



MARTIN WERBELOW LP
CERTIFIED PUBLIC ACCOUNTANTS
300 NORTH LAKE AVENUE, SUITE 930
PASADENA, CALIFORNIA 91101
TEL: (626) 577-1440 FAX: (626) 577-1082

Planning Alert *June 2007*

Closing the Tax Gap – The “tax gap” is the difference between what the IRS estimates it is owed compared to what it actually collects and during hearings held in May, the Senate Finance Committee did not hear the answers they were hoping for on “how to reduce the tax gap.” During his testimony, Treasury Secretary Henry Paulson estimated the 2001 tax gap to be \$345 billion mainly due to underreporting of income by self-employed individuals with self-employment tax liabilities and suggested that Congress should focus its efforts to reduce the gap by approving the entire IRS budget request for the next fiscal year and working to reduce the complexity of the tax code. Mr. Paulson felt that a major portion of the tax gap was unreachable “without adding draconian and painful requirements on all taxpayers.” Congress has previously raised several proposals to close the tax gap including making reporting to the IRS more extensive, increased withholding, and giving the IRS more power. It is perceived that these proposals would be difficult to implement and would also create bad policy and increased compliance nightmares for taxpayers. The current compliance rate among taxpayers is 84% while the goal of the IRS is get to 90% within the next 10 years which would result in an increase of \$180 billion collected per year. Stay tuned!

The End of the Internal Revenue Code? – The thought has likely crossed every taxpayers mind over their tax paying years – “*Life would be so much easier if we could get rid of the Tax Code!*” Well, now that once unthinkable thought has worked its way into Congress. Earlier this year, legislation was introduced by Senator Isakson (Georgia) to terminate the Internal Revenue Code of 1986. Senator Isakson likened the actions of Congress over the last 20 years in tweaking the Tax Code as treating the symptoms rather than treating the cause and referred to the Internal Revenue Code as a 6-pound weight, the burden of which “is equal to that or more of an 800-pound gorilla on the backs of American business and American families.” Being joined by some of his fellow Senators, Senator Isakson recommended the introduction of Tax Code Simplification legislation to finally address the “800 pound gorilla.” Although very dramatic in his presentation, the legislation actually calls upon Congress to create a tax review commission that would analyze all alternatives for revenue for the United States, including consumption taxes, sales taxes, flat taxes, income taxes, productivity taxes, and fees, among others. The commission would report back to Congress on July 4, 2010 at which point Congress could then debate the issues and make some better and more informed decisions than they have in the past. Sen. Isakson sees this as a more logical process in having educated people sit down for a prolonged period of time, analyze what is right for the United States, and then make recommendations to Congress. He believes this process will have the best chances of resulting in simplicity, fairness, and equity for all Americans. We’ll just have to wait and see what develops.

AMT Relief on Incentive Stock Options – Individuals who have had income from the exercise of incentive stock options (ISO) in the past have come to learn that alternative minimum tax (AMT) is an ugly monster that rears its head without warning. Although the exercise of ISO’s have favorable regular tax consequences, it does create an AMT liability due to the excess of the fair market value of the stock at exercise date over the exercise price. The AMT is typically the price paid by a taxpayer to achieve the benefits of an ISO plan, but the AMT liability creates an AMT credit at the same time

that taxpayers can carry forward and use in the future when they dispose of this same stock. In a perfect world, over time the AMT credit would completely offset the AMT liability initially incurred, however there have been very few taxpayers that have discovered this perfect world. An often overlooked aspect of the AMT credit is that it can only be applied against a taxpayer's regular tax to the extent that it exceeds the tentative minimum tax in that year. In addition, use of the AMT credit is reduced if the stock drops in value and is sold after exercise. This creates other limitations which could result in unused AMT credits hanging around with no place to go. However, the Tax Relief and Health Care Act of 2006 put in place some little-noticed provisions to help provide some relief to taxpayers with these "long-term unused minimum tax credits." These new provisions apply to tax years beginning after December 20, 2006 (and through 2012) and allow a portion of the minimum tax credit to be applied against a taxpayer's entire regular tax liability and can be refundable. The AMT refundable credit amount is normally going to be the greater of \$5,000 or 20% of the unused minimum tax credit (with phase-outs for higher income taxpayers). With this new law, Congress has provided some new tax planning opportunities for taxpayers with unused AMT credits hanging around that we'll be on the lookout for as we discuss tax planning strategies throughout the year.

Vacation Homes – “No” on 1031 Treatment – In early June, the U.S. Tax Court issued a Memorandum decision ruling that like-kind exchange treatment will be denied on vacation homes not strictly held for investment purposes. In the ruling, the Tax Court referred to a Georgia couple's exchange of vacation homes under Section 1031 of the tax code. The Tax Court's reasoning was that even if motivated in part by an expectation that the property will appreciate in value, it is insufficient to justify the classification as being held for investment and impossible to escape the residential status of the property simply by moving out. The court stated that the evidence was clear that the taxpayer's primary purpose for acquiring and holding both properties was to enjoy the use of them as vacation homes. In light of this ruling, it is clear that the tax-deferred provisions of Section 1031 for investment properties of any kind are on the IRS radar screen. If you have any questions or need assistance regarding a potential 1031 exchange, please contact one of our experienced tax professionals for help.