

## COMMENTARY

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### CHANGING TAX CLIMATE

By

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#### INTRODUCTION

This letter is an assessment of the current tax climate made on a composite of new events over the past nine months on Capitol Hill. It is necessary to take each of these “dots”, discuss them, and then to connect the dots to paint a “tax landscape”. Individually, these news items may not be significant, collectively they paint a picture of a changing tax environment.

Even though this letter is somewhat lengthy, it is only a summary of the news events discussed. Hopefully, this letter piques your interest enough to delve further into some of these events. Follow-up searches on the Internet will provide background on these news events in much greater detail.

This letter will deal with each of the areas separately, and will be tied together when we connect the dots.

A. Budgetary Woes. If you have been reading any newspaper, financial or otherwise, over the past two years, you saw numerous references of our country’s budget deficit. This has been a concern for many economists and was mentioned frequently by Allen Greenspan in his appearances before Congress prior to his retirement.

There have also been rumblings and concerns within the Republican Party, since one of the basic conservative issues has been reducing the deficit. Apparently, many of them have been able to swallow it and continue with a situation they are not happy with.

There have been recent announcements of an improvement in the deficit. This has been touted by the administration and others in Congress as good news. Mr. Walker, the Comptroller of the United States, said in a speech that these improvements are nothing to be proud of. In essence what we have done, is gone from a catastrophic situation to a disastrous situation. It may be an improvement, but nothing to cheer about. While there has been much talk and lip service paid to the problem in Congressional hearings, it is still a problem as indicated below.

B. Henry Paulson Hearings. Henry Paulson was nominated by the President to be the new Secretary of the Treasury. Confirmation hearings were held before the Senate Finance Committee on June 27, 2006. On June 28, he was confirmed as Secretary of the Treasury. These hearings provided an interesting legislative backdrop by the members of the Senate Finance Committee. This hearing ran for two and a half hours. The video of the hearing can be found on the C-Span website in its video library. It is worth watching for two reasons. First, it raises issues that have not been raised in the news media. Second, it shows there are members of Congress that are capable of asking intelligent, insightful questions.

The hearings delved into a number of areas concerning the budget. One issue raised during the hearing was the question of whether tax cuts produced more revenue than they cost. The consensus of a number of people on Capitol Hill, including Allen Greenspan, and the head of the Office of Management and Budget (OMB) is they do not. The senator raising the issues had graphs and calculations indicating the same. Mr. Paulson also acknowledged he agreed.

This issue was important with the backdrop of a budget deficit. Why should some tax cuts remain and continue to create a budget deficit when they are not producing sufficient revenue to maintain the basic revenue stream for our government? Mr. Paulson defended the administration's tax cuts, but did not explain why the average taxpayer would want to pay more in taxes to keep them.

Another issue that was not readily apparent, at least to me, was that Mr. Paulson made no comments about the desire to maintain a strong dollar. The financial industry jumped all over it as an indication the administration would allow the dollar to slide, which it did, to improve the balance of payments between our country and other countries. This means foreign goods would be more expensive, but our goods would be cheaper in foreign markets.

This reflects an interesting effect of the global economy. While it may appear we are doing better on a global situation, on a micro level at home, a consumer may not.

Another aspect that came up in the hearings had to do with the tax gap discussed in the next section.

C. The Tax Gap, and the Other Tax Gap. There have been numerous references to tax gaps for some years. The basic understanding of most people is that we are talking about a gap between income that is reported, and unreported income. This means some people have made money, put it in their pocket not declaring it on their income tax. Most people do not have a problem with actions being taken to require such people to pay their share of income taxes.

What is hidden in this discussion is another tax gap called the "adjusted gross income tax gap" (AGI Gap). The AGI tax gap, is the difference between your adjusted gross income on your IRS Form 1040 and the actual amount you end up paying taxes on. This includes deductions, credits, charitable deductions, and things of that nature. What is not commonly known is, the numbers in the AGI Gap also include income that is only partially taxed. In this context fully taxed income refers to earned income. Earned income is subject to your highest marginal tax rate, plus self-

employment tax of 15.3% on all amounts up to \$94,200.00 (for 2006), and Medicare tax of 2.9% on everything above \$94,200.00. Essentially, this would apply to capital gains, dividends, casual leasing where you are not in the business of leasing, and distributions from Sub-chapter S Corporations, as well as a number of other matters.

The first gap can be understood because it is essentially against the law not to declare your full income. The second is disturbing in that every single item in the AGI Gap is established by current tax law. For Congress to even look at it, means they are considering a tax change. These will obviously be tax changes you will not be happy with.

D. S Corporations. As indicated above, income derived from an S Corporation by the Shareholders as a distribution appears to also be in the cross hairs of some individuals with the IRS or in Congress. In a hearing before the Senate Finance Committee, J. Russell George, the Inspector General of the United States Treasury, stated that single member S Corporations were nothing more than employment tax shelters.

For background, Sub-chapter S Corporations are a flow-through entity and all tax attributes of the corporation flow through to the Shareholders. This means income generated by the S Corporation is taxed to the Shareholders at their marginal tax rate. As such, this increases the basis Shareholders have in their S Corporation. That way, when this income is eventually distributed to the Shareholders, it is not taxed to the Shareholders a second time, and is also not treated as earned income. This means it is not subject to the self-employment tax of 15.3% up to \$94,200.00 and is not subject to the 2.9% on all additional amounts.

It appears this comment did not go over well with the Senate Finance Committee considering S Corporations have been a darling of Capitol Hill over the last ten years. The legislative changes to S Corporations have been intended to help small businesses. From a tax standpoint, an S Corporation is better than a Limited Liability Company and many small businesses have converted to the S Corporation.

Essentially, S Corporations are like a “fish in the barrel”. There are not many directions small businesses using an S Corporation structure can go to adjust to tax changes. If Congress made a decision to have an S Corporation taxed exactly like a partnership, the tax benefits of having an S Corporation would no longer be available. This would be a significant increase in taxes. Small businesses would have very few options as an alternative.

This is an attack on small businesses. Why? Who is to benefit from it?

E. Offer in Compromise. On May 17, 2006, Congress passed the Tax Increase Prevention and Reconciliation Act of 2005. This law drastically changed the procedures for Offer in Compromises and made it more difficult to acquire an Offer in Compromise. These provisions went in to effect July 26, 2006. What is really strange is, most practitioners dealing with Offers in Compromise have been having difficulty getting offers through. They keep being rejected by the service for a ridiculous number of reasons. In addition, very little publicity occurred with

regard to this legislation. You wonder if rejections were done purposely, knowing this legislation was going to occur.

Anyone filing an Offer in Compromise after July 26, 2006 is required to put 20% down for the Offer. If the Offer is not accepted, the IRS gets to keep the money. In addition, if you are going to pay your offer by installments, you must make the monthly payments while the Service is considering your offer. If you miss a payment, it is treated as withdrawal of your offer. The IRS keeps the money you paid and there are no appeal rights. I don't know about you, but it sure sounds like dirty pool to me.

F. Who Do We Blame? If some of this stuff is starting to smell as you read this letter, before you start blaming one party or the other, stop, look, and listen and see which side of the political aisle is complaining the most. You probably hear silence since nobody is complaining.

If you really want to take this game out a little further, let us talk about immigration reform. We have a lot of undocumented aliens who are in the United States making money, and the money is going back to their native land. If the USA grants them amnesty to stay in the United States, what about the prior years they have spent in the United States earning money and did not pay their taxes? Is the amnesty for illegal aliens going to apply to their taxes also? That should raise some interesting constitutional issues.

G. Federal Estate Tax Repeal. If this letter has not depressed you enough, lets try another one. The repeal of the Estate Tax. Those familiar with estate planning, know people with larger estates use what is known as an A/B Trust. This is an estate splitting technique that allows the utilization of the credit against Federal Estate Tax for both a husband and wife. The primary purpose of this technique is to reduce Federal Estate Tax. Obviously, if there is no Federal Estate Tax you would not need to have an A/B Trust. Assume there is a repeal and we are three or four years down the line and the budget deficit is becoming a bigger problem, with a small switch in philosophy, it would not be surprising to bring back the Federal Estate Tax, say in November of a specific year applied retroactively for say, six or seven months back. Since people that died during this period of time would most likely not have an A/B Trust, Congress would be playing their favorite game, "shooting fish in the barrel". People in that situation would be unable to do any planning. They cant, they are dead. This is the reason many tax planners and estate planning attorneys are recommending people continue to have an A/B Trust. With this structure in your trust, in the event the credit against Federal Estate Tax drops drastically, or is repealed and then reinstated, you are protected.

H. Summary. If you do not find this letter disturbing, and have not run off to find the address for your United States Senator or Representative to Congress, then you need to read it letter again. If you do not agree with any of the aspects of it, it is very simple for you to search on the Internet and you will discover the same things you find in this letter.

Also, if you take a look at your financial statement and your net worth and find your total net worth is under two million dollars for a single person and four million dollars for a husband and wife, you are going to be hurt by the Estate Tax repeal. It is going to create anywhere from a 50

to 70 billion dollar a year tax reduction in revenues and Congress has to find someplace to get it. If you wonder where they are going to get it, put this letter down and go stand in front of a mirror. That's who.

With the background of this letter, you understand that most of the sound bites and comments by Representatives in Congress concerning tax reform, flat taxes, and other issues does not bode well for you from a tax standpoint. People keep asking for a flat tax. For most people making less than \$250,000.00 a year, this will most likely result in a tax increase. You would think conservative Republicans would have a problem with regard to a flat tax when they realize they and Jerry Brown, the former Governor of California and Mayor of Berkeley, is also in favor of a flat tax. Why would two groups with distinctly different philosophies on social issues and taxing be on the same side of an issue? Conservatives, BEWARE, and everyone else too.

For additional information see our website at [www.taxwarrior.net](http://www.taxwarrior.net)