

TAX WARRIOR

Roger V. Bennett
942 Enterprise Dr., Suite A-1
Sacramento, CA 95825
WWW.TAXWARRIOR.NET
(916)646-1876
(800)770-1876

SPRING 2006 NEWSLETTER

1. Estate and Gift Tax.

- A. The annual exclusion for Gift Tax for 2006 is now \$12,000 per person.
- B. The applicable credit amount against Federal Estate Tax for 2006 is two million dollars per person.
- C. Contrary to popular belief, you may not gift the entire amount of the credit against Federal Estate Tax. There is a separate credit amount for Gift Tax purposes, which is a maximum of one million dollars. Internal Revenue Code Section 2505.

2. Communications Critical in IRS Tax Audits. The electronic and global age has reached the Internal Revenue Service. In today's IRS, you do not know where the person handling the audit is or their background. The taxpayer may be in California, and the auditor on the East Coast.

This is important for communication purposes. IRS agents are human and have perceptions like other people. With these changes, you need to communicate more with the IRS in writing. The days when you sit down across the desk and chat with someone and play "let's make a deal" are disappearing. It is all about enforcement. They really do not care to deal with the masses.

Your oral conversations are not recorded. Results of the conversations are typed on computer as part of your file by the agent you talked to. That agent's perception of the conversation is what goes on the computer. It is important to go over who is to do what and by what date on the phone during the meeting to be clear. Write confirming letters of your understanding from the meeting. If you do not, the agent's perception, right or wrong, will rule the direction of the audit. Do not write your letter so they can be understood, write them so they cannot be misunderstood. Tax practitioners are used to having oral conversations with an agent and developing a relationship so each person understands what is occurring. That is not the case anymore. Written letters specifically confirming what your understanding is of what is to be done and what needs to be sent to the IRS, go in the file and are important in any disagreement.

Including letters with tax returns explaining areas where someone reviewing the return might have a question are important in preventing an audit. Use care in the drafting of all communications. Saying the wrong thing in oral communications or in written communications can cost a client dearly.

If there is an understanding the taxpayer is to do something by a specific date, it must be done or you need to call back before that date and get an extension. Remember, the IRS does not handle rejection well.

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3. Perceptions in IRS Audit. The first task in an audit is to assess the perception of the auditor. If there is a preconceived perception as to the issues in the audit, the manner in which a taxpayer should have conducted their personal or business affairs, or other issues, there may be substantial education and effort required by the representative to change that perception.

Failing to do so may be disastrous for the client. This process can be expensive and it will require letters, documentation, and oral communications to change an auditor's perception. An assessment must be made as to whether it is cost effective. There are no rules as to how many written communications you can send. The auditor must read them. You have a free shot at affecting the auditor's perception. Do not waste it. Pound the factual issues the audit turns on.

Do not ignore personal and geographical perceptions. These can be regional, state to state, or even perceptions between residents of two cities in the same state. Just think of professional sport rivalries.

4. Tax Gap, Tax Gap. No, that was not a misprint. For the past year, there has been numerous discussions in the media and on Capitol Hill related to the Tax Gap. What is misunderstood is there are two Tax Gaps. First, is the Tax Gap between income that is reported and unreported income. In other words, the amount people simply put in their pocket and do not declare on their income taxes.

The second Tax Gap is called the AGI Tax Gap, or the Adjusted Gross Income Tax Gap. This is the amount between the total adjusted gross income and the amount of income, tax is actually paid on. This number would include charitable deductions, capital gains, as well as other items. What is frightening is Congress also includes "partially taxed income" in arriving at this number. This would include capital gains and S Corporation distributions. Partially taxed income, is measured against the revenue that would be received if the income was treated as earned income. The only inference is certain groups in the Federal Government are looking for subtle ways to increase taxes. This means you are going to be the person paying the difference in taxes if the Estate Tax is repealed or the credit increased. In essence, there will be an Estate Tax reduction and an Income Tax increase.

5. S Corporation Reasonable Compensation. With the back drop of the "Tax Gap", the IRS has increased enforcement and collections. This applies to S corporations. While there is a tax benefit to distribute profits for an S corporation to avoid self-employment and medicare taxes, a reasonable salary must still be paid. If the wages section on your IRS 1120s shows no wages or a ridiculously low amount, you are asking for an audit.

6. Taxpayer Advocate. If you are having difficulties, contact the Taxpayer Advocate. They are independent of the IRS. It is headed by Nina Olson, the National Taxpayer Advocate. She is the taxpayers only friend on Capital Hill. (See www.irs.gov/advocate)