Inside Highlights

"...Socialism is not the least what it pretends to be. It is not the pioneer of a better and finer world, but the spoiler of what thousands of years of civilization have created. It does not build; it destroys. For destruction is the essence of it. It produces nothing, it only consumes what the social order based on private ownership in the means of production has created."

— Ludwig von Mises, Socialism: An Economic and Sociological Analysis (1922)

Tax and Financial Strategies

Issue #61 Late Fall 2016—Early Winter 2017

Wealth Creation Strategies

Charitable Donation Planning in Light of Future Tax Law

Charitable giving in what could be the last high tax-rate year

After this rather unusual whirlwind of an election, the future of tax law is anyone's guess. We have an idea that most will see their marginal rates cut, likely for tax year 2017, but we can't be certain until a bill is signed. However, for those subject to higher marginal tax rates this year than they expect to be in future years (for whatever reason, including the possibility that your income could decline in future years), 2016 could be the last best year in which to accelerate your charitable donations into this year. But before you open your wallet or ransack your closet, there are several considerations and caveats to help you decide on the optimal strategy for *you*.

1. If you don't itemize deductions, an increase in charitable donations until total deductions exceed the standard deduction won't save a dime in taxes. If you itemize, the tax you save could be dramatically more or less from what you "think" due to countless hidden tax brackets. E-mail us to help calculate the savings from additional charitable donations (we'll need estimated expected full-year income and deductions by category, as well as the additional contributions you wish to make and an idea of expected future substantive changes to your overall financial situation).
2. Your tax is calculated by subtracting two key items from Adjusted Gross Income (AGI). One, $4,050 (inflation-indexed) for each personal exemption (for you, your spouse and generally any dependents for whom you provide more than half their support). Two, the greater of your itemized deductions (which include qualifying medical expenses, state and local income or sales taxes, property taxes, charitable donations, personal and investment casualty losses, employee business expenses, investment expenses and a few other more esoteric items*), *or* a standard deduction based on filing status. For 2016, the standard deduction is $6,300 for single filers, $9,300 for those qualifying for "head of household" filing status and $12,600 for married filers (with an additional deduction for those 65 years and over of $1,250 for each married filer and $1,550 for single filers). *These amounts could double (or more) under Republican proposals, increasing the odds you won't itemize deductions in future years*. If your total actual deductions usually equal the standard deduction, plus or minus a few thousand dollars, and if your deductions generally include a few thousand dollars of charitable donations, tax year 2016 (or 2017 in the unlikely event tax reduction is delayed to 2018) could be the last (and ideal) year in which to accelerate the next several years of donations by "bunching" them all into this year.** (Regardless of whether the standard deduction is increased, this "bunching" strategy can result in thousands of dollars of tax savings in every two- or three-year period.)
3. If you want to "bunch" your charitable donations (as discussed in item 2 above), normally (or you plan to) donate large amounts ($5,000 or more), are in a high marginal tax bracket and don't want the donees to receive your largesse all at once, or you want to take some time to decide which charities are worthy of your hard-earned cash, we have the perfect strategy for you: a "donor-advised fund" (DAF). While this gets you an immediate tax deduction, it allows you to defer donations to your "real" donees to future years. When you contribute to a DAF, your money goes into a separate account, which in turn makes donations to your preferred charities at your direction.

"Donor-advised funds" (DAFs)

If, in the last few weeks of the year, you can't decide on amounts to donate to specific charities or don't want your favorite charities to receive so much at one time, you can make a donation to any one of thousands of "donor-advised funds." DAFs are accounts established by sponsoring organizations (ranging from stock brokers to the free-market oriented "Donors Trust"), which pool and manage the investments (ranging from cash to stocks and everything in between) you choose inside the DAF. Sponsors do the recordkeeping, tax receipting and

administration for you. After funds are contributed, the DAF makes distributions to charities based on your direction (while they aren't legally required to follow your directions, there are no known instances of a sponsor refusing to do so for those selecting legitimate 501(c)(3) charitable organizations). The original donation to the DAF is deductible in the year made; the DAF can make distributions in later years (but you don't get a second deduction). There is a big caveat, though: if you don't give directions to the fund sponsor, your money could be donated to a charity of the sponsor's choosing (even if you don't like that charity). And, if you don't direct your funds to charities promptly, fees can diminish the value of your donations (0.6% per year of average assets, for example, if Fidelity Investments manages your DAF). On the other hand, the fees could be dwarfed by the growth of a well-managed fund.

Fidelity's and Schwab's DAFs allow contributions of as little as $5,000 (the lowest minimum available). Both allow distributions ("grants") from the DAF to the charities of your choice in increments as small as $50. (By comparison, Vanguard's minimum DAF is $25,000 and minimum grants are $500. Pershing, the clearing firm for many brokers, requires a minimum $10,000 contribution to its DAF and appears to have no minimum individual grant, but requires total donations of 1% or more of DAF assets each year.) Most brokers allow transfers to DAFs they control of securities held inside their brokerage accounts, as well as physical stock certificates and cash donations, as late as December 31. (Fidelity's deadline is December 2 for transfers of securities held outside Fidelity accounts; other brokers likely have a similar deadline.)

The DAF and donations of appreciated stock

The best bang for the buck in tax law is the donation of appreciated assets held more than one year ("long-term"). This works whether the donation is to a DAF, or directly to a charity (which can be cumbersome). Either way, both you and the DAF/charity win big.

Say you have $20,000 in stock that cost $2,000 (you bought an Apple- or a Priceline-like stock at the right time). You can either sell the stock and donate the net after-tax proceeds, or donate the appreciated stock. With a sale, you'll pay tax, at long-term capital gains rates, of 0%, 15%, 18.8%, 20% or 23.8% (or any number of other possible hidden tax rates), plus a possible Alternative Minimum Tax (AMT) of as much as 7.5%, plus state income tax. If your total tax cost on a gain is 25% (we've seen "real" rates as high as 38% on large gains for those in the upper tax brackets; 22-25% is common for middle-income taxpayers and 30-35% is common for upper middle-income taxpayers with modest gains), your $20,000 donation is reduced by $4,500 of tax—leaving only $15,500 for the charity.

You then donate the net after-tax proceeds of $15,500 and save tax at your marginal tax rate (assuming your itemized deductions exceed the standard deduction before the charitable donation is added in). Let's say that's 40% (33% federal plus 7% state—obviously not California), which yields a $6,200 tax savings. So, you paid $4,500 and then saved $6,200, for an overall net tax savings of $1,700. Your cost of doing it this way, then, is ($20,000 - $1,700 =) $18,300. And your charity got only $15,500.

If you instead don't sell, but donate the stock directly to a charity or DAF, both you and the charity/DAF win. The charity/DAF gets a donation of a $20,000 stock certificate, which it can immediately sell at zero tax cost (because it will use the proceeds for charitable purposes); you get the full tax deduction of $20,000. In this example, that's worth (at your 40% marginal tax bracket) $8,000. And, since you paid no tax on the gain, your net cost of donating the stock is only ($20,000 - $8,000 =) $12,000. So in this example, your net tax savings are ($18,300 - $12,000 =) $6,300 more by gifting the stock directly vs. by selling the stock and then gifting the net proceeds. (And there may be additional tax savings, such as avoiding Medicare premium surcharges, created by keeping your AGI lower.)

What?! You pay no tax on the capital gain if you donate the appreciated stock?! Yup! None.*** The only fly in the ointment is something you'll likely never experience: donations of appreciated assets held long term ("capital gain property") are limited to a total deduction of 30% of AGI rather than 50% of AGI, as they are with donations of money. Either way, any unused portion can be carried over for up to five years (after which unused donation deductions are forever lost).

In the past, logistical challenges could prevent divvying up small donations of securities among a number of different charities. For example, if you've got a stock worth $80 per share and you want to donate $200 to a particular charity, you'd have to give them 2.5 shares. Trying to separate out a donation like that is cumbersome enough without contemplating donations to a dozen different charities. The DAF solves this issue: you donate all the stock to the DAF and they help to break it up into many small donations. For example, you donate 100 shares worth $8,000 (or 250 shares worth $20,000) to your DAF and from there you direct the sponsor of the DAF to distribute (make "grants" of) $200 to one charity, $2,000 to another, $500 to yet another and so on. Alternatively, you may want the DAF to hold the stock or sell and buy other stock, until you're ready to make grants in future years. If they grow (not in these markets for much longer, IMHO, but it's nice to know the options), even larger donations could be made later (the fact that the account could grow in value doesn't help you, but it's great for the charities).

There's a lot to consider about year-end donations and the possible use of a DAF with very limited time remaining this year. If you think this could be right for you, please talk to us right away so we can advise you.

For those who wish additional reading material, please see the links on the online version of our client letter at www.dougthorburn.com.

* Note that before they even begin to "count," qualifying medical expenses must exceed either (depending on age) a 7.5%- or 10%-of-AGI threshold, personal casual-

ty losses must exceed 10% of AGI plus $100 and most other ("miscellaneous") deductions must exceed 2% of AGI.

** And, possibly, other deductions as well. But be very careful: someone in a high tax bracket who accelerates state income and property taxes into 2016 but who is subject to the Alternative Minimum Tax (AMT) may get zero tax benefit by paying such expenses in 2016. If the AMT is eliminated or narrowed in scope, you could get a large tax benefit by paying these in 2017. Alternatively, those in a high tax bracket this year who are not subject to the AMT will benefit by an acceleration of deductions. This is an incredibly complex area of tax law; please consult with us if you think this may apply.

*** Because a charitable donation deduction is limited to the cost of capital gain property when you have a loss, you *never* want to donate a stock in which you have an unrealized loss (you haven't yet sold it). Instead, you sell the stock, deduct the loss (up to $3,000 per year with any excess carried forward indefinitely) and then donate the cash.

New Deadlines and Penalties for Filing Partnership Returns, Corporate Returns, 1099s and W-2s

Draco-like penalties for late filers

New deadlines for filing partnership, corporate and FinCen returns (foreign bank and financial accounts reports, formerly "FBARs") were discussed in issue # 58 of *WCS*. The penalties for late filing of such returns bear repeating: a failure to file timely S corporation and partnership returns are subject to penalties of $195 per month (or fraction of a month for those mid-month due dates) per shareholder/partner, applicable for up to 12 months. S corporation or partnerships with two shareholders/partners could, then, be hit with as much as $4,680 in penalties for failure to file timely returns that furnish only information, albeit usually (but not always) more information than 1099s and W-2s (which, as we will see, are subject to much lower penalties). Late filers of FinCen returns can still get hammered with $10,000 penalties, even though they are only information returns. These foreign financial asset reports are filed with the Financial Crimes Enforcement Network (that's the "FinCen") in Detroit, suggesting how the government views those with such assets and income.

New filing deadlines and penalties for 1099s and W-2s

The deadline for mailing W-2s and 1099s to recipients has been January 31, but the Social Security Administration and IRS mailing deadline was February 28 (which gave us time to make corrections before sending copies to the government). Now, in yet another attempt to prevent fraudulent claims of withholding on early-filed tax returns, the IRS wants to be able to more quickly match reported income and withholding on tax returns to actual W-2s and non-employee compensation payments (from box 7 on Form 1099-MISC). We can understand the rush to match W-2s, but since 1099s issued to non-employees rarely include tax withholding this requirement is unlikely to help anyone other than the government in Congress's unrelenting quest to collect yet more penalties from hapless entrepreneurs and rental property owners. Regardless of what we think, these forms must now be sent by January 31 to both recipients and the SSA (W-2s) or IRS (1099s).

Starting several years ago, all tax returns contain a clause confirming that all required 1099s have been filed. 1099-MISC forms are required for all payments of $600 or more per payee made to service providers in the course of operating a business or rental property. They are not required if you paid a payee less than $600 during the year, or if the payee is taxed as a corporation (with the exception of a legal or medical corporation, for which 1099s are required). They are also not required if payments were made by credit card, or for the purchase of goods subject to sales tax laws.

The penalties for failure to timely file information returns vary by their lateness. If filed within 30 days of the due date, the penalties total $100 per late-filed 1099 or W-2 ($50 for failure to furnish a copy to the recipient and $50 for failure to file timely with the appropriate governmental authority). If the returns are filed after that time but by August 1, the penalty is $200 per 1099 or W-2. If filed after August 1, the penalties total $520 per 1099 or W-2. These were increased from a much more modest $60/$120/$200 pre-2016 regime and have been ratcheted up from $10 for any degree of lateness as recently as recently as a few decades ago.

Because the timely filing of 1099 information returns is so crucial to penalty avoidance and penalties are potentially so large, we encourage clients to (1) obtain a completed, signed and dated Form W-9 from all service providers ***BEFORE*** making a payment of *any* amount in the course of operating your business or rental property, (2) keep a copy in a safe place (regardless of whether you issue a 1099) and (3) provide us with the information to file required 1099s in late December/early January each year. You can obtain the latest Form W-9 by simply searching for "Form W-9" on the web. Retaining a signed and dated Form W-9 from every person or entity you paid in the course of business or rental operations during the year is also important to prove when you don't need to issue a 1099.

There are two possible pieces of evidence required to prove you don't need to issue a 1099 to a service provider if otherwise required to file one: (1) a completed and signed Form W-9 with the "S Corporation," "C Corporation," or the second "LLC" box checked with the appropriate corporate business classification noted, or (2) the official business name contains an "unambiguous expression of corporate status" (such as "Inc." or "P.C.," which means "Professional Corporation") in the name, and you wrote the check to that business name. You are required to issue 1099s to any legal or medical firm to which you pay $600 or more during a calendar year, regardless of entity type. Also, having an FEIN

(Federal Employer Identification Number) rather than a Social Security number for a payee does not necessarily exclude you from 1099 filing; it depends on the type of business and how it is taxed.

Except for the aforementioned legal and medical firms, you can avoid having to file 1099s by paying only corporations or LLCs taxed as corporations to provide services. However, doing so limits the market of those you may wish to hire, and there are plenty of excellent providers who are not incorporated.

As an aside, you can request an extension to file Forms 1099 for up to 30 days. This must be requested by January 31, and due to tax season we'll need your requests by January 15.

The Statute of Limitations for Proving Income and Deductions in Audit Can Be Extended for Decades

The statute of limitations for proving income and deductions via receipts, mileage logs, bank/credit card statements and the like is commonly believed to be three years from the due date of a timely filed tax return, including extensions. Even four years, which most state statutes of limitations extend to, can be wrong for a myriad of reasons.

In our piece entitled, "Spring Cleaning: Just How Long Should You Keep Those Records?" in issue # 47 of *WCS* we suggested keeping absolute proof (receipts) of most non-capital deductions for at least four years after the due date of a timely filed tax return, with tangential proof (credit card and bank statements) forever.

However, four years isn't long enough for certain items required to be reported on tax returns. Consider a stock or mutual fund, or depreciable assets such as rental property or a business-use vehicle, sold years or decades after purchase. For capital items (usually "improvements" on one's home, or items required to be depreciated for a rental property or business), proof of all purchase costs and improvements must be kept for at least four years after the year of the sale or, in the case of an exchange (including business auto "trade-ins"), four years after the final sale of the last property or other business asset. For taxpayers with decades of traded-in business autos, this means keeping records of every car until the final vehicle is sold, as the final profit or loss is determined by the entire series of transactions. Without the entire history, any remaining undepreciated cost or other basis claimed could be disallowed in audit. We can even imagine a scenario in which proof of odometer readings and business-use mileage from the purchase of the original business-use vehicle forward might be required. Such a disallowance could involve thousands of tax dollars.

Some unusual but profitable tax strategies may require records going back years. One such strategy includes Roth IRA withdrawals; keeping the records means that you don't pay unnecessary tax and penalties on "basis," or tax on the profits which, if rules are adhered to, are tax-free. The Health Savings Account (HSA) strategy discussed in issue # 59 of *WCS* (in which a withdrawal is taken years after spending HSA funds on qualifying medical expenses) requires keeping the records proving not only the expenses but also that the expenses weren't deducted on a prior-year tax return.

Most auditors won't go this far, but some can be difficult. The IRS has the authority to require detailed proof going back decades if it's "relevant" (in their opinion) for the year under audit. This is especially true in Taxpayer Compliance Measurement Program (TCMP) audits, now referred to as the National Research Program (NRP), which involve a line-by-line review of randomly-selected tax returns for "research" purposes. The IRS can require receipted proof for every single number that appears on such returns.

From bad to worse: capital losses, net operating losses and late-filed returns

Another common issue requiring long-term record retention is the capital loss carryover from the sale of land held for investment, stocks and other securities. Taxpayers are limited to deducting capital losses against capital gains plus up to an additional $3,000 per year, whether single or married (making this one of 25 or so marriage penalties on the books). For example, a $60,000 capital loss with no subsequent gains would take ($60,000/$3,000 per year =) 20 years to fully deduct. We've got a number of clients carrying over large capital losses from the last market meltdown in 2008, including several with over $100,000+ losses. Should they live that long, some could be deducting the last of losses 34 years from now; many more might be deducting losses over the coming decades that will be created in the next crash. Because you are slowly deducting a capital loss that occurred in a prior year, the IRS could require you to prove both the loss and carryovers. Records must be kept until four years after the last of such losses are deducted, possibly decades after the original sale.

While not as common (but they do occur, especially during recessions and for those starting new businesses), business losses can create a special tax category of losses called "net operating losses" (NOLs). These can be carried forward to future tax years, reducing taxable income on future returns. For example, in year one you have a business loss of $50,000 (and we've seen much worse). You roughly break even over the next four years—but in year six you have a profit of $145,000. The $50,000 carryover loss may offset $50,000 of that $145,000 profit, reducing AGI to $95,000. Assuming you are married, after another $20,000 in personal exemptions and a joint standard deduction (assuming you stayed married through those lean years), taxable income is reduced to just $75,000, all of which is taxed at lower rates. That $50,000 NOL carryover saved $12,500 of income tax in year six; without the carryover loss to offset the profit, the $50,000 "chunk" of income would otherwise have been subjected to a 25%

marginal rate. If you file the return in year six and you're audited in year eight (and it could be as late as October 15 of year ten if you extended the filing of the return in year six), the auditor can require receipts proving the loss that occurred in year one. Yikes!

A recent Tax Court case highlights this problem. In *Ghafouri v. Comm., TC Memo 2016-6* (the sixth written memorandum of the Court in 2016), Mr. Ghafouri deducted an NOL carryover on his 2011 return that was incurred in 2008. Because he could produce only the tax returns showing the NOL carryforward consistently carried forward but not the receipts proving the original loss that occurred in 2008, the court ruled the NOL was not deductible in 2011. Not only did Mr. Ghafouri lose money in operating his business (no minimum wage for entrepreneurs!), but he also "wasted" zero tax rate brackets to the extent of personal exemptions and either the standard or itemized deductions (he'll never receive a tax benefit for those deductions). Anyone with an NOL carryover must keep detailed proof of the original loss(es) for at least four years from the due date (or filing date if later) of the last return deducting those losses.

There are two other relatively common instances of having to prove deductions incurred more than four years prior. One: because statutes of limitation don't begin to run until returns are filed, you could be required to prove deductions for unfiled or late-filed returns years or decades after their original due dates. Two: if audited and you find an error in the government's determination to your benefit within two years of the audit but more than three years after the return was filed, you'll need proof of the deductions the government improperly disallowed.

From worse to a horror show: undisclosed foreign accounts and a failure to file forms you've never heard of

Another instance of an extended statute of limitations includes an understatement of income of more than $5,000 from foreign financial accounts; these may include Internet gambling accounts, sales of assets from safe deposit boxes located in foreign countries, as well as other financial assets the IRS has yet to name. Others include "gross" understatements of income (foreign and domestic) or gross overstatements of your tax cost ("adjusted basis") of assets sold. The statute for audit in these cases is six years. "Gross" is defined as an understatement of gross income of more than 25% or an overstatement of the adjusted basis of an asset sold that has the effect of understating income by more than 25%. For example: you sell property for $500,000 and you claim basis of $180,000 rather than the correct basis of $100,000. If the $80,000 reduction in income is greater than 25% of your total income (i.e., your AGI is less than $320,000), the time limit for an audit is increased to six years. However, if "fraud" is involved (cases in which the government can prove intent, which does not include the "Hillary" defense), regardless of dollar amount, the statute ***never expires***. That puts tax fraud on par with murder, giving an idea of how seriously the government takes challenges to its revenue authority. Even rape and other violent crimes have statutes of limitations that eventually run out, if only because memories can get hazy and evidence can disappear.

The statute of limitations also doesn't begin to run on returns omitting foreign income or assets, even if there is no change to tax. These include a failure to file the standalone "FinCEN" (formerly FBAR) foreign bank and financial accounts reports (required if foreign financial assets exceed $10,000 at *any* time during the year), as well as Form 8938, a report of foreign financial assets, which is required when such assets reach either $50,000 on the last day of the tax year or $75,000 at *any* time during the year ($100,000 and $150,000 for joint filers). Another is a failure to file Form 3520, used to report assets held in foreign "trusts," as well as distributions from such trusts, and gifts or inheritances of cash or non-cash assets in excess of $100,000 from foreign nationals or entities. Form 5471 reports ownership of even a small part of a privately-held foreign corporation; the failure to file *or even to complete the form accurately* can result in $10,000 penalties, even if no tax is due. Failure to file any of these forms, even if inadvertent, tolls* the statute of limitations until filed.

The Founders would be aghast that rules like these are on the books, much less that we put up with them. However, we must deal with reality and do everything possible to not run afoul of these draconian edicts.

* Tolling is a legal doctrine that pauses or delays the running of the period of time set forth by a statute of limitations. So, the statute of limitations doesn't even begin to run until the proper return or form is filed.

Rental Property Owners: Planning for Major Renovations Can Save Serious Tax Dollars—or Not!

Those who don't think lawmakers and IRS regulation writers could make tax law even more complex are naive. New law and regulations on repairs vs. improvements and depreciation periods for business and rental properties are a classic case in point: they are mind-boggling. However, many of the new rules can work to the taxpayers' advantage. We can't begin to explain them, as there are too many variations on multiple themes, but we can give you some examples. Calling us to consult on prospective major repairs or improvements could make the difference between an immediate tax deduction versus being forced to depreciate the expense for a residential rental property over a period as long as 27.5 years (39 years for commercial property). If you already did anything substantial this year, please give us the details ***now***, while we have time to do any necessary research that would support

a shorter depreciation period or even an immediate deduction.

1. Adding on a room must generally be depreciated over 27.5 or 39 years ("a long time"). However, there are a few circumstances under which you can immediately deduct a new room.
2. Adding a spa/Jacuzzi must usually be depreciated over 15 years, but in a few circumstances you can deduct it.
3. The same is true for adding on a garage.
4. Air conditioning systems must be depreciated over "a long time." However, depending on various factors, they may be depreciated over 15 years—with half deducted this year—or deducted in full. Alternatively, the undepreciated cost of an old air conditioner system, which came with the building purchase, may be written off in the year a new HVAC system is purchased (but you can't take a deduction for both).
5. You might be able to deduct the cost of new flooring—or you might not (and the alternative is that "a long time" depreciation). The same is true for new windows. It depends on how much/how many you replaced as a percentage of what is replaceable (but the IRS has given no exact percentage).
6. A new roof could be deductible, or not, depending on which part of the roof is actually replaced. The roof membrane (shingles, etc.) can be deducted if none of the wooden structural support was replaced; if the latter was replaced, the entire cost of both must be depreciated. (Unless the roof gets blown away or suffers serious termite or fire damage, we can't think of many circumstances in which you'd have to repair or replace the structural support.) Note the roof rules have nothing to do with the percentage of shingles replaced.
7. If you knew asbestos had to be removed when the building was purchased, the cost of removal must be depreciated over "a long time." If you didn't know about it and it's at least three years after purchase, the cost can be immediately deducted. The rules for other environmental hazards are different and more stringent.
8. Moving interior walls may generally be deducted—but if any are structural load-bearing walls, they must be depreciated over "a long time."
9. Replacing electrical wiring is usually not currently deductible, but if you replace somewhat less than half of it, the cost might be deductible.
10. A kitchen or bathroom remodel could be fully deductible—or it might not be, depending on how long you've owned the building.

You can see how confusing this can be. Be sure to call us before (not after!) any major expenditures you are contemplating that are not obvious repairs, as there is major tax planning to be done.

As an aside, improvements for public safety such as structural improvements for earthquakes, hurricanes and tornados must be depreciated over "a long time." This is true even if local authorities require that improvements be made. This is poor public policy.

Bitcoin Users Beware

The IRS recently sent a "John Doe" request to Coinbase, the largest Bitcoin (and other) virtual currency wallet company in the United States, seeking disclosure of all Coinbase users' names and other information—all five million—who opened digital currency accounts during 2013-2015, in an attempt to find those who made transactions that might be taxable. The IRS's concerns over taxpayers using virtual currencies to evade income tax follows on the heels of a report from the Treasury Inspector General for Tax Administration (TIGTA) that found the IRS should be doing more to ensure taxpayers aren't using virtual currencies like Bitcoin to evade taxes. As we mentioned in issue # 55 of *WCS*, Bitcoin is not treated like cash, but rather as a financial asset like stocks or collectibles. Because of this, every sale of Bitcoin, *which includes purchases of goods and services using Bitcoin* creates a taxable gain or loss (when goods or services are purchased using any cryptocurrency, you are deemed to have "sold" that currency in exchange for the goods or services). As alluded to in issue # 55, this creates enormously complex tax reporting.

Remember, the crackdown on those holding foreign financial accounts began on an even smaller scale, with just one Swiss bank: UBS AG. This expanded to other Swiss banks and then to banks around the world. As Forbes' columnist Robert Wood puts it in a December 8, 2016 article at www.forbes.com, "Coinbase may be the tip of the iceberg, too….Just about everything is income to the IRS. If you suspect you might need to clean up past tax filings, or just want to fly right in the future, don't wait….If you fear that you may be at risk of a criminal investigation, you may want to consider [hiring a tax attorney now, in order to establish attorney-client privilege with your tax-pro]." One comment by the Senior Revenue Agent, David Utzke, who filed the John Doe case, should send shivers down the spines of anyone who has failed to report the sale of a cryptocurrency: "[I am] assigned to investigate tax non-compliance connected with the use of virtual currencies….Although [my Offshore Compliance Initiatives] program typically involves abusive offshore transactions and financial arrangements, the virtual currency issues I have been working on are not limited to offshore activities." He explained that *all Bitcoin users are by nature suspect*, because cryptocurrency transactions do not require third parties, including Coinbase, to report them to the government.

Anyone using or selling Bitcoin or other cryptocurrencies who hasn't properly reported such transactions (whether or not held via Coinbase) should read the two best overall reviews we've found on the subject, (the links are available online at dougthorburn.com), and, if appropriate, consult with a tax attorney immediately.

Health Care Cops are Now College & Trade School Tuition Cops Too

Refundable tax credits are available to low income Americans regardless of tax liability; even if the tax is zero, a payment is given to the filer. Because refundable credits are so easy to create out of thin air and the credits can be so big, tax administrators and fraud detectors have their hands full.* For decades, the Earned Income Tax Credit (EITC), which allows tax "refunds" of as much as $6,000, has been used heavily by fraudsters, who create fake work-related income or kids to get an illegal payment. For example, if work-related income is $5,000 the EITC can be as much as (depending on number of children) about $2,000; if such income is $14,000 to $17,000, the EITC increases to about $6,000 (with no income tax due at either level of income). An estimated 27% of EITC claims are, according to the Treasury Inspector General for Tax Administration (TIGTA), fraudulent. Several years ago, the level of fraud prompted the IRS to require preparers to police those who claim the EITC and impose large penalties on both filers and preparers who improperly claim an EITC.

There are similar problems with two additional refundable credits: the Child Tax Credit (CTC), which can create a refundable credit of up to $1,000 per child, and the American Opportunity Credit (AOC), which offers a refundable tax credit of up to $1,000 (and up to a $1,500 "non-refundable" credit) per child paying post-K-12 accredited college or trade school tuition and classroom-required books, supplies/materials and equipment (BSME). As a result, the IRS has now conscripted tax professionals as cops to police these two credits in a much more stringent way than previously, for tax year 2016 and forward. Preparers are now required to scrutinize copies of receipts (something previously only required of auditors) for tuition payments *and* classroom-required BSME if net tuition (after grants/scholarships) was less than $4,000 per student during the year, *and* to keep such copies for three years. It's a valuable credit: it's dollar-for-dollar up to the first $2,000 spent and a 25% credit up to the next $2,000, for a total maximum credit per dependent student of ($2,000 plus 25% of the next $2,000 =) $2,500. 40% of the total credit is refundable, up to a maximum of ($2,500 x .4 =) $1,000. (The other $1,500 is non-refundable and can be used only to offset a tax liability.) Therefore, we will need copies of both tuition payment receipts and, to the extent tuition was less than $4,000 per year, copies of receipts for classroom-required BSME, in addition to Form 1098-T (which you may have to access online). Please fit receipts to as few pages as possible and DO NOT send originals! Due to huge (new) preparer penalties ($510 per incident), we cannot take a credit without those receipts.

In the case of the refundable Child Tax Credit, we'll be developing a questionnaire similar to the one we currently use for the EITC, asking questions such as, "does your child exist" and "are you including all of your income but not overstating it?" As with the EITC, the CTC is also very easy to manipulate: a parent with two children whose income is $5,000 gets a refundable CTC of $300, but if income is inflated to $17,000 the CTC increases to at least $2,000. Because preparer penalties are huge for the CTC (another $510), we have to ask extra questions here, too (and yes, fees will reflect this extra work and risk on our part).

* In a related action, the IRS will not process *any* tax returns in which even $1 of a refund includes refundable credits (Earned Income Tax Credit, American Opportunity Credit or Child Tax Credit) until February 15, which means refunds including such credits will not be received until at least March. The law precludes the IRS from issuing refunds of the portion of a refund unrelated to a refundable credit. *Please* don't let this deter you from getting your information to us as early as possible, however; if you are eligible for a refundable credit, we can get everything ready for e-filing so yours will be among the first.

Corporate Income Tax Reduction, with a Little History

Behind the United Arab Emirates and Chad, and tied with Puerto Rico, the United States has the third highest corporate tax rate in the world. The rate is 16% higher than the world-wide average. Reading between the lines in issue # 60 of *WCS*, if overall societal wealth is to be maximized (including the wealth of low-income Americans), it's clear the corporate tax should be abolished. Greater investment in capital in the long-run increases everyone's wealth and retained earnings by corporations comprise the greatest source of capital formation.

The corporate tax itself is an accident of history. John Steele Gordon in "Top 10 Reasons to Abolish the Corporate Income Tax" writes in *The Wall Street Journal* (December 30, 2014):

> "In 1909 President William Howard Taft, a Republican, called for a constitutional amendment to establish a personal income tax and, meanwhile, persuaded Congress to pass a tax on corporate profits as part of the Payne-Aldrich Tariff Act. Technically…there was no constitutional impediment to [a corporate income tax]…."

The original intent was to use a tax on corporate income only until the 16th Amendment to the Constitution (creating the personal income tax) could be ratified, which occurred four years later. Unfortunately, government doesn't typically repeal revenue sources, so the corporate tax was retained. The interplay of the two taxes has been one of main causes of complexity in our tax system, helping to create an army of lobbyists and tax professionals to do their best to minimize the effects of what was likely the first instance of double-taxation (corporations pay a tax on net income which, when distributed to shareholders as dividends, is taxed yet again). It's also one of the main obstructions to

the creation of wealth, since corporate managers not only devote tremendous resources to lobbying and tax avoidance strategies, but also a large fraction of net income goes to government rather than increasing investment, production and job creation in the far more productive private sector.

With this in mind, the economy will benefit greatly if and when corporate income tax rates are slashed from their current 35% to 15%. Since corporate income is taxed again when some of the leftovers are paid as dividends or, due to perceived company value in the form of realized capital gains, it shouldn't surprise us to see the current tax-favored treatment of dividends and capital gains at the individual level become less tax-favored, which is a possible outcome that a number of our clients in low brackets receiving substantial dividends might wish to plan for.

A Personal Note

Many of you know I stumbled into the tax field because of my respect for property rights: I believe wholeheartedly that what you earn should be yours to keep and do with as you will, so long as it doesn't interfere with someone else's rights to their property. I realized the libertarian in me would make a great tax pro; after all, who better to help you keep what is yours than someone who believes what you earn *is* yours? (I elaborated on this in issue # 41 of *WCS*, "An Outside-the-Box Thinker Gets into the Tax Business.") But I'm also a pragmatist and acknowledge the power of government: I've devoted my life to working *within* the system (so long as there is still some semblance of freedom), using the rules wherever possible to benefit our clients. My respect for government power has also kept us from straying outside those rules to keep you out of trouble. (Back in the day of the "tax protestor" movement of the early 1990s, I even wrote a piece vilifying tax protestors who view themselves as libertarians who, because they don't acknowledge the power of government, can hardly be described as such.)

The recent Presidential election, however, stretched my patience. I'll be frank: if the "true believer" Bernie had won, or the pathological lying Hillary had won *and* taken both houses of Congress with her, I'd have "gone Galt" * (and many fellow libertarians would have joined me). That's not to say I'm thrilled with Trump (I'm the proud owner of the only "Rand[Paul] 4PR" license plate in California); he is no free-market thinker, not to mention rude, crude and lacking a decent vocabulary. However, a number of his advisers and cabinet *are* free-market proponents (contradicting his delusional views on foreign trade and jawboning business). Additionally, a number of libertarian-leaning Republicans in Congress will push free-market parts of his agenda. In my mind (and I understand those who may disagree), despite the contradictions (and they are numerous), his election has re-instilled some measure of hope for the possibility of an economically freer United States. Partly because of my unique niche in long-term tax strategy planning, this makes my work as a tax pro continue to be fun and puts the idea of "going Galt" on hold, hopefully forever.

However, it's possible Trump's advisers and Congress will simplify the tax system. It won't go nearly as far as it should from a libertarian perspective (which would shift entirely to a consumption-based tax, dramatically reduce the size and powers of government and, for the good of wealth creation, put tax pros out of business), but to the extent taxes are simplified our business "could" shrink. Those with businesses and rental properties will always need our services, but employees taking the standard deduction may not *think* they need us. And, while some *may* not, our unique approach to taxes, from "bunching" deductions and "income smoothing" and decision making as to which and what kind of retirement plan is optimal for your particular situation and circumstances, to when to start taking Social Security and other retirement income, will keep us busy. These tax planning and retirement income decisions are best made by those with the experience to weigh costs and benefits as a function of marginal tax rates, age and current assets held inside retirement plans, as well as other assets and expected retirement income.

I enjoy the work and the camaraderie with friends and clients, many of whom I've known for decades. I realize, however, things don't last forever; so, I've been grooming a much younger Kristin Ericson, E.A., to eventually take over. I hired her with precisely that in mind: within thirty minutes into our first interview over five years ago, I had sized her up as INTP (google Myers-Briggs or Keirseyan Temperament to understand what this means) and made her a job offer on the spot (and of course as a "P" I knew she would have to think about it for a few days). Tax pros often work well into their 80s (and I've known a few who worked into their 90s), but she'll take over more functions as I take more personal time and devote myself more to the aspects of the business I enjoy most, including writing and researching. Regardless of how long the transition takes and so long as we've got clearer heads in Washington, DC and I remain in good health, you'll always be in great hands. And, I'll likely fully retire, if ever, after most of you.

* "Going Galt" is in reference to Ayn Rand's hero John Galt in *Atlas Shrugged*. It's the story of builders of industry, innovators and investors, weary of the fleecing by non-producers, "shrugging off" the parasitical state and stopping the motor of the world by opting out of working for others by keeping their ideas, sweat equity and brilliance to themselves. Until this election, I hadn't been so close to "going Galt" since August 15, 1971, when a Republican president took us off what remained of a real money standard, gold, and imposed wage and price controls. Whatever you've heard about Rand's work is likely wrong: *Atlas Shrugged* is the greatest story ever told pitting market entrepreneurs, who earn their way by satisfying the Consumer King, against political entrepreneurs, who steal their way by gaining favors from politicians. If we continue along the same path as that of the last 100 years, *Atlas Shrugged* may be in our future. (If you'd like to see what society looks like in *Atlas Shrugged*, look at Venezuela today.)