



TAX ALERT

JUNE 30, 2006

IRS EXPANDS ITS ENFORCEMENT EFFORT

The IRS continues to be concerned about the growing tax gap - the difference between what taxpayers actually owe and what they voluntarily pay. The IRS estimates that the tax gap is presently 345 billion dollars per year and growing. The Service has concluded that almost half of the tax gap is attributable to underreporting of income and self-employment taxes by self-employed individuals.

It has undertaken a variety of approaches to reduce the tax gap. The Service receives approximately 135 million income tax returns each year. After many years of decline, the percentage of returns audited has begun to increase. In 2005 the Service audited approximately 1.2 million income tax returns, up approximately 20% from 2004. It has hired additional revenue agents and plans to continue to increase its audits this year.

Audits come in several forms. Some are handled by correspondence. In those cases the Service asks for documentation to support a particular item on your tax return, such as charitable contributions. Or, the Service may contact you and arrange an appointment for an agent to come to your home, place of business, or your tax advisor's office. You will be asked to have available substantiation of certain expenses that were deducted on your tax return.

The Service has begun focusing on the questions of whether business profits or losses claimed on your tax return are active or passive.

Passive losses result from business activities in which you don't materially participate. Generally, passive losses are not deductible unless certain requirements are satisfied.

Rental activities are automatically treated as passive, regardless of whether or not you participate. Therefore, rental losses generally are not deductible unless you have passive income. There are exceptions based on the amount of the losses, the size of your adjusted gross income, or whether you qualify as a real estate professional.

Under all of the material participation tests, the IRS will require you to establish how you participated and the amount of time you spent doing so. If you fail to substantiate your material participation, you will lose the right to deduct the loss.

Another approach is the Service's matching program. For many years, the Service's matching program was limited to sampling Form 1099's (information returns) submitted by third parties to locate omitted income. This was done on a test basis because the Service did not have the personnel to check all of the 3rd party information. Now, the Service has started to match amounts on partnership K-1's with amounts reported by taxpayers on their income tax returns. This could uncover a large amount of unreported income. However, it is difficult to match items reported on K-1's with tax returns. This will result in unnecessary correspondence.

The Service also feels that there is substantial underreporting of taxable income from sales of

securities. Brokers have been required to report securities sold by each taxpayer, showing the dates and sales price. In order to generate additional taxable income, the General Accounting Office (GAO) has recommended to Congress that brokers be required to report to the IRS the date of acquisition and the adjusted basis of the securities that were sold in addition to the proceeds. While an effort in this area could generate substantial revenue, the difficulties in implementing a program of this nature are almost incomprehensible.

Whatever changes occur, the message is clear - everyone should exercise greater care in reporting their income and deductions.

FIGHTING THE IRS IS AN OPTION

If the disputed amount is large enough to justify the cost and effort and you have a sound position, you can appeal the Service's initial position. The Government Accounting Office (GAO) estimates that over 40% of the cases heard by the IRS Appeals Office in 2004 resulted in partial or complete victory for the taxpayers. One reason that Appeals officers overrule the decisions of their fellow employees is that Appeals officers have more experience and with that experience often comes better judgment. Also, Appeals officers are often able to look at the issues in a more objective manner.

If you lose your case in Appeals, your only recourse is to go to court. Going to court is a very expensive process which should not be undertaken unless you feel that you have an excellent case and the amount involved is very large.

ESTATE TAX REPEAL FAILS AGAIN

Earlier this year, the House of Representatives passed a bill repealing the estate tax. The bill failed to pass in the Senate, receiving three votes less than the 60 needed. The

Administration's efforts to repeal the estate tax have been led by Senator Jon Kyl (R. Ariz.) Last week, House Ways and Means Committee Chairman William M. Thomas offered a compromise estate tax reform bill which was passed by the House of Representatives. The Senate will vote on the bill this week. While Republicans outnumber Democrats in the Senate, they may not have the 60 votes needed for passage.

Congressman Thomas' bill, which was passed by the House, is very much like Senator Kyl's compromise bill. The House bill exempts the first five million dollars of a taxpayer's estate or 10 million dollars per couple. The exemption is presently two million dollars per taxpayer or four million dollars per couple. The tax rate would be decreased to the long-term capital gains rate, currently 15%, on the first 25 million dollars. The bill provides for a carryover of unused estate tax exemption from one spouse to another. For example, if the first spouse died and only used two million dollars of estate tax exemption, the surviving spouse could use eight million dollars of estate tax exemption. The income tax basis step-up for inherited assets would remain in effect.

Congressional tax experts estimate that if the changes become law, only 5,100 estates would be subject to estate tax when the changes are fully in effect in the fiscal year beginning October 1, 2011. The Internal Revenue Service levied taxes on more than 30,000 estates in 2004. The proposal, if passed, would cost the government approximately 275 billion dollars over the next 10 years.

FLORIDA INTANGIBLES TAX

The Florida legislature has reduced the intangibles tax in the past. For years many have predicted that the tax will be eliminated altogether. It appears that this prediction is coming true. The Florida legislature has approved a bill to repeal the tax as of January 1st

next year and Governor Bush plans to sign it into law. The Florida intangibles tax affects many of our clients who are residents of Florida. It is assessed on investments such as stocks and most bonds. While the amounts collected are not large, the tax is an annoyance and its repeal will be applauded by many of our readers.

MUTUAL FUND INVESTORS TO EXPERIENCE A TAX INCREASE

Income realized by mutual fund investors usually takes the form of capital gain and ordinary income distributions. For the past several years, the distributable capital gains have been small because the fund managers have been able to offset current capital gains with losses incurred during the bear market of 2001 and 2002. Unfortunately, the supply of old losses has been exhausted. This tax impact could be avoided if taxpayers are able to structure their investments so that tax-exempt entities such as IRA's or 401(k)'s own the mutual fund investments. If this is not possible, try to avoid purchasing a mutual fund which is scheduled to make a large distribution. This normally occurs towards the end of the year.

TAX INCREASE PREVENTION AND RECONCILIATION ACT OF 2005

The Tax Increase Prevention and Reconciliation Act of 2005 (the Act) was approved by Congress and signed into law by President Bush last month. Overall the Act is taxpayer friendly. The main provisions of the Act are as follows:

■ **Alternative Minimum Tax**

The Act increases the alternative minimum tax (AMT) exemption for individual taxpayers only for 2006. The increase in the exemption is from \$58,000 to \$62,550 for married taxpayers and from \$40,250 to \$42,500 for single taxpayers. However, the exemption phase-out remains unchanged at

25% of the excess of AMT income over \$150,000 for married filers and \$112,500 for single filers. Taxpayers will also be able to use nonrefundable personal tax credits (i.e. the dependent care credit, the credit for the elderly and disabled and the Hope/Lifetime credits) to offset their AMT liability.

■ **Dividends and Capital Gains**

The 15% tax rate for dividends and long-term capital gains was scheduled to expire at the end of 2008. The Act extends the lower tax rates for capital gains and dividends through December 31, 2010.

■ **Immediate Write-Off of Fixed Assets**

The Act increases the amount of costs for qualifying fixed assets that a business can immediately expense. In 2006, a business taxpayer could directly expense up to \$108,000 of qualifying fixed asset additions as long as total fixed asset additions did not exceed \$430,000. These amounts continue to be indexed for inflation for years beginning before 2010.

■ **Roth IRA Conversions**

The Act does away with the \$100,000 AGI limitation for converting traditional IRAs to Roth IRAs effective after 2009. The Act does not extend this conversion option to include 401(k) plans. (However, it may be possible to convert a traditional IRA that has received proceeds from a 401(k) plan to a Roth IRA.)

■ **Kiddie Tax**

One of the most negative aspects of the Act is on investment income such as interest and dividends received by minor children. Under the Act, the Kiddie Tax will apply to children under the age of 18 (previously, it applied to children under 14) with the related income taxed at the parents'

marginal tax rates for net investment income over \$1,700. This change further restricts the ability of a parent or grandparent to transfer income producing investments and have the income taxed at a lower rate. This change is effective immediately for the entire year 2006.

■ **Expatriates**

Under the Act, expatriates (U.S. citizens and green card holders living abroad) will most likely be allowed a smaller foreign housing exclusion. In addition, any earned income received that is not covered by the foreign income exclusion will now be taxed at the higher rates that would be in effect had the exclusion not been available. The U.S. is one of only a handful of countries that taxes its citizens' income regardless of where they reside. This change effectively increases their tax.

■ **Reporting Tax-Exempt Interest**

The new law requires that tax-exempt interest be reported on a Form 1099. Although tax-exempt interest generally is not taxable on your federal return, it affects certain tax computations. Generally tax-exempt interest is taxable on your state income tax return.

If you have any questions about these provisions or any provisions of the new law, please contact us.

CONGRATULATIONS - SCOTT

Congratulations to Scott Sattler on his recent promotion to manager. Scott divides his time between the audit department and the tax department. It's rare today to be able to play well on both sides of the ball. We all wish him many more years of continued success at Shepard Schwartz & Harris.

IRS Circular 230 Notice: Any tax advice contained herein is not intended to be used and cannot be used by the recipient for the purpose of avoiding penalties that may be imposed by law.