Tax Newsletter 2012

Cats and dogs get along better than Congress critters. The Democrats called House Republicans' bluff in December's battle, and won. Payroll tax cuts, medicare payments, and unemployment benefits will continue, but only for 2 more months. In January they will fight again over these benefits, and how to pay to extend them beyond February, 2012. Washington will fight about anything that might give one party a winning complaint against the other in the November, 2012, elections.

Washington's obsession with creating private sector jobs and other short term band aids, using temporary tax incentives, is **worse than useless**. The economy can hardly thrive with all this fighting, which creates an **unreasonable** and **unpredictable** political environment.

The Republicans' self announced goal is to beat President Obama, apparently regardless of the economic and political turmoil. The Republican right wing refuses even to close tax loopholes, for fear of being seen as raising taxes.

President Obama will negotiate **major tax reform** in the early years of his second term, if he wins reelection. So I have predicted for the last 3 years. Politicians will bury their differences in a huge bill, hoping that their constituents will not notice that they compromised their uncompromisable positions.

Major tax reform puts at risk **AMT** preferences, especially **itemized deductions**, especially for the high income, including state income and property taxes, high home mortgage interest, charitable contributions, investment expenses, and unreimbursed employee business expenses. At risk are **refundable tax credits**, which have grown like topsy, and are often abused. IRS cannot correctly process them all. (see pages 2-3) At risk is **carried interest**, which has been taxed at lower investment rates, but might really be business profit, taxable at ordinary tax rates.

2013 Tax Increases

You may wish to **accelerate income** to 2012, to avoid higher rates in 2013. Regular tax planning, which defers tax as long as possible, is turned on its head.

2013 sees the **expiration of Bush's 2001 tax cuts**, and $1.2Trillion across-the-board expenditure cuts. The lame duck Congress in December, 2010, extended these tax and expenditure cuts 2 more years, just days before they were to expire. Politicians hoped to avoid voting on deficit reduction and compromise by appointing a Super Committee. But it, too, failed to compromise.

2013 sees the historically low 15% maximum rate on capital gains and qualified dividends return to 20%. All the ordinary income tax rate brackets increase, including the top 35% maximum individual rate, returning to 39.5%. The $5Million Estate tax exclusion returns to $1Million. Other recent Estate tax provisions will expire, too, such as portability of the exclusion, which allows married couples to avoid the trouble and expense of making and administering a living trust (see page 4).

2013 sees a **3.8% surcharge** on **investment income** of taxpayers with income over $200,000 (single). The 20% regular rate, plus 3.8%, will total 23.8%, plus any AMT. Washington says it needed this new tax revenue to offset rapidly rising medicare costs. Politicians have always diverted medicare and social security revenue to pay for other programs. Now, other programs must pay for increasingly costly social security and, especially, medicare.

2012 sees **Alternative Minimum Tax** (AMT) increase, again. 2013 will see the issue again, as Congress will probably extend the exemption, probably in the lame duck session after the November elections, for only one year, as it has done for years. Politicians wouldn't stand up to the backlash of 30 million new, mostly middle class, AMT taxpayers and voters.

AMT is complex, and too often **surprises** taxpayers. Politicians pander to voters by promising to do away with AMT, but cannot because it is so **lucrative**. It will raise more than the regular tax in just a few years without the annual exemption, or some other reform. AMT has become a major tax on those with middle-high income and the wrong mix of income and deductions. The rub is that very high income taxpayers escape AMT altogether. I have predicted for years that the next **major tax reform** will blend all or much of AMT back in with the regular tax system.

New Tax Traps

Pay the default California **use tax**, new this year. California loses $Billions every year, mostly to internet sales by out-of-state sellers. Use tax collects **unpaid sales tax**. But most people have paid no use tax. Many have lied on their California tax returns, which have included a use tax line for years. Now, California forces the issue**,** by including default tax based on your income tax bracket. But you may override the default, and pay your actual use tax, if you bother to track it. You may even pay zero. But you should strongly consider paying use tax, to start the statute of limitations.

Analyze your **property taxes**, which are not all deductible. Look up each line item at the county assessor's web site, to determine if it is deductible, or not. You can deduct general taxes, which are based on the value of your property, and which do not benefit only you. You cannot deduct services and improvements which directly benefit your property, nor fees not based on the value of your property. California says it will require you to report your property tax assessment parcel number on 2012 returns, so it can confirm your deduction.

Stockbrokers start **basis** reporting **to IRS** on Form 1099B in 2012, for 2011 transactions. They will report basis for common stock sales, including splits, reinvested dividends, corporate mergers, and wash sale disallowance. ***IRS research exposed the huge scope of misreported capital gains and losses largely due to taxpayers not accurately reporting their securities' cost, or "basis."*** IRS Commissioner Douglas Shulman

(continued page 2)

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

The most telling indicator of taxpayer confusion over the code's ***complexity*** *is that today, 90 percent of individual taxpayers pay for professional tax preparation or tax software to prepare their tax returns.*
IRS Commissioner Douglas Shulman

(continued from page 1)
In 2013 stockbrokers will report basis to IRS for mutual funds, dividend reinvestment plans, and most Exchange Traded Funds (ETFs). In 2014 and beyond, IRS is considering basis reporting for bonds and other fixed income securities, options, partnerships, derivatives, straddles, conditional sales, and esoteric short sale adjustments.

Shulman tells us to expect more and more 1099 reporting. Starting 2012, for 2011 transactions, financial institutions will report revenue you receive electronically to IRS, through merchant credit cards and intermediaries such as Paypal. ***Over 96 percent of income that is subject to substantial information reporting and/or withholding, such as wages, interest, and dividends, is accurately reported on timely tax returns. However, most estimates show that only around 50 percent of income is accurately reported where there is little or no information reporting. Beginning in 2012, electronic payment processors, including credit and debit card processors, will also be required to make an annual information report to the merchant and the IRS stating the gross amount paid to the merchant during a calendar year.*** IRS Commissioner Douglas Shulman

Individuals must report ownership of, or signature authority over, **foreign assets** totaling over $50,000 (single), on new Form 8938. You may have to report the same assets under both these new rules, and the foreign bank account reporting (**FBAR**) rules, which have been around for years, and which have been the subject of 2 amnesties. As with FBAR, the penalties for not reporting correctly, on time, start at $10,000.

Amnesty

When will they offer amnesty that **I** can use? IRS twice (2009 and 2011) let **offshore** tax scofflaws avoid potential criminal prosecution by paying past tax, plus penalty. In 2011 IRS allows **employer** tax scofflaws to start treating workers as employees, with minimal penalty. California has last offered amnesties in 2004, 2005, and 2011.

Offshore tax scofflaws can still come clean, and probably **avoid criminal prosecution**. Expect to pay **25%-50%** of the maximum value of your overseas accounts, maybe more, in tax, interest, and penalty. IRS' 2009 amnesty, Offshore Voluntary Disclosure Initiative (OVDI), attracted 12,000 scofflaws, who have paid $2.2Billion so far. IRS expects the final average paid to be about $180,000 apiece. IRS' 2011 amnesty, OVDI2, attracted 15,000 more offshore tax scofflaws, who have deposited $.5Billion so far.

We are in the middle of an unprecedented period for our global international tax enforcement efforts. We have pierced international bank secrecy laws, and we are making a serious dent in offshore tax evasion. IRS Commissioner Douglas Shulman

The **Voluntary Worker Classification Settlement Program** (VCSP) allows **employer** tax scofflaws to come clean by classifying workers properly as employees, rather than as independent contractors. Pay only one year's tax on misclassified wages, and **10% penalty**. Employee misclassification is common, in this complicated and politically sensitive area. Politicians have long asked IRS not to enforce the rules. But Congress doesn't ever clarify the rules.

Beware penalties from California, the Department of Labor, and other agencies, which have no amnesty. IRS probably will disclose your settlement to them in their normal information exchanges. Employees may object to missing employee benefits such as pensions, unemployment insurance, disability insurance, health insurance, and stock options.

Employer Penalties

IRS and California **1099 penalties** start at $50, and increase after the January 31 annual deadline. This year they ask *have you filed?* on more tax returns. IRS, but not California, has a safe harbor (§530) for employee misclassification. One of the requirements is that you file that worker's 1099.

California's new civil penalties for **willful employee misclassification** can be as high as $15,000 per violation, or $25,000 where it can prove a pattern. The penalties apply to anyone who participates in the misclassification, except attorneys and employees.

California **names and shames** scofflaws by requiring them to post a visible notice on the scofflaw's own web site that it has stopped its wrongful misclassification practices, and directing workers to the Department of Labor. California requires that the **Contractors' State License Board** take disciplinary action against licensees who participate in misclassification.

California EDD requires that you **report new employees** and **independent contractors** to them within 20 days. See EDD Forms DE34 and DE542 for detailed instructions. Their primary purpose is to collect delinquent child support payments. These rules are years' old, but EDD says it will now start imposing penalties: $24 per instance, increasing to $490 if nonreporting is willful.

Free Money

Refundable credits are **free money**, and IRS Commissioner Douglas Shulman is proud of it: ***IRS is now recognized as a highly effective and efficient mechanism for distributing economic benefits. Frankly, there's not another government delivery system as efficient as the IRS. We have become the go-to agency to convey these benefits to individual and business taxpayers.***

Making the tax code ***less complex*** *is the single most important thing that could be done to improve taxpayer service and boost compliance. When laws or regulations are complex, it creates opportunities for those who want to* ***game the system****. And when people game the system and pay less than they owe, it is the honest American taxpayer who picks up the tab.* IRS Commissioner Douglas Shulman

But here is the other side of the story:

In the course of less than a decade, improper payments arising from refundable tax credits have cost taxpayers an estimated $106Billion. House Ways and Means Subcommittee on Oversight Chairman Charles Boustany (R-LA)

Based on our review of the various refundable credits, we believe the IRS should require individuals to provide documentation to support eligibility for all refundable tax credits. J. Russell George, Treasury Inspector General for Tax Administration (TIGTA)

The term "refundable tax credit" is a deception. In reality, refundable credits are more akin to welfare payments. Government welfare programs are fine as long as voters understand them and approve of them. I don't think refundable credits pass that test. Plus, well-conceived government welfare programs are closely monitored. You typically have to show up in person, with documents in hand, and be interviewed by a skeptical case worker in order to collect anything. To collect refundable credits, all you have to do is mail in some forms and wait a few weeks for the check to arrive. And since only around 1% of returns are audited, fraudsters are right in thinking they will probably never be caught. For all these reasons, if Congress wants to get serious about fiscally responsible tax policies, it should repeal refundable credits ASAP. Bill Bischoff, The Tax Guy, Wall Street Journal's Smart Money

Free money from refundable **homebuyer** and **education** credits are small compared to **earned income** tax credits (EITC). TIGTA says IRS improperly paid $11 billion to $13 billion in 2009 to EITC fraudsters, 23 to 28 percent of the total earned income tax credits paid that year. ***This is an outrageously high improper payment rate. It's higher than Medicare's. For more than eight years, the IRS hasn't made a dent in this problem. If the IRS can't handle its existing responsibilities, it won't be able to handle its new responsibilities under health care reform.*** Senate Finance Committee ranking member Chuck Grassley (R-IA)

Inside IRS

Lobby your Senators and Representatives, if you agree with IRS Commissioner Douglas Shulman's 4 general suggestions to **improve the income tax system**. If he is really serious, he will lobby Congress. But bureaucrats seldom bite the hand that feeds them.

First. Seek common or standardized definitions. A good example is the code's definition of 'qualifying child'. Perhaps nowhere else in the world do the same words have so many definitions than in the US Tax Code. It would make Webster weep.

Second. Eliminate multiple approaches and hew to just one. A perfect example is promoting higher education. Senate Finance Committee Chairman Max Baucus says ***There are more than 15 provisions to assist with the rising costs of higher education. The sheer number of options, and choosing between them, often overwhelms taxpayers.***

Third. Resist short-term provisions that may expire but are then extended. Last year, the Joint Committee on Taxation identified more than 130 tax provisions that were set to expire at the end of 2010, with another 65 due to sunset at the end of 2011.

The most visible example of short-term extension is the Alternative Minimum Tax, or AMT. For each year, Congress has enacted an 11th hour AMT "patch" – a short-term adjustment that generally reflects inflation – to prevent more middle-class taxpayers from being caught up in the AMT's costly web. The projected cost of repeal under the budget rules has prevented repeal or permanent indexation.

Fourth. Set effective dates far enough ahead to allow implementation to go smoothly and to create a real incentive. Last year we actually delayed the opening of tax filing for 6.5 million Americans, from January 14th to February 14th because of late tax law changes. That meant 6.5 million people, including school teachers who wanted to take a deduction for classroom supplies that they paid for themselves, had to wait an extra month to get their refund.

Wealthy Audits

IRS audits the very high income magnitudes more than the rest of us. IRS probably uses information on their income tax returns to choose these audit candidates, including:

• large deductions from **investments** and **passive activities**, which might be deferred, sometimes until sale.
• **pass-through entities** such as partnerships, trusts, and S corporations, which can obfuscate the flow of money, risk, and tax benefits.
• large **home mortgage interest** deductions, especially if you do not report large income. Home mortgage interest on loans over $1.1Million is not deductible.

IRS also gathers information from other Federal and State sources, including:

• **property transfers**, especially if not reported on gift tax returns. A Federal court just allowed IRS to issue John Doe subpoenas in California to find such transfers.
• unreported **foreign**, or **offshore**, income. (see page 2)
• **big spenders,** who do not report correspondently high income.

Living Trusts

Your living trust is probably **obsolete,** so you may dump it and save a great deal of trouble and expense. A married couple's trust would transfer an unused exclusion to the surviving spouse, under decades old rules. But trusts are expensive to create, and more expensive to maintain, including filing trust tax returns for the life of the surviving spouse. There are non-tax reasons for a living trust, such as privacy and relief from court supervision. But the overriding reason, tax savings, no longer exists for most estates.

Now, starting 2011, Congress allows **portability** of the unused exclusion. The deceased spouse's estate must elect portability on a timely filed Estate Tax Return, to pass on the unused exclusion to the spouse.

Any married couple with an "A-B" trust should, at the very least, have it reviewed. Depending on the size of the estate and the nature of the assets, many married couples will wish to amend or revoke their existing estate plans. Jacob Stein, Los Angeles attorney.

Beware that your Estate must allocate basis to your different assets. If you leave these assets to different beneficiaries, your estate is also leaving them with different future tax obligations. ***There will be plenty of mistakes***. Catherine Hughes, US Treasury.

Marriage

IRS is slowly being drawn into the 21st century.

As more states move to recognize same-sex couples, our federal tax law should reflect that move to equality. Currently, 15 states recognize same-sex marriage or domestic partnerships, The absence of federal recognition for these couples has created ambiguity and complexity in the tax law that can, in part, be mitigated through IRS action. Now, more than ever, our tax system must be simplified for taxpayers and provide for the efficient and economical administration of our tax law. These couples face significant complexity in filing even the most simple of returns, often resulting in improper enforcement action by the IRS at a considerable cost to these taxpayers and the federal government. We urge the IRS to take swift action to address these issues and ease the unequal burden faced by these taxpayers. letter to IRS Commissioner Douglas Shulman by Jim McDermott (D WA) and 74 other House members

Today, each of our states recognizes same-sex marriages or domestic partnerships that the federal government does not recognize. When couples in these relationships attempted to calculate their tax returns this year, they encountered significant problem. We respectfully request that you take steps to provide appropriate guidance to these couples. Until the full Congress acts, however, it is essential that the IRS take steps to ensure that couples have the guidance they need to file accurate tax returns under current law and that an administrative system be in place to recognize accurate returns when they are filed. Senators Patty Murray (D-WA), Maria Cantwell (D-WA), Dianne Feinstein (D-CA), Barbara Boxer (D-CA), Sheldon Whitehouse (D-RI), Patrick Leahy (D-VT), Tom Harkin (D-IA), and Jeff Merkley (D-OR)

California

More and more cities are sharing information with California Franchise Tax Board to find **businesses** which must pay **city license fees**. San Jose, my city, has caught and penalized businesses for years.

Other local cities that share information with California include Sunnyvale, Santa Clara, Santa Cruz, Menlo Park, San Francisco, Burlingame, Livermore, and Berkeley.

California requires **real estate property managers** to **withhold** tax before passing rents along to **nonresident** owners. California too often loses the tax as nonresident owners fail to file California tax returns. Beware that California requires withholding of all managers, unless they are employees, which most of them should be, anyway. Even unpaid managers, such as family members and friends, must withhold.

Nonresident owners may apply for **reduction** or **elimination** of the withholding requirement, usually by showing that they have filed and paid the last 2 years' California taxes. California says it is considering reducing **excessive rental withholding**, because it currently allows no reduction for expenses, such as management fees and repairs.

California will **revoke your drivers' license**, if you are on it's top 500 lists of sales tax and income tax deadbeats. It is easy to search for celebrity names on the 'top deadbeats' list, which California has published for years.

California will also revoke your **professional license**, including physicians, nurses, building contractors, barbers and cosmeticians, CPAs, and other tax preparers. Attorneys and alcohol sellers are sometimes protected by Federal or other special rules. California may find it even harder to collect its tax, after removing the scofflaws' license to earn income.

California will get alot of publicity for this revocation program. If it is successful, California will probably expand the top deadbeats list.

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