William M West Certified Public Accountant

Wisdom to build Wealth

Tax Newsletter 2010

Change comes hard in Washington, despite President Barak Obama's campaign promises. The Democrats control both houses of Congress, including the 60 Senate votes to defeat a Republican filibuster. But the Republicans all vote together, and the Democrats do not.

Tax increases on high income taxpayers are inevitable. President Obama promised many times. Pundits predict that the Democrats will allow Bush's substantial ten year tax cuts to expire at December 31, 2010, including raising the maximum bracket to **39.6%** from 35%, and the maximum capital gains rates to **20%** from 15%. Health reform will likely include tax increases to offset its costs.

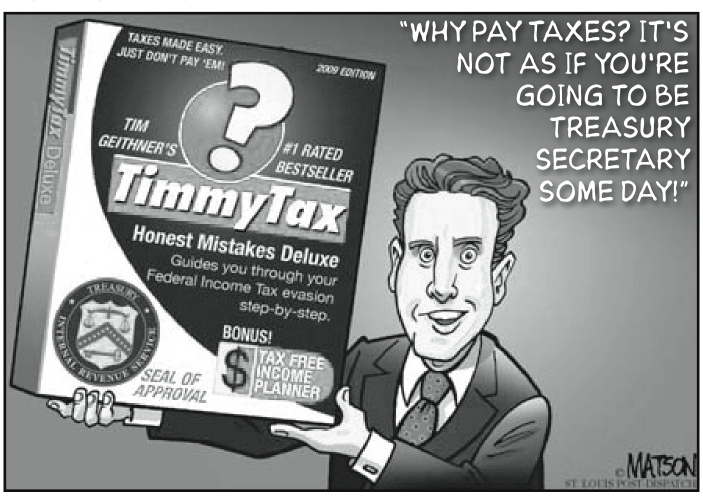
Tax cuts are common this year for low income taxpayers to stimulate the economy. Yet the National deficit is already huge. The recession is over, says Washington. Much of the economic stimulus funds already allocated remain to be spent.

President Obama promised on April 15 to rewrite and simplify ***a monstrous tax code***. He acknowledged that it will take time to end the damage caused by ***years of carve-outs and loopholes***. He promised a comprehensive tax proposal by December 31, which is nowhere in sight.

California's dysfunctional government and resulting systemic budget crisis almost ensure further tax increases. California's 2009 tax rates have already increased by .25%. The maximum tax bracket is 9.55%, plus the existing 1% health surtax for taxable income over $1Million.

Change makes planning more important than usual this year. Confirm the current law before you take action. Washington argues over **health** reform (as of this writing, mid December), which will likely add to the monstrous tax code. It will increase income tax rates to pay for, and penalties to police, the new health regime.

Washington is still working on major legislation that will affect 2009 income taxes, including another $1Trillion jobs relief, plus the normal bills to extend a raft of tax benefits one more year, and to correct technical problems. Washington is in a big hurry to fix the **Estate tax**, to give certainty to families of people who die beginning January 1, 2010.



Tax Tips

Sell long term **capital gain** property, to lock in the **15%/5%** rates, which expire on December 31, 2010. But do not wait until the last minute, as many others will be selling, driving prices temporarily down.

Accelerate income, to lock in the **35%** highest tax bracket, which expires on December 31, 2010.

Convert an IRA to a **Roth IRA.** The $100,000 modified AGI limit expired 12/31/09. Spread the income over 3 years. Recharacterize back to your regular IRA by October 15, 2011, if your planning goes awry. Pay tax from outside the IRA, so you convert the full IRA. Beware that you now pay tax at your current rate, which may be high. Make sure you can reasonably predict that the tax savings from earnings within the Roth IRA over the years will exceed the conversion tax you pay now.

Buy a home for refundable **tax credits.** Three separate sets of rules for different purchase dates, including anti abuse limitations, make the rules very complicated. The credit now expires June 30, 2010, so long as you have a binding agreement by April 30, 2010. Claim a 2010 purchase on your 2009 tax return. **First time** homebuyers get up to $8,000 for buying a home up to $800,000, including escrow fees. **Long time** homeowners get up to $6,500, if they have lived in their current home five consecutive years of the last eight. You must live in your new home as your principal residence at least 36 months. Congress now forgives the required repayment in the first version of this law for purchases after 2008. The credits phase out over higher limits, $225,000 AGI ($125,000 single).

Give (part of) an **IRA** to charity, to avoid ordinary income. This provision expires in 2009, but the House has passed a bill to extend it, as of this writing in mid December. Give **appreciated property** to charity, to avoid capital gains tax, as has been permitted for many years. Or, give to another person, perhaps a family member, who can sell and pay a lower capital gains tax rate than you.

Energy

Invest in energy saving **upgrades** for your principal home to get up to $1,500 tax credits, through 2010. Congress restarted and enhanced the tax credit that expired at the end of 2007. Make sure to get the manufacturer's certificate that each exterior window, door, heating and air conditioning system, or whatever, meets minimum energy efficiency standards.

Invest in new **renewable** energy systems for residential property, not just your main home, such as solar, geothermal, and wind, for a new, unlimited, 30% tax credit. Business incentives are available, too, and are much more complicated. These credits also reduce Alternative Minimum Tax (AMT).

Invest in **alternate fuel vehicles** and **refueling equipment.** These rules get more complicated, as Congress keeps fine tuning them.

Our federal tax system is ***so shot through with deductions, credits, exclusions, loopholes and outright noncompliance that it fails in its essential job of raising revenues efficiently. The complexity and instability of the tax system also leads people to believe that the average person always gets stuck, while the big hitters find ways to avoid paying, regardless of the advertised tax rates***. former IRS Commissioner Charles Rossotti.

Phaseouts

Many new benefits are phased out, but at different AGI limits.

Workers get the **Making Work Pay** credit up to $800 ($400 single) through 2010, phased out after $150,000 ($75,000 single).

Children get expanded and refundable **earned income** and **child** tax credits.

Students get expanded and partly refundable **education** benefits, starting 2009. The **American Opportunity** credit expands the old Hope credit for all 4 years of college. 40% of the credit is now refundable. It allows expenditures up to $2,500 for required course materials, phased out after $160,000 ($80,000 single). **529** plans can now distribute funds for computer hardware and software, and internet access.

New vehicle buyers get the **motor vehicle sales tax** deduction for purchases up to $49,500, without itemizing, from February 17, 2009, through December 31, 2009, phased out after $250,000 ($125,000 single).

Unemployed workers can exclude benefits up to $2,400, through 2009.

Laid off employees get better **COBRA** benefits. Employers get more payroll tax credits. Employees laid off between September 1, 2008, and December 31, 2009, get benefits for 9 months. But recapture benefits on your income tax return, if your AGI exceeds $250,000 AGI ($125,000 single).

Business

Invest in depreciable personal property and get **accelerated first year depreciation**. The §179 maximum is restored to $250,000 for 2009. The limits on 50% bonus depreciation increase for 2009 and 2010.

Carryback 2009 Net Operating Losses (**NOL**s) up to 5 years. The new rules substantially expand 2008's similar carryback rules. All businesses now qualify, not just small businesses.

One quirk is that a carryback to the 5th preceding year is limited to only 50% of the NOL.

Business employers get **job credits**. The Federal and California rules are different, and complicated, requiring, variously, specific geographic locations, targeted groups of disadvantaged workers, increased number of workers, and advance notice or permission. **File early**, as California will terminate its program when it has reached its funding limit. Some employers qualify for additional **Health Coverage Tax Credits** for laid off workers.

It Takes a Thief

It takes a thief to catch a thief. **Timothy Geithner** must not have anticipated becoming Secretary of the Treasury, when he cheated on his income tax. He ignored his employer, the International Monetary Fund, which clearly notifies employees that they must pay their own social security and medicare tax. He used TurboTax®, so one cartoonist made fun of both of them. (page 1)

The House Ethics Committee is investigating **Rep Charles Rangel** (D NY), Chair of the House Ways and Means Committee, for failing to disclose assets and tax fraud. The assets may include over $1Million, including municipal bonds, in accounts at a federal credit union and Merrill Lynch. The tax may include real estate income from a multifamily brownstone building in New York, and a villa in the Dominican Republic.

Jesse Ayala Cota, plead guilty to one count of conspiracy to defraud IRS. He was an **IRS District Director**, a very high position. He conspired with the Kansas firm Renaissance, the Tax People Inc, in a scheme called *The Tax Advantage System.* They told business owners to reduce their taxes by reporting personal expenses as business deductions. Cota apparently gets a lighter sentence, after cooperating with IRS in convicting his co-conspirators.

IRS' Telephone Scam

Many courts over many years found the 3% long distance excise telephone tax to be **illegal**. In 2009, Judge Janice Rogers Brown of the US Circuit Court of Appeals for the DC Circuit (in Cohen v United States), harshly criticized IRS:

Comic-strip writer Bob Thaves famously quipped, "A fool and his money are soon parted. It takes creative tax laws for the rest."

IRS unlawfully expropriated billions of dollars from taxpayers, conceded the illegitimacy of its actions, and developed a mandatory process as the sole avenue by which the agency would consider refunding its ill-gotten gains.

Even this remarkable feat did not end the IRS's creativity. When it finally conceded defeat on the legal front, the IRS got really inventive and developed a refund scheme under which almost half the funds remained unclaimed.

This unlawful refund scheme is still in the courts. In December 2009, the US District Court for the Middle District of PA allowed a suit to proceed with class action status. The suit alleges that IRS failed to notify millions of low income telephone users that they had to file an income tax return to get their refund.

Whistleblowers

Whistleblowers may be the most dangerous problem for tax fraudsters. IRS now pays up to **30% reward**. Your target will be someone you know well, like your employer, neighbor, competitor, or mother-in-law. IRS insists on a **smoking gun**, like documents, photos, or recordings. Most whistleblowers wait a long time for IRS to prosecute the case, get few status reports along the way, as tax information is confidential, and get no reward.

Germany caught LGT bank of Liechtenstein when a bank employee blew the whistle. Germany paid him $6.2Million for a CD containing secret data on more than 1,000 wealthy individuals' offshore accounts.

***The income tax has made more liars out of the American people than golf has. Even when you make a tax form out on the level, you don't know when it's through if you are a crook or a martyr*.** Will Rogers

Bradley Birkenfeld just filed a claim for $Billions of reward from IRS. He blew the whistle on his employer, Swiss bank **UBS**, which encouraged US account holders to hide accounts and to evade US taxes. In February 2009, UBS paid $780Million to settle civil and criminal fraud charges. UBS account holders will pay untold $Millions or $Billions in overdue income taxes, interest, and penalties.

This is another step in our ongoing effort to pursue hidden offshore assets - no matter where they are located*. *You can expect us to use all of our enforcement tools to stop this abuse. For people with hidden offshore assets, they have an opportunity to get right with the government. IRS Commissioner Doug Shulman.

14,700 US taxpayers, who hid money in offshore accounts, turned themselves in to get IRS' partial amnesty, which expired October 15, 2009. Then, IRS disclosed details of the new Swiss tax **treaty**. Switzerland now promises to disclose specific fraudulent accounts which IRS requests, plus all accounts with assets over about $1M, or earnings over about $100,000 per year. IRS still gives US taxpayers a penalty break if they voluntarily disclose their offshore accounts and income.

This US-Swiss deal is ***at most a modest advance*** toward ending abuses of bank secrecy, says Senator Carl Levin (D MI), Chair of the Homeland Security and Government Affairs Subcommittee on Investigations.

In August, 2009, Birkenfeld was sentenced to 40 months in jail, after pleading guilty to **criminal** charges of helping US taxpayers evade US taxes. When he gets out, his whistleblower reward may make him very wealthy. Or, IRS may deny his claims, and discourage other potential whistleblowers.

FBAR

Foreign Bank Account Reporting (FBAR) has grown since 2003 from a little known disclosure with little penalty, to one of IRS' main tools in catching **offshore tax evaders**. Check a box on Form 1040, Schedule B, if you have an offshore financial account, from which you can get cash, that does not report on IRS' Form 1099. If the total of all these accounts exceeds $10,000 at any time during the year, then report the details of each account on Form TDF-90.22.1. IRS keeps changing the reporting rules, which are very complex. This Form is due June 30, with no extension, and with no mailbox rule (which allows the postal date mark to be the filing date). It cannot be efiled, and does not have the same, strict, privacy protection as income tax returns.

Penalties start at $10,000, merely for not timely filing Form TDF-90.22.1, or one of the other Homeland Security disclosure forms. Monetary penalties can easily exceed the amount invested in and earned on a foreign account. Or, you must convince IRS that you did not willfully fail to file a disclosure form, and that you really did pay all your tax on any offshore earnings. Penalties are not dischargeable in bankruptcy, and are not appealable in Tax Court. You must pay any penalty before District Court will accept any suit against IRS for refund.

Mandatory Penalties

Penalties should not be mandatory. The vast majority are not. But Congress **mandated** huge penalties, in a kneejerk attempt to catch tax fraud. ***I did not intend to bankrupt small businesses that had no ill intent, when I advanced this legislation to shut down tax shelters. I was focused on the big corporations that were actively seeking to hide their participation in tax shelters***, says Sen. Charles E. Grassley (R IA), ranking Republican on the Senate Finance Committee.

These penalties can far exceed any alleged tax savings, or the investment itself. IRS assessed nondisclosure penalties of $1.2Million against one small business owner who saved only $6,812 tax. IRS forced a coin operated car wash business into bankruptcy, after assessing a $900,000 penalty. The car wash had set up a retirement plan for its seven employees, and saved about $45,000 tax. The 72 year old owner says he never would have invested in this tax shelter, if his advisors had told him that IRS might assess such big penalties merely for not filing some disclosure forms.

I am dismayed…that…penalties are way out of line with penalties for other similar cases of noncompliance, said IRS Commissioner Doug Shulman, when he suspended collection activities in these egregious cases. Congress informally requested extra time to correct their legislation on this mandatory penalty, which they have not yet done.

Avoid Penalties

You can talk your way out of penalties. Congress' Government Accounting Office (GAO) says IRS does not administer penalties efficiently, effectively, fairly, and consistently, to encourage voluntary compliance. In 2007, IRS abated about 38% of all penalties, $11.1Billion out of $29.5Billion assessed, from over 150 specific code sections.

You can also talk your way out of IRS **collection** action, says the Treasury Inspector General for Tax Administration (TIGTA), which found IRS 2008 collection attempts were not as aggressive as the law prescribes in 4,250 cases, about 21% of the total. ***Lien, levy or seizure actions should have been pursued when taxpayers missed specific deadlines or did not respond to letters or messages for the taxpayers to contact the revenue officers***, says TIGTA. Sometimes IRS collectors continued as if the deadline were not missed. Sometimes they did not follow up at all.

When IRS does attach **liens**, it very often **tramples taxpayer rights**, says TIGTA. IRS failed 83% of the time to properly research and resend notices to taxpayers, when the post office returned original notices as undeliverable. IRS failed to notify the taxpayer's representative in 30% of all those cases.

1099 Reporting

Fraud and mistakes are much less when financial institutions and others report directly to IRS. ***Time and time again, we have seen that better information reporting helps the tax system work better by ensuring that everyone pays what they owe. We know that those taxpayers who have their taxes withheld and reported to the IRS through third parties are the most compliant. On the other end of the scale, those operating without withholding and reporting are the least compliant. What's the lesson here? Simple: Better information reporting can boost compliance.*** IRS Commissioner Doug Shulman.

Upcoming enhanced 1099 reporting includes more offshore accounts by offshore banks which do business in the US, the basis of capital gains and losses by investment brokers, payments to contractors by the government, and credit card transactions and fees by credit and debit card companies.

Sole proprietors...are responsible for a large portion of the tax gap, says IRS Deputy Commissioner Linda Stiff. Future 1099 reporting, and backup withholding, may include payments to all independent contractors.

California

Dysfunctional California government has a **systemic budget crisis**.

California **tax reform** from Governor Schwarzenegger's Commission on the 21st Century Economy is **dead on arrival.** It would require two thirds majority in the legislature. Five of the fourteen Commissioners refused to sign the final report. The major recommendations provide more stable revenue with a flatter income tax, and easier tax collection with a business gross receipts tax, similar to the European value added tax.

Ronald M. George, Chief Justice of the California Supreme Court, surprised pundits with extraordinary criticism of California's **dysfunctional** legislative and initiative process. ***California's lawmakers, and the state itself, have been placed in a fiscal straitjacket by a steep two-thirds-vote requirement — imposed at the ballot box — for raising taxes. Much of this constitutional and statutory structure has been brought about not by legislative fact-gathering and deliberation, but rather by the approval of voter initiative measures, often funded by special interests. These interests are allowed under the law to pay a bounty to signature-gatherers for each signer.***

Frequent amendments - coupled with the implicit threat of more in the future - have rendered our state government dysfunctional, at least in times of severe economic decline. At a minimum, in order to avoid such a loss, Californians may need to consider some fundamental reform of the voter initiative process. Otherwise, I am concerned, we shall continue on a course of dysfunctional state government, characterized by a lack of accountability on the part of our officeholders as well as the voting public.

Kiss Your Assets Goodbye

Nevada is the 2nd friendliest state in the US for small businesses and entrepreneurs, according to the 14th annual Small Business Survival Index. California is 49th.

You can Kiss Your Assets Goodbye, if you keep your business in California, according to Nevada's 2009 ad campaign (on the left). In 2004, Governor Arnold Schwarzenegger drove a moving van down the Las Vegas Strip to bring a small business back to California. Nevada responded with a *Will Your Business be Terminated?* campaign slogan, referencing Schwarzenegger's famous role in the Terminator movies.

Beware, California is on the warpath against Nevada and those who wrongly claim to escape California tax by doing business in, or moving to, Nevada. Under California's complex residency rules, you may still owe California tax.

Use Tax Registration

California requires that businesses file a new **use tax return**, first due April 15, 2010, for the year 2009. California badly needs the $1Billion per year that it looses to unpaid sales/use tax on **internet purchases**.

You still owe the **use tax** on property you use in California, when an out of state seller is not required to collect the California sales tax. California tried to collect use tax 5 years ago with a line item on income tax returns, which most people have ignored.

California requests businesses to register if their gross income is greater than $100,000. There is no penalty for failing to register. But there is a substantial penalty for failure to file and to pay the tax.

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