

O'MALLEY NEWS & VIEWS

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In This Issue...

In Washington Watch, Chuck discusses the latest chapter in the debt and deficit crisis, the why's and wherefores of the latest developments and what may evolve in the future. Below are some thoughts on year end tax planning and the introduction of a new staff person.

Year End Tax Planning...

The tax rules and rates are the same this year (2011) and next year (2012) as they were in 2010. The usual year end tax tactics of accelerating or delaying income and/or deductions will work in either year depending on your individual requirements. Too much income, too high a tax bracket, then accelerate deductions to reduce taxable income. If your income is low this year, but expected to be higher next year, possibly you should delay some deductions until next year. Please call us if you have a specific question and/or wish to review your current tax situation.

Introducing...

In early September Elyse D. Robinson joined our firm. The pleasant new voice on our phone belongs to Elyse. In December, she will complete her college studies in accounting and taxation at Rider University and plans to pursue a masters program and then become a Certified Public Accountant. Elyse assists all of us at O'Malley & O'Malley, LLP so your phone message and/or request will be delivered to the proper person.

Washington Watch ■

On deficit reduction and/or revenue increases, Congress has failed again!

The Super Committee comprised of six Republicans and six Democrats, from both the House and the Senate, like the rest of Congress, was unable to find common ground for any agreement. Their assignment was to find \$1.2 trillion in a combination of spending cuts and increased revenue over the next ten years. However, unless you are like some of those running for the presidential nomination, who neither read nor listen to the news, you already knew that. What follows may be new information.

One of the reported reasons why the Super Committee was unable to reach an agreement was a Republican members' suggestion of a tax revenue increase by way of eliminating the mortgage interest deduction on vacation homes in exchange for reducing the top tax rates of 33% and 35% to a maximum of 28%. Taxable joint household income (not total adjusted gross income) must exceed \$212,300 to be taxed at rates above 28%. Taxpayers do not have to be wealthy or in the 33% or 35% tax bracket to have a vacation home mortgage.

A mortgaged vacation home is not necessarily an estate. Many times it is a small condo, or a larger house shared with other family members such as a parent and adult children or brothers and sisters or even good friends who have pooled their resources to have a taste of the American Dream. They could not have acquired a vacation home without a mortgage. Even at 25% or lower, the tax deduction is a big help in being able to afford a vacation home. Sometimes the vacation home is a camping trailer, a motorhome or even a small boat which has sleeping, cooking, and bathroom accommodations. These all qualify per the Internal Revenue Service rules. Just like primary housing, many vacation properties have lost their value in the current market place. Any restrictions on the vacation mortgage interest deduction could further reduce the value of vacation properties and also reduce the demand for related consumer products.

\$1.2 trillion is a lot of money until you realize that it is only 8% of the total \$15.1 trillion debt that America owes, which being paid back over ten years is only eight-tenths of 1% per year. To put this in a loan amount that most of us can understand, it is equivalent to paying \$80 a year on a \$10,000 credit card balance. Even at 0% interest it would take 125 years to pay off the \$10,000 balance. Even the earlier alleged "Grand Bargain" of \$4 trillion over ten years was only 2½% a year or 37½ years to pay off at 0% interest. Obviously, neither of these ideas are good money management nor sound fiscal policy, but \$4 trillion would still have been better than \$1.2 trillion. The \$15.1 trillion debt is approximately equal to

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by Charles K. O'Malley, CPA, CFP

America's Gross Domestic Product (total country's income) but about 6½ times the government's annual revenue. At some point in our lives most of us have had a home mortgage that exceeded our annual income, but generally personal debt is not 6½ times a person's annual income.

This is the monumental size of the problem that Congress and the President have been and will continue to wrestle over. The solution will not be easy. It will require massive cuts in expensive programs and yes, increased revenue in the form of new taxes. This is the challenge that our country is facing now and will continue to struggle with in the future.

However, there are some who believe that this failure by the Super Committee will actually create a better solution. The 74 page Budget Control Act of 2011 that created the Super Committee had an automatic provision for \$1.2 trillion in cuts over the next ten years. Starting January 1, 2013, the cuts will be split, approximately half in defense and half in discretionary spending, but Social Security and Medicare benefits are exempt. Additionally, the Bush tax cuts are scheduled for expiration at the end of 2012. The combination of these spending cuts and revenue increases will yield a total of \$4.5 trillion over a ten year period or 3% a year. Even at a 0% interest rate it would still require 30 years to pay off the full \$15.1 trillion, but as of now this is the best possible solution.

Lowering America's debt is important and it has been a focal point of the Tea (Taxed Enough Already) Party, but their unwillingness to accept any revenue increases, supported by Grover Norquist's Americans for Tax Reform "No New Tax Pledge", has prevented any negotiated compromises. We all want government services and benefits, but nobody wants to pay for them. David Gergen, an adviser to four former presidents (Nixon, Ford, Reagan and Clinton) and currently a political analyst, professor and Director of the Center for Public Leadership at the Harvard Kennedy School of Government recently commented:

"...Republicans complain that federal spending under President Obama has gone up dramatically and cuts should come there, before any new taxes... Democrat say that the rich have increased their wealth much more rapidly than the other 99% of Americans, while their taxes have gone down, so that the first order of business is to raise taxes on them...., Both sides have valid points, worthy of debate. But such contentious disagreements have characterized our politics since the dawn of the republic, and in almost all crises of the past, political leaders have worked out compromises..."

As Thomas Jefferson put it in 1790, "...In general I think it's necessary to give as well as take in a government like ours...",
George Washington agreed and pushed continually for what he called, "...a spirit of accommodation..."

Our "leaders" of today, however, have tossed aside the wisdom of the Founders..."

Some of our political leaders are so confused about history that they don't even know the sequence of events, or even the location, because they are too busy trying to re-write history to fit their needs and/or the occasion.

The national debt at the end of the Clinton administration was \$4.2 trillion, at the end of the Bush administration it was \$10.6 trillion and as of December 2, 2011 it was \$15.1 trillion. President Obama has threatened to veto any attempt to undo the automatic cuts that are scheduled to go into effect on January 1, 2013 due to the Super Committee's inability to find a compromise in spending cuts and revenue increases. Only time will tell if Congress will try to pass laws to circumvent the automatic cuts and/or consider any revenue (tax) increases and if the President will keep his promised veto threat.

All indicators are that debt reductions and/or tax increases will become a 2012 election year issue.

Recently, there has been an "Occupy Movement". It is an international protest which is primarily directed against economic and social inequality. It began on September 17, 2011 on Wall Street in New York City and on the same date in San Francisco. Surprisingly, as of November 26, 2011 "Occupy Together" had listed 2,668 occupied communities in over 95 cities and 82 countries, worldwide. The movement's slogan is "We are the 99%". Unlike the Tea Party, most politicians have been hesitant to embrace the "Occupy Movement". Some feel that it looks more like a resurgence of the 1960's hippies or Vietnam War protesters, mainly because of the participants' clothing and appearance. Others question if this is the beginning of a French Revolution style uprising against the upper class or a taxpayers' revolt.

Why is this happening?

Higher long term unemployment (8.6% as of December 2nd), an increasing poverty rate (15.1% in 2010, 20%+ among children), a decline in the middle class real income and a disproportionate transfer of wealth since 1986, when then President Ronald Reagan succeeded in getting the top tax rate of 50% lowered to 28%. Prior to 1964, the top tax rate was 90% and between 1964 and 1981 it was 70%. During the 1990's it went up to 39.6%, but the Bush tax cuts of 2001 and 2003 lowered it back to 35%.

Our more mature clients (born prior to 1940) remember the sacrifices that were made during World War II. In addition to a military draft, there were all kinds of shortages. Food rationing, women could not buy nylon stockings, there were air raid practices with night time blackouts and new car production ceased between late 1941 and late 1945 because all of the factories were producing military machinery. People bought war bonds to help finance the government and the top tax rate was 90%. 100% of the country (men, women, children, and even politicians), were all contributing to the war effort. While not as severe, the same was true in the 1950's during the Korean War. The two wars that have followed "Nine-Eleven" have not required either the sacrifices or the taxation that was experienced by non-military families during the 1940's and 1950's. The years that followed World War II helped create the strong middle class in America, which many now believe is in a decline. These may be some of the economic and social inequality reasons behind the "Occupy Movement".

Who are the 99%?

Gross Income (Not Taxable Income)	Number of Households	Percent of Population
up to \$25,000	31,995,000	28%
\$25,000 to \$50,000	30,211,000	27%
\$50,000 to \$75,000	20,752,000	18%
\$75,000 to \$100,000	12,428,000	11%
\$100,000 to \$150,000	12,000,000	10%
\$150,000 to \$200,000	3,600,000	3%
\$200,000 to \$250,000	1,300,000	2%

The national median household income is approximately \$44,400 a year and less than 23% of the 99% are college graduates. 32.7% of households, "The Working Poor", make less than \$30,000 a year. They normally have 7.65% withheld from their pay for Social Security and Medicare tax (for 2011 it was reduced to 5.65%, the President wants this extended for 2012) and they generally pay very little (if any) in income tax.

Who are the 1%?

In 1986, it only required an annual gross household income of \$232,600, by 2007 (the top year) it required \$424,400, but by 2009 the entry level had declined to \$344,000. However the average 1% has \$960,000 in gross yearly household income. They included 1.4 million households, mostly college graduates, who earned 17% of the nation's income (\$1.3 trillion) and paid approximately 37% of the collected income tax.

For more than a year, Patriotic Millionaires for Fiscal Strength, have been begging Congress to be fiscally responsible and raise their taxes. On November 16, 2011, a letter signed by 148 of them supported the 99% and stated:

"...Republican counterparts on the Super Committee and in Congress continue to ignore the realities of failed economic policies. They care more about their pledge to Norquist than their pledge to the United States Constitution..."

Back in November 2010, a small business owner from Lincoln, Nebraska (a member of Business for Shared Prosperity) said:

"...a fellow businessman once told me, 'Give me more customers and I'll be forced to buy equipment and hire people to meet demand. Give me a tax break without more customers and I'll just go to Aruba'..."

Warren Buffet has frequently stated "...raise my taxes..." After a lot of debating in the news, Buffet revealed in October 2011 that his adjusted gross income for 2010 was \$62,855,038, but after deductions (mostly charitable contributions and local taxes), his taxable income was only \$39,814,784, which produced a total federal tax of \$6,923,495 or 17.4% of his taxable income (due mainly to capital gains and qualified dividends) and only 11% of his adjusted gross income. It is now understandable why Buffet has repeatedly said "...his tax rate is lower than his secretary's..." (See the **Tax Note** below). He has also repeatedly stated that "...trickle-down economics (supply side) is not working..." Trickle-up economics is full employment with everyone making money.

**These millionaires and billionaires are the job creators,
but there are apparently others who do not agree with them.**

Tax Note: All workers pay 1.45% (self employed 2.9%) on their total earnings for Medicare tax plus 6.2% (4.2% in 2011) on up to \$106,800 of their earnings for Social Security tax (self employed 12.4%; 10.4% in 2011). In 2012, the wage limit will be \$110,100. Medicare tax and Social Security tax are only on workers earnings and are in addition to income tax. Thus, the higher the income, the more of it that comes from capital gains and qualified dividends, the lower the percentage of total income tax.

Since the Winter 2011 Edition of *O'Malley News & Views*, Washington Watch has discussed the numerous facts and figures on America's debt and deficit with detailed information on what is causing it and debt comparisons to other major countries. America is not the only country with debt that equals or exceeds GDP. (USA 103%; Australia 106%; Italy 152%; Germany 194%; Greece 208%; Spain 214%; Portugal 252%; France 255% and England/UK 471% debt to GDP ratio, note how many European countries have a higher ratio.) In our Summer 2011 Edition of Washington Watch I continued the detailed analysis, including a summary of the Budget Control Act of 2011. I also raised the question of how much is the value of the government's assets? There does not appear to be a published balance sheet that lists the total dollar value of America's asset holdings, only the debt is listed. Is it possible that the asset value of government owned land, national parks, mineral deposits, buildings, highways, bridges, and other infrastructure items, plus the vast amount of military assets far exceeds the debt?

Generally, when banks lend money there are two important questions that must be answered. Is there enough market value in the pledged assets (security for the loan) to pay off the loan in the event of a default and does the borrower have sufficient income to repay the loan? These two questions should be asked of every country. American's annual revenue (income) is insufficient, thus the debt keeps increasing, but what about the asset (loan security) value, does it exceed the debt? Because revenue increases may eventually happen, we previously provided multiple income and tax comparison tables showing various taxation levels for the last year of the Clinton tax rates (2000) vs. the extended Bush tax cuts experienced in 2010. The extended Bush tax cuts are scheduled to be in effect for 2011 and 2012, but will expire on December 31, 2012, unless there is a bipartisan agreement to extend part or all of the Bush tax cuts. All of the prior *O'Malley News & Views*, Washington Watch and the taxation comparison tables are available on our website at:

www.omalley.com/resources

Christmas is on Sunday this year, so Congress may have an extra day or two to perform their year end two-minute drill. Extending expiring temporary tax provisions (including the 2011 two percent Social Security tax reduction) is still on their to-do list and could be done retroactively in early 2012. You need to make your Senators and House of Representatives members aware of your opinions and positions on all of these issues. Unless you are deaf and blind, everyday you hear and see special interest groups political advertisements supporting their cause. These same special interest groups, their corporate sponsors and the K-Street lobbyists regularly call on your Congressional Representatives. You need to do the same. Go to your elected Senators and Representatives website, click on contact and use their website e-mail to let them know your position on all of the issues.