

October 25, 2006

TAX REPORT

Panel Plans Ways To Narrow Tax Gap

Proposals May Raise Levies
For Investors, Homeowners
And Family-Held Firms

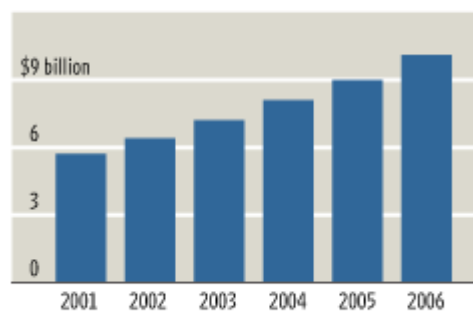
 By **ROB WELLS**
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Congress, in a perpetual hunt to raise revenue without appearing to raise taxes, has a new list of ways to fatten the federal Treasury.

One proposal would force brokers to track historical price-basis information on stock sales, which could mean a stiffer capital-gains hit for investors who, intentionally or not, misstate the original purchase price. Another proposal would tighten the interest deduction for some mortgage refinancings. Still another would remove a key tax advantage for many family-owned businesses.

Closing a Loophole

Estimated tax revenue lost due to an employment tax loophole for sole proprietors and single-shareholder S corporations.



Source: Treasury Inspector General for Tax Administration


The proposals, released to little fanfare last week by Congress's Joint Committee on Taxation, are viable options for lawmakers looking to offset the cost of future tax cuts, tax experts say. The nonpartisan joint committee estimates the revenue costs of tax measures and is an influential behind-the-scenes player in tax bills.

This list of revenue-boosting options was produced at the request of Senate Finance Committee Chairman Charles Grassley (R., Iowa) and Sen. Max Baucus (D., Mont.), who asked the joint committee to pinpoint ways to close the estimated \$290 billion tax gap, a measure of uncollected taxes.

Tax experts believe closing the gap will remain a significant goal of Congress regardless of which party prevails in next month's elections. "Over the long term, a number of the options will get looked at pretty hard because we will need revenues," says C. Clinton Stretch, partner at Deloitte & Touche LLP in Washington.

Brokerage firms are nervous about a recommendation to force brokers to report to the Internal Revenue Service the adjusted basis of publicly-traded securities sold during the preceding taxable year. Adjusted basis measures the original cost of a security for tax purposes.

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While brokers foresee major record-keeping problems, many investors could end up paying higher taxes because the new records could document significant capital gains. The IRS estimates that underreporting of all capital gains resulted in \$11 billion in uncollected taxes in 2001.

Some tax experts predict problems tracking records with older stock portfolios, inherited securities or portfolios recently transferred to a new firm. They urge that the requirement be applied to future stock transactions instead.

Ken Busey, a partner at PricewaterhouseCoopers LLP in Washington, says brokerage firms might report a basis figure to the IRS in conflict with a taxpayer's records, he says. Still, Sens. Grassley and Baucus have been examining a bill to require such basis reporting. Sen. Evan Bayh (D., Ind.) introduced a basis reporting bill earlier this year.

IRS taxpayer advocate Nina Olson made a similar recommendation in 2005. "For taxpayers, tracking basis can be extraordinarily complex and many taxpayers seeking to comply with the law find that they simply cannot do so with accuracy, leaving them exposed if audited," Ms. Olson wrote then.

The report also seeks to clear up confusion over timing of a homeowner's interest deduction when they refinance their home. Mortgage interest generally is deductible but there are important qualifications. Points paid on a refinancing generally must be claimed on a prorated basis over the life of the loan. Interest can be deducted on home-equity loans of as much as \$100,000. The joint committee said homeowners are confused about mortgage-deduction rules, suggesting some are claiming more generous deductions. The committee is urging clearer details about these limits and timing restrictions for taxpayers.

The scope of erroneous mortgage deductions isn't clear. But since taxpayers are expected to deduct \$69.4 billion in interest on homes in 2006, even low levels of avoidance "would involve significant dollar amounts," the report said. And many of such interest-deduction errors likely occurred during the recent mortgage-refinancing boom, says Bill Smith, national tax office director at CBIZ Inc., a Cleveland consulting firm. "I think the vast majority of people out there have no idea there are limits on deductibility on mortgage interest," he says.

The report proposes a significant tax-law change for law firms and family-owned personal-service firms, which may face new self-employment tax obligations. Typically, an executive in a "subchapter S corporation," used by many family businesses, takes a salary and distributes the remaining profit in a dividend that isn't subject to self-employment taxes, Mr. Smith says. The report suggests a new uniform rule to have these entities covered by the same self-employment tax regime as partnerships or sole proprietors.

Not having a uniform rule is a sizable problem: \$39 billion of the tax gap was attributable to the self-employment tax and an estimated \$15 billion of the tax gap attributable to unemployment taxes. Yet Mr. Smith says in his experience, most people using an S corporation don't pay themselves "ridiculously low" salaries and take the rest in a tax-advantaged dividend distribution.

* * *

SOME 39 MILLION TAXPAYERS became ineligible this year for free electronic filing due to new income limits.

The IRS "Free File Alliance," launched in 2003, directs taxpayers from the agency's Web page to free taxfiling services of private-sector tax preparers such as H&R Block.

The firms restricted their free services in 2006 to taxpayers earning \$50,000 or less. This limit arose after some tax preparers complained competing firms had lifted all income caps in a bid to boost market share. Some companies threatened to drop out of the alliance unless the IRS agreed to an income limit, negotiated in October 2005.

As a result, Treasury's Inspector General for Tax Administration or TIGTA, said the income limit cut program participation by 23%. It also made 39 million people ineligible for free tax filing and pointed to another problem: Only 38% of taxpayers with incomes less than \$25,000 have access to the Internet, TIGTA said.

"Free File Alliance" had nearly four million participants in 2006, down from five million in 2005.

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BRIEFS: IRS announces a \$15,500 limit for 401(k) contributions in 2007, up from \$15,000 the prior year, thanks to a cost-of-living boost...U.S. Attorney General Alberto Gonzales last week praised the Justice Department's pursuit of tax crooks, citing 250 injunctions against tax-fraud promoters since 2001.

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