

TAX WARRIOR

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SUMMER 2006 NEWSLETTER

OVERVIEW:

On June 28, 2006, the United States Senate confirmed the nomination of Henry Paulson as Secretary of Treasury. Mr. Paulson replaced John Snow as Treasury Secretary. To see the Finance Committee hearing, look on www.c-span.org, click on Congress under video library and scroll down until you hit Senate Finance Hearing on the Henry Paulson nomination as Treasury Secretary. It will last about two hours and thirty-five minutes. What was interesting about this nomination was the number of insightful issues affecting every taxpayer raised in the confirmation hearing on June 27 in front of the Senate Finance Committee. The issues raised are pivotal on tax policy and future tax legislation. Some of these issues will be addressed in this Newsletter.

1. Closing the Tax Gap. The hot issue on Capitol Hill had been studies and reports that address the gap between taxes legally owed and taxes collected in a timely fashion each year. This is estimated to be in excess of three hundred billion dollars. This issue says more about the current budgetary situation than any true tax gap issue. Issues related to the tax gap have been discussed in Congress for the last 20 years. Since Congress cannot appear to either reduce spending, or come up with a revenue program, it will have to be raised administratively through increased enforcement by the Internal Revenue Service. Many taxpayers are going to be targeted and audits are going to increase.

This is most likely going to require more reporting on the part of legal taxpayers which is going to cost everyone more money reducing productivity.

2. Do Tax Cuts Create More Revenue? We have been told that reducing taxes generates economic growth to raise more in tax revenues. Most people agree the dropping of the capital gains coupled with the dropping of interest rates most likely did result in additional tax revenue. Across the board, however, with the tax cuts of the recent years, there has been much debate as to whether this has occurred. Allen Greenspan has voiced the opinion that tax cuts do not result in more revenue than they cost which has also been echoed by the Chairman of the Office of Management and Budget. A fair amount of the hearing dealt with this particular issue, and Mr. Paulson admitted that tax cuts usually do not raise enough tax revenue from additional economic growth to pay for themselves. He did, however, defend the tax cuts in existence for the benefit of the economy. The problem is, he did not explain how this benefits our economy as a whole.

Some in Congress feel we should allow the tax cuts to expire. Others from the President's side feel that the tax cuts should stay. Essentially administratively we are going to make other taxpayers pay for the difference.

The budgetary shortfalls are a real problem for many legislators. This is also causing a road block with regard to the repeal of the estate tax. With an estate tax repeal, this would create an additional shortfall of another

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60 to 70 billion dollars a year. Congress is not going to reduce spending and have been talking about the tax gap for years which they have done very little to close. Look for additional taxes in some form or another.

3. Strong Dollar. An issue not mentioned during the hearings on Mr. Paulson, reverberated through the investment community because of its silence. This was the question of maintaining a strong dollar. Each of the two prior Secretaries of the Treasury had stressed the need for maintaining a strong dollar. Mr. Paulson was silent on the subject. This was an indication the administration may allow the dollar to drop in value on the global market. (Which it did) Some see this as a way to help the so called global imbalances with regard to U.S. current account deficits.

A weaker dollar would raise the cost for imports which would affect consumers, but make U.S. exports cheaper on a global level helping to shrink the deficit. Talk to your investment advisor as to how this would affect your investment portfolio.

4. Attack on "S" Corporations. The issues discussed above reflect a battlefield of administrative and tax policies most people are not aware of. A major target for one of these is Subchapter "S" Corporations. Numerous groups are doing studies and analysis concerning these issues, and certain battle lines appear to be forming.

These issues relate to self-employment tax and medi-care tax that is applicable to earned income. In an "S" corporation, the tax attributes of income is taxed on the returns of the individual shareholders of an "S" corporation in proportion to their share ownership. If the corporation makes a \$100.00 profit, the \$100.00 is taxed to the individual shareholders regardless of whether any of that money is distributed. This money is not subject to self-employment tax or the medi-care tax. This income increases the shareholders' basis in their shares. When S distributions are declared, the money is after tax money and is received by the shareholders which in turn reduces their basis in the shares. When this money is received, there is no additional tax for self-employment (15.3%) or medi-care (a tax of 2.9%).

This is different from a partnership where all operating income is treated as earned income to the partners and subject to self-employment and medi-care tax.

This also applies to limited liability companies (LLC) which are generally taxed as partnerships. Because of this differential, many limited liability companies have found it advisable to convert from a limited liability company to a Subchapter "S" Corporation status for tax savings. For limited liabilities in California, this conversion avoids the fee imposed by California on gross income levels of an LLC. With many companies going to "S" corporations, this has resulted in tax savings for many small businesses.

It should be noted in "S" corporations all of the profits can not be taken out as "S" distributions since there must be at least a reasonable salary paid to shareholders that are active in the business. Since this is an administrative issue, the IRS can push this issue in audits without the need for a tax law change.

For more background see "Changing Tax Climate (Summer 2006) under COMMENTARY in this website.

5. Itinerant Taxpayer. These are not homeless people. These are taxpayers without a permanent residence and a principal place of business. These taxpayers are not entitled to employee business expenses tied to being away from home. (EXAMPLE: travel expenses, meals, lodging, etc.)

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Examples of such occupations; golf caddies, stagehands for touring shows, traveling engineers , artists, etc.

6. Rental to Employer. An employee may rent a portion of their residence to an employer. If the employee does so, allowable trade or business expenses, business casualty losses, and depreciation may not be deducted for that portion of the home if it is used for performance of services for the employer. Mortgage interest and real estate taxes are deductible. (IRC 280A(c)(6))

7. Offer in Compromise (Taxpayer Mugging). The Tax Increase Prevention and Reconciliation Act of 2005 was signed May 17, 2006 by the President. It made major changes to the Offer in Compromise (OIC) program. When you file an OIC now, you must pay 20% of the offer amount with the offer. If it is not accepted, the IRS keeps the money!

If you are going to pay by installments, you must make the monthly installments while the offer is being considered. If you fail to, it will be treated as a withdrawal of the offer. Again, the IRS keeps the money and there are no appeal rights. To continue, you must file a new offer and start the process all over.

These provisions became effective July 26, 2006.