bribes and kickbacks I pay out are non-deductable?"

Reregulating the financial industry is a major argument waiting to happen. Sitting politicians were a big part of the regulatory problem. We will see how they change their tunes as they become part of the solution. They are just beginning to struggle with the **fraud**, the liars loans, which created many of the troubled financial assets. The fraudsters are apparently too many, too respectable, and too big, to put in jail.

The Emergency Economic Stabilization Act of October, 2008, was the biggest single set of tax changes in many decades. In addition to the $700Billion financial industry bail out, it included 300 separate tax changes, totaling another $150Billion. This one Act contributes half of 2008's $2Trillion deficit. Republicans should be mortified, that the overall federal deficit has **doubled** on Bush's watch, including war spending, to about $10Trillion.

Tax Tips

There were so many tax changes in 2008 that this Newsletter can only hit the highlights. See p 2 for more tips related to Alternative Minimum Tax (AMT), homeowners, and tips for low asset prices in these troubled times.

You may still qualify for more of the **economic stimulus rebate**. The 2008 Rebates were based on 2007's tax. You get a second chance to qualify in 2009, based on 2008's tax. Qualifications that might change include your income falling under the limit, filing status, or claiming another dependent.

Kiddie tax now applies to your children until they become **24** (from 18) years of age, or stop qualifying to be your dependents, perhaps by finishing school. They pay tax at your higher rate, until they age out of this tax. It is now much harder to fund your children's education, by giving them stocks to sell to pay for school.

Sell **capital gain** assets. If you have a net capital gain, which is difficult in this economy, you pay maximum **15%** tax (plus AMT, for those who pay AMT). This rate is the lowest in generations, and will expire on Dec 31, 2010. The Democrats are unlikely to extend this investment tax benefit, which they have defiled. They may even raise the rate sooner. Use the opportunity to rebalance your portfolio. Or buy back the same security immediately, as there is no *wash gain* limitation, as with losses.

Washington has allowed the usual **extenders** for one more year, including the itemized deduction for state & local sales tax, higher education tuition deduction, teachers' classroom expenses, and direct IRA charitable contributions. **Business** extenders include the research credit, and faster leasehold and restaurant improvement depreciation. **Energy** extenders include deductions and faster depreciation for home and commercial energy efficient property improvements; and clean energy production by wind, biomass, solar, and microturbine.

The San Jose, San Francisco, Oakland metropolitan statistical area has the **highest** median household income in the United States. (US Census Bureau)

AMT

Washington has completely changed its stance toward **Alternative Minimum Tax** (AMT) income from **incentive stock options** (ISOs). This AMT income is generated by the exercise, but not sale, of ISOs in the same year. The problem, especially in the bust, was that many of the shares became worthless, so owners could not sell them to pay the tax. Now, Washington offers **quicker refunds** of the AMT carryforwards for those who paid the tax. Washington **forgives** the tax, penalty, and interest for those who still owe it. IRS may even refund part of the interest and penalty that you have already paid.

Congress passed the usual annual AMT exemption increase timely, unlike last year. The Democratic Congress followed the Republican lead of the last few years, and raised the Federal deficit, instead of raising other taxes to offset the AMT tax loss. ***Forget the loopholes, forget the revenue losses, forget the indebtedness – at least for now***, says House Ways and Means Chair Rangel, D-NY. Congress allowed some more personal tax credits to qualify for AMT deduction, as these credits always have always been deductible under regular tax rules.

Complete elimination will be the biggest AMT change to come. It has been hard to eliminate AMT because it raises so much revenue. AMT falls mostly on high income taxpayers, whom the Democrats want to tax more heavily. But AMT is too big a surprise for most. If they eliminate AMT, they may incorporate the same tax increases into the regular tax. They may justify any revenue shortfall as acceptable stimulation of the economy in these troubled times.

Homeowners

Homeowners benefit from a slew of new laws enacted due to the housing finance meltdown, most very narrowly tailored.

First time homebuyers get an **interest free loan** in the form of a very unusual, repayable, tax credit. IRS refunds $7,500, even if you owe no tax. You must purchase your home between April 9, 2008, and July 1, 2009. Your AGI must be less than $150,000 ($75,000 single), so few of my silicon valley clients qualify. You must repay the loan/credit by $500 per year for 15 years, or until you sell the house at a profit. Form 5405 will track this repayment, if taxpayers cooperate over 15 years through life changes such as conversion to rental use, marriage, and divorce.

Home foreclosure income is generally taxable, just as in a sale. The normal exception is for capital gains over $250,000 per person, if you lived in the house 2 of the immediately prior 5 years. As in a sale, you have phantom income to the extent you spent refinance proceeds on something other than your home. Now, Washington forgives the tax on the first $2M ($1M single) foreclosure income from home acquisition debt, through 2012. CA's homeowner mortgage forgiveness law is less favorable than IRS'.

Washington closed a **loophole** that allowed owners of multiple rentals to move in, use the former rental as a home for 2 years, and **exclude** their **entire gain** on sale. Now, to get the full $250,000 per person capital gain exclusion, they must live in the former rental as a main home for **5 years**.

Nonitemizers can deduct property tax, only for 2008.

Tips for Troubled Times

You may save significant tax, with the economic cycle at its lowest in many years, and asset prices very low.

Convert an IRA to a Roth IRA, if you are in a low tax bracket this year because of the economy. In 2009 your income must be less than $100,000. In 2010, that limitation goes away. If you need the cash, and are over 59½, you can distribute the IRA, and most other tax deferred accounts, without penalty.

Recharacterize a Roth IRA conversion from earlier this year. Escape the higher taxable income, if the value has declined. **Reconvert** next year, with less taxable income.

Deduct the loss when you close an **entire tax deferred** account, such as an annuity, 401k, IRA, or 529. With stock prices lower than in many years, many people have tax losses. That is, your sale price must exceed your tax basis.

Wealthy families who would pay **estate tax** might **give or sell** assets to the next generation. You benefit if these beaten down assets substantially increase in value during your lifetime, and would have been included in your taxable estate. You might do so in conjunction with many types of trusts and other estate planning entities, which can save big estate tax. Such estate planning gets complex very quickly.

Do you have problems **paying** your tax? IRS is emphasizing expanded programs due to the economy, including (partial) installment agreements and offers in compromise. Make sure to file your returns on time, to avoid those penalties.

IRS

National Taxpayer Advocate Nina Olson points out that IRS's budget ***emphasizes enforcement at the expense of taxpayer services***. She says that there is **no reliable data that shows more enforcement increases taxpayer compliance.**

IRS does **not protect your information**, says Congress' Government Accountability Office (GAO). IRS has not resolved 147 of GAO's outstanding recommendations, over half of which relate to material weaknesses in information security. GAO fears the situation will deteriorate as IRS increasingly relies on **computer**, not paper, records. GAO says that IRS' records are so bad that it cannot ***determine whether IRS's financial statements are fairly stated***.

IRS has **failed to collect** over $58Billion in unpaid federal payroll taxes from 1.6 million businesses. IRS allows businesses far too long, before taking

San Jose residents pay the **highest** total taxes (Federal, California, local) of any big US metropolitan area. (KPMG)

enforcement action, such as filing liens. IRS is particularly lax in allowing federal contractors to abuse the tax system. GAO says ***although IRS has powerful tools at its disposal to prevent the further accumulation of unpaid payroll taxes and to collect the taxes that are owed, IRS's current approach does not provide for their full, effective use***.

Private collectors have cost taxpayers **$81Million** a year, says National Taxpayer Advocate Nina Olson. IRS pays private collectors up to 25% commission to collect IRS' simplest cases. IRS employees are more efficient, and, some say, more knowledgeable and respectful of the proper collection procedures to safeguard taxpayer rights. Washington could easily cure the problem, but it is **politically incorrect** to give IRS the budget to hire more employees. Olson says ***I believe it is time to end the program***.

Washington has mandated vastly increased **1099 income reporting**, starting 2011. IRS has found that such reporting substantially increases proper reporting of income. Merchant credit card companies will report deposits to your account. Stock brokers will report your basis and gains/losses when you sell. Stock brokers will have to improve their back office systems, as their gain/loss calculations (which aren't currently reported to IRS) are sometimes wrong.

"Don't deposit it till Thursday."

Beware to keep **good records** to show your **basis** to calculate **capital gains**. Pay tax on the entire sale price, if you cannot show actual basis. I have never seen that strict rule fully enforced. But that is the rule.

Corporate taxation is extremely complex and hopelessly **politicized**. GAO reports that most small corporations pay no income tax, since they pay all their profits as salaries to the owners. Only about 77% of large corporations pay tax in any given year. 72% pay no tax in some years. 24% get permanent tax subsidies, and have paid no tax in at least four of the last eight years.

Many economists believe (as I do) that corporations should pay no tax. Individuals who own corporations should pay, at possibly higher rates. Instead, political fiddling with corporate tax rates adds more complexity, and plenty of contributions to the politicians.

Don't be fooled by fraudsters who **impersonate IRS** to get your personal information, so they can steal your identity to steal your money. IRS, and most government, very rarely uses email, and never **initiates** contact with you by **email**.

Tax Fraud

The biggest single cause of the financial meltdown was fraud. The entire financial industry appears to have **conspired** with liars loans and other deceptions to create phony assets to sell to greedy and gullible investors. As to more normal tax frauds….

Congress changed the law in 2005 to combat fraud in **automobile charitable contributions**. Sure enough, contributions declined by **67%-80%**, depending on how you measure. Congress limited the typical tax deduction to the charity's sale price (wholesale, not retail), with a maximum of $5,000. Some now say that Congress should not have been so strict, and should help charities by relaxing the rules.

Fraudsters got **$1.6 billion** income tax **refunds** in 2006 and 2007, according to the Treasury Inspector General for Tax Administration (TIGTA). IRS refuses to implement about half of TIGTA's recommendations to combat such fraud.

As the use of direct deposit grows, the risk of potential large-scale fraud will increase, says TIGTA. IRS says that it identified 1,800 errant direct deposits in 2006, which is a very small number, compared to 61 million direct deposits. But IRS refuses to follow TIGTA's recommendations to set a reasonable limit on the number of direct deposits it sends to the same account, allowing one fraudster to get many refunds. IRS also refuses to take responsibility for sending direct deposits to the wrong account.

IRS convicts very few people of tax crimes. TIGTA says that for 2007, ***the number of taxpayers convicted of a crime was 2,155, which exceeded the FY 2007 performance plan goal of 2,069 and was an increase of 6.7 percent from FY 2006***.

Washington will not appropriate the funds to hire more criminal investigators. ***We have a lot of people at the IRS who could leave and make double or triple their salary***, says IRS Commissioner Douglas Schulman.

Tax related identity theft is one of the most serious problems facing taxpayers, says the National Taxpayer Advocate. IRS took one small step last year with an **identity theft hotline**, 800-908-4490 or irs.gov. If you notify IRS, they will check their computer records to try to stop your problem from getting worse.

IRS pays up to **30% reward** if you turn **whistleblower**. Your target will be someone you know well, like your employer, neighbor, competitor, or mother-in-law. IRS insists on a **smoking gun** to pay the maximum percentage, like documents, photos, or voice recordings. Most whistleblowers wait a long time for IRS to prosecute the case, get no confidential information along the way, and eventually get no reward.

Offshore Fraud

Secretive offshore tax havens have helped the wealthy avoid taxes for centuries. IRS loses $100Billion per year, says Senator Carl Levin (D-MI), Chair of the Homeland Security and Government Affairs Subcommittee on Investigations. Another tax wag estimates IRS loses $255Billion per year.

UBS, a **Swiss** bank, admits its fraud, as IRS investigates 17,000 US taxpayers with suspected Swiss secret accounts. Bradley C Birkenfeld, a former senior UBS private banker and American citizen, has plead guilty to conspiring to help conceal assets. IRS has indicted Raoul Weil, UBS senior manager, of orchestrating the UBS fraud. UBS has stopped doing offshore business with US residents, and will report the names of its US clients to IRS.

LGT, a **Liechtenstein** bank, signed an agreement in December to share information with IRS. An LGT employee/whistleblower had sold a CD containing data on more than 1,000 wealthy individuals' secret accounts for $6.2Million to German tax authorities. IRS has widened its criminal investigation to Credit Suisse and HSBC. **Monaco** and **Andorra**, two nearby tax havens, still apparently keep their records secret.

Religion

IRS has **never revoked** a church's tax-exempt status, apparently for fear of political backlash. Yet the law strictly prohibits any tax exempt organization, including churches and other religious organizations, from advocating any specific candidate or position in an election. A number of churches tested the law by civil disobedience on Sunday, Sep 28, 2008, so called **Pulpit Freedom Sunday**. IRS has not yet responded publicly.

IRS often ignores or downgrades Churches' tax evasion, such as on payroll taxes, and income taxes on business income not required to perform their religious functions. Washington should provide an intermediate penalty, short of revoking a Church's tax-exempt status.

Instead of not taxing religions, which requires **defining religion**, I suggest that churches should pay taxes, just like the rest of us. Gifts are never taxable income, so that is not a problem. Churches should pay taxes on all their sale income and bingo games. Just like the rest of us.

California

Every year I complain that California hopelessly complicates your tax return with rules that do not conform to IRS' rules. I charge you more to follow these separate rules. Even before the current severe budget problems, California just gets worse.

Republicans in the California legislature will not hear of any tax increase. But they will try every accounting trick in the book to raise some taxes and penalties to balance the budget. They hope you will not notice, or care.

Limited Liability Companies (LLCs) must now pay their 2009 $800 annual tax by April 15, 2009, and their full 2009 LLC annual gross receipts fee by June 15, 2009. California has lost a number of court actions, so it recently changed its rules to tax multistate LLCs only on their California income.

You must buy and keep property out of California for 12 months, to escape **sales tax**. This was a big tax savings for expensive cars, boats, and airplanes, when the time limit was 90 days.

Pay estimates faster starting in 2009. Pay the first two estimates (due 4/15 & 6/15) at **30%** of last year's tax, and the last two (due 9/15 and 1/15) at **20%**. Gone are the days when you simply pay 25% four times per year. This law also affects wage earners, who pay as they go through withholding. Although, California will probably give them a pass in 2009, as they have already distributed 2009 withholding tables.

Pay estimates based on your actual income, not the **safe harbor** based on 110% of last year's tax. Individuals earning less than $1Million ($500,000 single) are exempt in 2009.

Pay all your taxes **electronically**, once you pass a threshold. Pay a 1% penalty, if you do not use some electronic method, such as Electronic Funds Withdrawal (EFW), WebPay, or credit card. 2009's thresholds are that you owe more than $80,000 total tax in one year, or make a single payment over $20,000. IRS is moving to require electronic payment, too. It costs them alot less, when you ePay.

California withholds **business** credits and Net Operating Losses (NOLs) for the next two tax years, beginning in 2008 and 2009, except for small businesses with less than $500K net income. Business credits are limited to 50% of tax liability. However, for taxable years beginning on or after January 1, 2008, NOLs may be carried forward for 20 years; NOLs may be carried back for two years for losses generated in taxable years beginning on or after January 1, 2011.

Corporations now pay 20% **underestimate penalty**. Most corporations will be below 2009's $1 million income threshold.

California will likely lower these thresholds, so that more and more people will have to pay tax electronically, pay sooner, and pay greater penalties. If you notice, and care, complain to your legislator.

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