

TAX NEWS

Fall 2007

TAX CLIENT NEWSLETTER

The Fall 2007 Tax Client Newsletter brings you current with a number of important tax law provisions that have already expired or are scheduled to disappear at the end of 2007 which may significantly impact your tax bill for this year.

One of the most popular tax breaks set to disappear at the end of 2007 involves state and local sales taxes. If you itemize your deductions, you have the option of deducting your state and local sales taxes instead of your state and local income taxes. This provision benefits many people and more than 11.4 million taxpayers claimed this sales-tax deduction for 2005.

Older taxpayers can take advantage of a charitable giving provision which is set to expire on December 31, 2007. If you are age 70 ½ or older you can transfer up to \$100,000 directly from an individual retirement account, IRA, to a qualified charity without having to pay income tax on the distribution. This transfer counts toward your required minimum distribution as well as assists you with estate planning.

For 2007 but set to expire on December 31, 2007 is the deduction for mortgage insurance. It does not apply to mortgage-insurance contracts issued before 2007 and it begins to phase out once your adjusted gross income exceeds \$100,000 or \$50,000 for married people filing separately.

Deductions for high education tuition and fees and a credit for certain energy efficient home improvements are also set to expire this year. The tuition deduction is taken as an adjustment to income not requiring taxpayers to itemize their deductions to claim.

At the end of 2007 the \$250 per educator for the cost of books, computer equipment and other classroom supplies they pay out of their own pockets is an adjustment

to income for elementary and secondary school teachers and other qualified educators. More than 3.5 million taxpayers took this deduction for 2005. To be eligible, you must be a kindergarten through grade 12 teacher, instructor, counselor, principal or aide for at least 900 hours during a school year.

The alternative minimum tax or AMT is the largest single issue facing taxpayers in 2007. If Congress does nothing to alter the AMT, about 25 million taxpayers will be affected by it for 2007, up from about four million for 2006, according to the latest U. S. Department of the Treasury estimates. The AMT is a separate method of calculating income taxes, with different rules than the regular tax system. Higher AMT exemption amounts expired at the end of last year. While it is anticipated that Congress will take some action to prevent the AMT from spreading rapidly, it is not clear how lawmakers will accomplish this goal. In the recent past, Congress has passed temporary fixes to the AMT which is widely expected to reoccur this year.

It is advisable to review your investment portfolio, focusing on stocks, bonds or mutual fund shares that are selling for less than you originally paid for them or for the basis you have in the investment. If you have been thinking of disposing of the investment, before the end of the year may be the perfect tax time.

Capital losses on the sales of such investments can offset realized capital gains. If your losses exceed your gains, or you did not have any gains for 2007, you can deduct as much as \$3,000 a year from your wages and other ordinary income. The limit is \$1,500 for married couples filing separately. Any unused loss can be carried forward into future years to be used.

You will want to watch for transactions called "wash sales" which typically happens when you sell a security at a loss and, within 30 days before or after the sale, you buy the same thing or something "substantially identical." If you discover you did participate in a wash sale, you cannot deduct your loss. However, the disallowed loss on the transaction is added to the cost of the newly acquired security and the result is an increase in the basis of the new security.

Much tax savings can be obtained by fully participating in retirement plans available from your employer such as a 401(k) or 403(b) plan. Check with the human resources department where you work to see if you are participating at the maximum level and certainly to the extent the employer will match your contributions.

Business owners can shelter profits from their business in a qualified retirement plan. Sole proprietors can create 401(k) plans and contribute to their retirement while obtaining substantial retirement savings. The maximum annual 401(k) plan contribution through a salary reduction is limited for 2007 to \$15,500. If you are age 50 or older by the end of the year, an additional \$5,000 "catch up" contribution is allowed. However, if you work for an employer who provides participation in a 401(k) and you are also self-employed, the overall elective contribution cannot exceed the annual limit.

If you participate in a 401(k) plan through your employment and you also have a profitable business from self-employment you can use a Simplified Employee Pension plan account, SEP, to shelter business income.

Seniors who continue to have earnings after age 70 ½ can contribute to a Roth IRA. You would be required to have a modified

adjusted gross income below \$156,000 on a married filing joint tax return or \$99,000 for single taxpayers in order to make a full contribution of \$4,000. The \$4,000 could be supplemented by an additional \$1,000 as a "catch up" contribution.

Self-employed individuals who do not have medical coverage through an employer or under a spouse's policy can deduct insurance premium costs as an adjustment to gross income. They are not required to itemize their deductions on their tax return. The definition of insurance includes supplemental cancer policies and long-term care insurance subject to age limitations.

Individuals who are not self-employed must itemize their deductions in order to claim medical expenses. These medical expenses are deductible only to the extent they exceed 7.5 percent of your adjusted gross income.

For charitable contributions made on or after January 1, 2007 a donor may not claim a deduction for any contribution of cash, a check or other monetary gift unless the donor maintains a record of the contribution in the form of either a bank record, such as a cancelled check, or a written communication from the charity, such as a receipt or a letter, showing the name of the charity, the date of the contribution, and the amount of the contribution.

The written acknowledgement required to substantiate a charitable contribution of \$250 or more must contain the following information:

- Name of the organization;
- Amount of cash contribution;
- Description (but not value) of non-cash contribution;
- Statement that no goods or services were provided by the organization, if that is the case;
- Description and good faith estimate of the value of goods or services, if any, that organization provided in return for the contribution; and
- Statement that goods or services, if any, that the organization provided in return for the contribution consisted entirely of intangible religious benefits, if that was the case.

One of the more problematic tax issues arises when a taxpayer endeavors to be in business and the business is not profitable. The question that immediately surfaces is whether the loss created was done with a

profit motive or was the activity engaged in as a hobby.

Hobby income is reported as "other income" on the taxpayer's personal income tax return. Hobby related expenses are limited to the amount of hobby income and are claimed as a miscellaneous itemized deduction, deductible only by the amount exceeding 2 percent of the taxpayer's adjusted gross income.

The Internal Revenue Service supported by court decisions have developed various factors used to determine whether an activity is a hobby or a business. Some of these factors include:

1. Does the time and effort put into the activity indicate an intention to make a profit? The activity must be conducted in a business-like manner meaning having a written business plan, good books and records, and a separate business bank account and credit card.
2. Does the taxpayer depend on income from the activity?
3. If there are losses, are they due to circumstances beyond the taxpayer's control or did they occur in the start-up phase of the business?
4. Has the taxpayer changed methods of operation to improve profitability?
5. Does the taxpayer or his/her advisers have the knowledge needed to carry on the activity as a successful business?
6. Has the taxpayer made a profit in similar activities in the past?
7. Does the activity make a profit in some years?
8. Can the taxpayer expect to make a profit in the future from the appreciation of assets used in the activity?

It is normally believed that an activity is carried on for profit if it is profitable in three of the last five years, extended to two of the last seven years in the case of horse breeding, showing, training or racing activities.

Another common issue during tax filing season is the eligibility of a home office for a deduction, converting nondeductible personal expenses such as home-owner dues, insurance, utilities, etc., into deductible business expenses.

Qualifying for a home office deduction requires the owner to meet two tests. First, the home office must be the principal

place of business for the activity. It is not a requirement that the activity be full-time. A home office is determined to be a principal place of business if it is used for substantial managerial or administrative purposes such as scheduling appointments, ordering supplies and keeping records. There can be no other fixed location for such activities.

Second, the space used must be used regularly and exclusively for the activity. You are not required to dedicate a full room to the activity but the space allotted cannot be used for personal purposes. In 2007, the United States Tax Court did hold that keeping some personal papers in a home office will not void the exclusive use test.

An office in the home deduction cannot exceed the gross income derived from the home-based activity. Any unused losses can be carried forward until used.

Claiming a home office deduction does not eliminate the home sale exclusion of income for a homeowner when the home is eventually sold. Depreciation claimed after May 6, 1997 must be recaptured at 25 percent at the time of the sale of the home.

Will the deduction of a home office cause the Internal Revenue Service to audit the tax return? While there is no statistical evidence to support such conclusions taxpayers should be aware of the requirements to claim an office in home deduction and document the use of such home office. In doing so, the taxpayer may want to discuss insurance coverage with their home owner's carrier. The taxpayer will want to make certain coverage is sufficient to obtain the insurance liability of the office in the home.

While Congress has several tax acts under consideration, none have been passed at this time. As your tax professional, I assure you that I will be keeping a watchful eye on legislation which may affect your tax filings.

If you have concerns or questions about your taxes, our focus should be on how the tax law changes affect you, how the tax law changes can benefit you and what tax planning techniques should be implemented in order to maximize their tax benefit to you.

Thank you for reviewing the Fall 2007 Tax Client Newsletter and for the opportunity and privilege of allowing me to serve as your tax professional.