William M West Certified Public Accountant
Wisdom to build Wealth

Tax Newsletter 2011

There has been near universal agreement for years that the tax code is broken and needs to be fixed.

National Taxpayer Advocate Nina Olson

The 111th Congress passed more major legislation in its 2010 lame duck session than any Congress in memory. They had already passed major health care and finance reform in 2010. A perfect storm allowed the moderate wings of both parties to compromise. It was a big surprise, as the Republican leadership says their main goal is to fight President Obama at every turn, to deny him a 2nd term; and they had just regained control of the House, in the biggest midterm election turnover since 1938.

The Tax Relief, Unemployment Insurance Reauthorization and Jobs Creation Act of 2010 (**TRUIRJCA**), was the tax compromise, which President Obama signed on December 17, 2010. TRUIRJCA extends for two more years most of the tax benefits from the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), which ten year life expired in 2010. This is not the major tax reform which newly elected President Obama promised on April 15, 2009. If Obama wins reelection, he may follow President Reagan's precedent. In his second term, Reagan signed major tax reform, the Tax Reform Act of 1986.

The 2010 Health Care Acts made major tax changes to support the health goals, and to offset new costs with tax increases. Republicans vow to fight these health changes with their new control of the House, especially substantially enhanced 1099 reporting by businesses. (see page 2)

Congress' very late passage of TRUIRJCA is just one more indicator that a **train wreck** approaches. As **tax complexity** increases, taxpayers stop voluntarily filing and paying their taxes. Nina Olson, National Taxpayer Advocate, says the US already spends 6.1Billion hours every year on our income taxes. Everyone games the system, to keep up with their neighbors. IRS will now take until the middle of February to reprogram its computers for the 2010 tax changes, in order to process returns and issue the refunds that most early filers expect. IRS also takes on another social welfare task, health taxes, which dramatically conflicts with IRS' traditional culture of revenue collection.

Tax & Financial Tips

►Pay off your **credit-card** debt.
►Maximize your **401k** and **IRA** contributions.
►**Shop** around for banking, credit card, & insurance. Find accounts with the big **free offers**. Then **cancel**.
►Use **individual** credit cards. The credit card companies are pushing business and professional cards, which do not have the same **consumer protections** under the Credit Card Accountability and Responsibility and Disclosure Act of 2009.
►**Sell** that vacation home, that motor home, that extra vehicle.
►**Zero** your **tax refund**, which averages nearly $3,000, says IRS. Invest it. Beware penalties if you lower your withholding and owe too much tax.

TRUIRJCA 2010

Tax complexity and uncertainty continue for 2 more years with TRUIRJCA, the **Tax Relief, Unemployment Insurance Reauthorization and Jobs Creation Act of 2010**. The extension of the EGTRAA (Economic Growth and Tax Relief Reconciliation Act of 2001) tax cuts and other tax stimuli will cost $858Billion over ten years. Taxes will be uppermost in the 2012 presidential campaign. Further extension, temporary or permanent, may be left to that 2012 lame duck session to resolve, again.

TRUIRJCA substantially lowers employee **payroll** taxes, by 2%, but only for the year 2011. This is the first time payroll taxes have ever decreased.

In 2013, all the **income tax** brackets will return to the pre EGTRAA levels. The maximum rate will be 39.6%, up from 35%. Capital gains rates will increase to 20%, or 18% with a 5 year holding period, up from 15%. Qualified dividends increase to 39.6%, up from 15%. These percentage tax increases for those in the highest tax bracket, not including AMT, are 13% for ordinary income, 33% for capital gains, and an astounding 264% for qualified dividends.

TRUIRJCA extends and expands slightly the **Alternative Minimum Tax** (AMT) exemption, but only for 2010 and 2011. Politicians promise to do away with AMT. It is very complex. It affects mostly higher income taxpayers. It often upsets tax planning with nasty surprises. Yet it is extremely **lucrative**, projected to raise more than the regular tax in just a few years. I predict that the next major tax reform will blend all or most of AMT back in with the regular tax system. The rub is that politicians have an incentive to keep AMT, or maybe to return it to it's original form, which was originally designed to affect only a few extremely high income taxpayers. The politicians get a huge political advantage by hiding these tax increases in plain sight, while trying not to offend most taxpayers/voters.

Everyone hated the default 2011 **Estate tax**, which was likely a major driving force behind the whole TRUIRJCA tax compromise. The 2011 rate would have reverted to the pre-EGTRAA rate, 55%, after $1M net worth exclusion. EGTRAA eliminated the estate tax altogether in 2010, for the first time since its inception in 1916. Families of individuals who died in 2010 would pay income tax on sale of inherited assets, using the decedent's basis. TRUIRJCA now gives them the choice of using the EGTRAA 2010 rules, or the 2011 TRUIRJCA rules: 35% rate, after $5M net worth exclusion.

The 2 year TRUIRJCA extension pushes back the estate tax conundrum until 2013. Estate tax remains the one tax with so many **loopholes**, that most anyone with sufficient dedication and perseverance can avoid it altogether. **Macabre** stories abound, now with a December 31, 2012 deadline. Throw momma from the train. Cut her life support. She may take her own life.

(see page 2)

1905 Park Avenue, Suite 100, San Jose CA 95126 • 408-554-0400 • billw@wmwest.com • www.wmwest.com

Tax law complexity is nothing new. The Tax Code is already four times longer than War and Peace.
IRS Commissioner Doug Shulman

TRUIRJCA extends a laundry list of **individual** tax benefits, including the phaseout of itemized deduction for high income taxpayers, sales tax deductions, tax free charitable distributions from retirement plans, refundable child tax credit, limited marriage penalty relief, enhanced dependent care credit, adoption credit, employer credit for child care assistance, enhanced earned income credit, enhanced Coverdell Education Savings Account contributions, Employer Educational Assistance, enhanced Student Loan Interest Deduction, and American Opportunity Tax Credit.

TRUIRJCA extends for 2 years many **business** benefits, including the Research and Development credit, and accelerated, 15 year, depreciation for certain leasehold, restaurant, and retail improvements. Expanded business benefits include 100% bonus depreciation through Dec 31. 2011, $500,000 first year (§179) depreciation for new property purchased and placed in service in tax years beginning in 2011 and 2012, 2% reduction in the FICA/self employment tax rates through Dec 31, 2011, and myriad energy related benefits.

Health Reforms

The Republicans promise to repeal Obama's health reforms, which start in earnest in 2011. In 2010, as economic stimulus, some small employers did receive income tax **credits** for paying over half of employees' health insurance costs. They must have had fewer than 25 full time equivalent employees, averaging less than $50,000 per year. In 2011 employers may qualify for credits for hiring and retaining workers who did not previously earn wages, and remain employed at least one year.

In 2013, the itemized medical expense threshold increases to 10%, up from 7.5%. Medicare tax increases to 2.35% on earnings above $200,000 ($250k married), up from 1.45% now. A new 3.8% medicare tax applies to investment income & most income over $200k ($250k married), except business and qualified pension plans income.

Health Savings Accounts (HSAs) are great, if you have the savings not to use it, and to pay high insurance deductibles, maybe $3,000/yr for an individual. Deduct your HSA contributions. Pay your IRS approved medical expenses from other funds, so that your HSA account defers taxes on earnings, like a Roth IRA (which is also great).

1099 Reporting

Form 1099 reporting is the future of taxes. So 1099s are becoming more and more tedious to prepare. And income tax filing can be much more complex, when you must correct erroneous 1099s. ***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****, says* IRS Commissioner Doug Shulman.

Credit card companies will use a new Form **1099K** to report merchants' monthly gross receipts over $20,000 and 200 transactions per year, starting 2012 for 2011 transactions.

Stockbrokers will report **basis** on Form **1099B** in stages, starting 2012 for 2011 transactions. Initially, they will report your basis when you sell common stock, including splits, reinvested dividends, and corporate mergers. They will later report basis of sales based on dividend-reinvestment plans, options, and fixed income and debt instruments, such as bonds. In future years they may be required to report basis for even more complex sales, such as for partnerships, derivatives, straddles, conditional sales, and esoteric short sale adjustments.

Stockbrokers have already started to contact customers to make sure that their computers contain the correct basis. You may have to specify basis for inheritances and gifts, and transfers between brokers. Wash sale rules apply to all your accounts, including IRAs, though brokers are only required to apply those rules to each account. Brokers will use IRS' default FIFO (First In First Out) rule for multiple lots of the same security. You can override that default by specifying the lot(s) sold, before the settlement date of each sale, so the broker includes the correct lot(s) on your confirmation. IRS will have to change Schedule D to allow for reporting any basis discrepancy.

Landlords must now file 1099MISCs, as all businesses, starting 2012, for 2011 transactions. Most landlords are small investors, not full businesses. They don't have the computer power of the big financial institutions. Many will have problems reporting correctly, and paying more to report.

1099 Penalties

The ultimate Federal penalty for failing to file 1099s is **20% backup withholding**. That is, deduct 20% from the purchase price, and pay it to IRS. IRS will likely apply this penalty more often. ***A vendor may simply refuse to sell goods to any purchaser that refuses to pay the full purchase price***, says National Taxpayer Advocate Nina Olson.

Late filing penalties now incur bigger penalties, the later you file. The penalty increases to $30 per 1099 ($250,000 maximum per year, $75,000 for small businesses) for forms filed after January 1, 2011, and only a day overdue. Pay up to $100 per 1099 if you file after August 1 ($1.5Million/$500,000 maximum).

California law imposes the ultimate penalty for unfiled 1099s - **denial** of the deduction. California threatens to enforce this stiff penalty, which it has chosen not to enforce until now.

The idea of paying taxes is kind of fundamental to a sound democracy. I'm a great defender of our tax system, with all its pockmarks. What people forget is that a sound tax system is at the heart of a democracy. Mortimer Caplin, IRS Commissioner during the terms of Presidents Kennedy and Johnson.

New 1099 Reporting for Goods

Everyone hates the huge 1099MISC enhancement with which Congress partially financed health reform. If you agree, **tell your Congressmen** to finance health reform some other way.

Businesses must report purchases of **goods**, also known as tangible property, starting 2013, for 2012 transactions. Corporations will no longer be exempt from getting 1099MISCs. The annual threshold is still $600. You will have to track detailed records of **all** payments to **all** vendors, including restaurants, chain stores, and street merchants. Or, pay **20% backup withholding** (above).

A huge part of the tax gap comes from the **underground economy**, where cash income is never taxed. Congress hopes to ensure that everyone pays tax on their income, by making law abiding businesses turn in their payees via Form 1099MISC. ***Sole proprietors...are responsible for a large portion of the tax gap***, says IRS Deputy Commissioner Linda Stiff.

Identity theft may increase, with all the individual identifying information floating around. IRS assumes that 1099s are correct, forcing you to prove that they are not. ***At this point, the taxpayer may have to prove a negative***, says Taxpayer Advocate Olson.

If you pay for business/rental expenses by credit card, then the credit card companies may report for you on Form 1099K (above), and you do not have to duplicate reporting on Form 1099MISC. ***Many large vendors already have computer systems that can track purchases by customer. They are likely to advertise that they will track each customer's total purchases and send them a report at the end of the year that business customers can use to comply with the Form 1099 filing requirement. Small businesses seeking to minimize recordkeeping burden thus will have an incentive to use large vendors that can produce these reports for them***. Taxpayer Advocate Olson

The new reporting burden, particularly as it falls on small businesses, may turn out to be disproportionate as compared with any resulting improvement in tax compliance. A vendor may simply refuse to sell goods to any purchaser that refuses to pay the full purchase price. Such an outcome could significantly impair the normal course of commerce. The IRS will face challenges making productive use of this new volume of information. Consequently, the IRS would have to develop a process for verifying and using information reports to establish an accurate amount of gross proceeds. In our view, it is highly likely that the IRS will improperly assess penalties that it must abate later, after great expenditure of taxpayer and IRS time and effort. Taxpayer Advocate Olson

The expected exponential increase in the number of returns filed, especially paper returns, and the hurdles the IRS must overcome in actually utilizing the return information in any matching program between information returns and tax returns, cry out for a series of exceptions where the utility of the data is small relative to the cost to produce and process it. IRS' Information Reporting Program Advisory Committee.

Tax Evasion?

President Obama has set a very poor example by hiring tax evaders. Tom Daschle withdrew to be Secretary of Health and Human Services when his $120,000 back tax bill became public. Timothy Geithner, current Secretary of the Treasury, cheated on his income tax by underpaying $42,000 while working for the International Monetary Fund. On the Congressional side, Rep Charles Rangel (D NY) resigned as Chair of the House Ways and Means Committee over chronic ethics violations. The House Ethics Committee censured him after convicting him on November 16, 2010, on 11 charges, including failing to pay taxes on rental income from his Dominican villa.

Federal employees owe $1Billion, out of $100Billion owed by all US taxpayers, says IRS. Starting in 2012, Federal and State governments will withhold 3% income tax from payments to vendors for goods and services over $10,000 per year. ***Congress and their staff - because they are the people who write the tax laws and because they work for the public - have to be held to a higher standard***, Steve Ellis, Vice President of the watchdog group Taxpayers for Common Sense. ***They certainly have a special obligation in that regard.*** Mortimer Caplin, former IRS Commissioner. ***If you're on the federal payroll and you're not paying your taxes, you should be fired,*** Rep Jason Chaffetz (R-UT).

Some call US corporations illegal tax evaders. More say they just take advantage of legal loopholes. US corporations pay less tax than in almost any other developed country, though the US rate is 35%, the second highest, behind Japan. The US corporate tax system is **deeply flawed and in need of reform**, says the advisory panel report to the White House, led by former Federal Reserve Chairman Paul Volcker. Pundits whisper of another perfect political storm to reform corporate taxes, just as happened in the TRUIRJCA compromise. (see page 1)

IRS & Social Welfare

Complexity reigns. IRS is hard put to collect tax revenue. Yet Congress confounds IRS with social welfare tasks. ***The trend toward requiring the IRS to administer social benefits in addition to its core tax administration duties increasingly diverts current IRS resources and diminishes taxpayer services. I have no doubt the IRS is capable of administering social programs, including health care, but Congress must provide sufficient funding and the IRS itself must recognize that the skills and training required to administer social benefit programs are very different from the skills and training that employees of an enforcement agency typically possess. While some enforcement measures are required to prevent inappropriate claims, the overriding objective of agencies that administer social benefit programs is to help as many eligible persons qualify for the benefits as possible. That requires outreach and working one-on-one with potentially eligible individuals. If the IRS continues to ramp up enforcement while reducing taxpayer service programs, I would be concerned about its ability to administer the new health care credits and penalty taxes in a fair and compassionate way***. Taxpayer Advocate Olson

There are substantial differences between benefits agencies and enforcement agencies in terms of culture, mindset, and the skill sets and training of their employees, As the IRS prepares to administer large portions of the health care legislation, it will have to shift from being an enforcement agency that primarily says, in effect, 'you owe us' to an agency that places much greater emphasis on hiring and training caseworkers to help eligible taxpayers receive benefits and work one-on-one with taxpayers to resolve legitimate disagreements. Taxpayer Advocate Olson

IRS may pay $1Billion erroneous **Earned Income Tax Credit** (EITC) refunds every year, in violation of Executive Order 13520. ***I am troubled that we found a lack of adequate corrective action by the IRS to address improper claims in the EITC program, which is particularly vulnerable to fraud. These problems allow a substantial number of erroneous refunds and credits to be granted that are not allowable by law***. says Russell J George, Treasury Inspector General for Tax Administration (TIGTA). IRS Division Commissioner says weakly ***We employ a sophisticated risk-based scoring model to identify and select the most likely EITC noncompliant returns for review***.

Their mission has been watered down. ***The new programs require [IRS] to carry out other functions for which they're not qualified***. ***IRS personnel are people with accounting, economic and investigative abilities. It tends to move the IRS from its basic responsibilities, which is to help raise the revenue of this country. Even the Earned Income Tax Credit could have been handled by Health and Human Services. What has happened is that there are a tremendous amount of fraud and deficiencies associated with the program. This has produced a great loss of revenue, because the Service has to focus attention on the wrong returns. Rather than looking at high-income returns, with, say, foreign investments, they have to examine the EITC.*** Mortimer Caplin, IRS Commissioner during the terms of Presidents Kennedy and Johnson

Tax Preparer Registration

IRS depends on professional tax preparers, who prepare 60% of all returns, and who are too often inept and fraudulent. Starting January 1,2011, IRS requires all paid tax return preparers to **register**. IRS will investigate prior felony convictions and income tax problems, and eventually require testing and continuing education. This new program will not (yet) register non-paid preparers, such as volunteers in senior centers and IRS' own VITA (Volunteer Income Tax Assistance) program. ***Requiring tax preparers to register and verify their competency may be one of the most important steps the IRS has made in the tax system in our lifetimes. A tax return prepared improperly or fraudulently can have negative ramifications for years for an unsuspecting taxpayer — and it's clear from the board's survey that Americans know that***, IRS Oversight Board Chairman Paul Cherecwich.

Prisoner Tax Fraud

The tax system is so complex that IRS cannot even halt prisoner tax fraud. Yet IRS knows these filers are already criminals, and where they are – in prison. The number of returns IRS has identified as fraudulent doubled from 2004 to 2009. ***More than two years ago, Congress gave the IRS the authority to share tax information with the Federal Bureau of Prisons. The IRS and the Federal Bureau of Prisons still don't have an agreement in place to share information. Meanwhile, the number of inmates' false returns and refunds continues to rise. This signals that prisoner tax fraud is a low priority for the federal government. The agencies need to take action and correct that impression. While they wait, taxpayers are picking up a growing tab for prisoner tax fraud.*** Sen Finance Committee ranking member Chuck Grassley (R-IA).

This a perfect example of the overly complex US tax system that IRS cannot easily administer. The US tax system depends on voluntary compliance, which is decreasing. Some people game the system, so, pretty soon, everyone games the system. At some point, the **train wreck** will force Washington to greatly simplify this tax system that collects revenue, and, increasingly, redistributes income, and administers social welfare programs.

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

1905 Park Avenue, Suite 100, San Jose CA 95126 • 408-554-0400 • billw@wmwest.com • www.wmwest.com