



TAX NEWS & TIPS

FALL 2007

Tax Surprises In Iraq Spending Bill

On May 25, the President signed the an Iraq war-funding bill. Look closely. Congress couldn't resist tacking on a few tax provisions.

NEW Kiddie Tax To Age 24. One year ago, the "kiddie tax" was extended from age 14 to age 18. In 2008, it will affect students up to age 24!

The "Kiddie Tax" Idea. To catch parents who move income into a child's lower bracket, there's a special rule. A youngster with investment income over \$1,700 is taxed at the higher of the tax rate of the child or the parent. Income from a job is not affected.

In the year the youngster reaches age 18, the rule does not apply. Few families can afford to sock away enough money to generate this much investment income for a youngster. But, for those who *can* afford it, this rule is a big problem.

Target 2008. Here's the latest plan to collect extra tax from middle and high-income families. Next year brings the lowest capital gains rates in history. We currently have five tax "brackets". Find your taxable income, and use these rates:

	Txbl. Inc. Up To	Tax Rate
Singles	\$ 7,825	10%
	\$31,850	15%
	over \$31,850	25% & up
Couples	\$15,650	10%
	\$63,700	15%
	over \$63,700	25% & up

Long-term capital gains get lower rates. The lower rates also apply to dividends of domestic corporations. This type of income acts as if it "floats" at the top of the taxable income pile. Any capital gain income falling in 25% or higher

brackets is taxed at 15%. Long-term capital gain falling in the normal 10% or 15% brackets is taxed at 5%. Sound good? Wait until next year! For 2008, 2009 and 2010 the rate on that 10% or 15% layer drops from 5% to ZERO! Not one penny of tax!

Trap! More "Kiddies" Next Year. Families who can afford to save for college banked on using that 0% tax rate for help. Transfer stocks to the youngster. Let the youngster sell to pay college costs – with no loss to income tax. Congress has shot down this plan. For 2008 and on, dependents between age 19 and 23 who are full-time students will be considered "kiddies". Their long-term gains will be taxed at the higher tax rates of the parents. The only way to avoid the rule is to show the youngster has enough W-2 income to cover more than half his/her support costs. Not likely.

NEW Expensing Business Equipment. A business normally must depreciate equipment. Small businesses can choose to write off limited amounts of equipment. This applies for up to \$112,000 of equipment, but only if the business spent less than \$450,000 on new equipment. Congress just raised the \$112,000 to \$125,000, and raised the total spending cap to \$500,000. The rules will be with us (and adjusted for inflation) through 2010. After 2010 we are scheduled to return to the \$25,000 limit from 2001 when these changes began.

NEW Break For Mom & Pop Businesses. When both spouses run a family business, IRS had insisted they file a partnership return, except in community property states. Now Congress says they may simply file a joint return and split the profits equally.

NEW Other Business Items. The Work Opportunity Tax

Credit offers incentives to hire certain groups of workers. The credit was set to expire after 2007, but is extended to those hired before September 1, 2011. Several new categories of workers were added. Several measures for businesses affected by Hurricane Katrina were extended.

NEW Other Measures. IRS is given more powers to deal with late return filings and erroneous refunds. They also got stiff new penalties for tax practitioners. The new sanctions cover all returns, not just income tax for individuals and businesses. Tougher standards, and larger fines will help IRS crack down on unscrupulous practitioners. I'll be doing more careful research on "gray" areas.

More Laws To Come?

We're likely to see more changes. However, some important items will likely be left for next year. Reform of the Alternative Minimum Tax is still a hot issue, but complicated, and very expensive. The Estate Tax is still unsettled after 2009. We are not likely to see these resolved in 2007.

This Issue

- Tax Surprises In Iraq Spending Bill
- Mutual Funds For Beginners
- Hybrid Cars - Some Credits To Disappear
- I Get Questions
- IRS Crackdown Coming
- Tips For You
- Your Tax Calendar

Mutual Funds For Beginners

The stock market is rocketing to new highs. More and more people are turning away from banks and savings accounts. They're jumping onto the mutual fund bandwagon. It's a very different game.

More Growth – More Risk.

Generally speaking, money invested in the business community will grow faster than money deposited in a bank. Generally. Eventually. Banks provide the money used by business for growth. They collect interest. They return some of the interest to account holders who supplied the money. Business must generate more profits than the interest they pay. It's practically a Law Of Nature.

In the bank, your money is secure, but the growth is slow. In the stock markets your "account" balance rises and falls. If you invest in the wrong companies you could lose everything. But, eventually the markets must show more growth (or else America is doomed!).

Mutual Funds vs. Stocks. Most people don't buy individual stocks. You need to "diversify" to protect against the occasional failure of a business. In a mutual fund, hundreds of investors pool their money to buy a diversity of stocks. Fund managers make the actual decisions. The pool of investors share in the profits, the risks, and the cost of management.

Capital Gains Taxes. Good news at tax time. Interest you earn from a bank is taxed as "ordinary" income. Stocks can yield *two* types of income, dividends (a share of the company profits), and capital gain (or loss) when the stock is sold. Current tax law gives both dividends and long-term gains lower rates than other income. If your taxable income is in 10% or 15% brackets, your long-term gain is taxed at only 5%. If your tax rate is 25% or higher, most of your mutual fund income is taxed at 15%. Quite a savings.

Record Keeping A Must! You can ignore a bank account if you wish. Your money is always there – along with some interest income. The bank sends a Form 1099-INT each January showing the income you must report. Easy.

Mutual funds take more work. Sure, the dividend income is reported on Form 1099-DIV. Gains, however, may come in two different forms:

1. Capital Gain Distribution.

This means the fund manager sold some of the fund's stock at a profit. The profit is not paid to the investors. It's used to buy some other stock. That's how a fund grows. Problem – you are taxed on this gain, even though you don't receive any money. Tax law says it's a long-term capital gain, even if you invested just a few weeks ago. Of course, you get the low tax rates mentioned above.

2. Gain/Loss Upon Sale.

When you sell some or all of your shares you must report the sale. Your cost for the original shares (including any commission) is compared with what you receive upon sale (less any commissions paid) to measure the gain or loss. If you have held the shares for more than one year those extra-low tax rates mentioned above will apply.

Full Details Needed. A full history of your investment is needed to measure your gain. Suppose you invested \$1,000 a few years ago, and now sell for \$1,400. You might think your "profit" or "gain" is \$400. But, what about capital gain distributions.

Likely you have nearly \$400 of such distributions over time – that's why the fund is now worth an extra \$400. You *already paid tax* on the \$400. You have no gain or loss.

Broker Often Helps. Today most brokers and mutual fund companies keep these records for you. They send a "Statement of Realized Gain/Loss" when you sell. IRS would like them to report your gain/loss directly to them. This is all well and good – until you change brokers. How can the new broker know your investment history? If you invest using an on-line account, the information can be found in the "My Account" section, but many folks don't know how to use the feature. Keep records!

Reinvesting Dividends. This is the most popular form of investing. To maximize growth, the fund offers to use your dividends to buy more stock. Now the records are a serious chore. You made a buy when you started, but you buy more stock every time there's a dividend – often it's *every single month!* After a few years there are dozens of purchases to track. Thank goodness the brokers offer to provide a statement of your gain/loss. Don't lose it!!!

Hybrid Cars – Some Credits To Disappear

More and more hybrids qualify for up to \$3,400 in tax credits. Problem – Toyota's credits will end in September.

Gasoline prices continue to rise. Hybrid car sales increase just as rapidly. These vehicles feature both a gasoline engine and an electric motor – *plus* a higher price tag. Tax credits help cut the cost, but the credits' days are numbered.

Credits Limited. If your tax bill is low, the credits can only reduce it to zero. The extra credit is lost. Also, your credit can be lost if you run into the Alternative Minimum Tax. Call me before you buy – I may be able to tell whether the credit is available.

Toyota Credits To Decline. IRS has approved more than 35 models for the credits so far. Ask your car dealer, or check at the IRS website. In theory, the credit can be as large as \$3,400. In fact, Toyota Prius has the highest credit so far at \$3,150. However, Prius's credit is already less, and soon will be gone.

Credits decline after more than 60,000 qualified vehicles are sold by a given manufacturer. Toyota (who also makes Lexus) sold the 60,000th hybrid in June of 2006. For all models of Toyota and Lexus hybrids, here's the scheduled "phase out":

Until October 2006	Full credit
Oct '06 until Apr '07	50% credit
Apr '07 until Oct '07	25% credit
Starting October 1, 2007	No credit

For April 1 through September 30 of 2007, the Toyota credits are:

\$787.50	– Toyota Prius
\$650	– Highlander Hybrid
\$550	– Lexus RX 400h
\$387.50	– Lexus GS450h

The numbers were twice this size for purchases earlier in 2007. Ford, GM, Honda, Mazda, and Saturn all have vehicles qualifying for varying amounts of credit. None have reached the 60,000-vehicle level to date.

I Get Questions

Here are a few questions that pop up over and over again.

Q Roth IRA. I had to take some money from my Roth IRA. I'm only 51 years old. Will there be a tax, or penalty, or both?

A Perhaps Neither. A Roth IRA has a peculiar "layering" of the dollars within it, much like a cookie jar. The first dollars you take out are deemed to be the ones you contributed. You got no tax break when you contributed, so there is no tax or penalty on these dollars. The second layer of money is any that you "converted" from traditional IRA to Roth IRA. You already paid the tax, and won't be taxed again, but a 10% penalty applies unless the conversion was more than 5 years ago. The bottom layer is the growth money. Take any of these dollars and both income tax and penalty (since you are not yet 59½) will apply.

Q Closed Business. I shut down my business last year, but paid the last of the expenses this year. May I deduct these?

A Very Likely! Assuming you were a "sole proprietor" filing Schedule C, we'll simply file another Schedule C and deduct the expenses. If your business was a partnership or corporation things are more involved, but we'll still get value from your expenses.

Q Large Medical Gift. I've heard the most I can give to someone this year is \$12,000. I just paid \$26,000 of my mother's medical expense. Do I have a problem?

A Nope! You fall under an exception. A gift is limited to \$12,000 in any year. There is an unlimited exception for medical expense or school tuitions. The single catch is that the payments must be made to the provider or school rather than to your mother. You may have a small bonus – your mother might qualify as your dependent, but I'll need more information from you.

Q Charity From Inheritance. My mother passed away this year. I donated her furniture to a local charity. Do I get a deduction?

A Depends. We need to know *who* made the contribution. I realize you did this, but who did the furniture belong to? Was it your

IRS Crackdown Coming

The "Tax Gap" – IRS Top Target. Last year IRS concluded a massive study of 2001 income tax returns. They wanted to measure the "Tax Gap", the difference between the income tax we *actually* paid and what we *should have* paid. Why did this take 5 years? Late in 2001 IRS began the National Research Program (NRP) to study our 2001 income tax returns. They randomly selected 46,000 returns for audit. The audits were thorough and time-consuming. The NRP took 3 years to complete.

\$345 Billion Shortfall. The number is indeed large. Consider that in 2001 we paid income taxes of just under a trillion dollars. We *should have* paid another \$345 billion. IRS says we should have paid over one-third more than we did. Why? Clearly, some tax is underreported. IRS says the largest understatements come from self-reported items – no big surprise.

How To Fix It? IRS wants to see more information reporting. They'd like brokers to report gains/loss from stock sales. Even more information on W-2s. Reporting on government contracts. And - - - more and more. They also want stiffer audits and more information on where the errors are most likely to be found.

Tougher Audits. Early this year IRS set up new standards for audits. We can expect more correspondence reviews on items that do not match IRS records. Face-to-face meetings last longer, and auditors demand more and better records. They ask more questions than ever – probing questions aimed at understanding spending patterns and life-style. The only good news here is the total number of face-to-face audits will decline a bit as more time is spent on each case.

Random Audits Return. It's been more than 10 years since IRS was forced to stop a different random audit program. They used results to fine-tune their top-secret computer program to identify items most likely to yield extra tax revenue. IRS did about 2,500 of these special audits each year. They checked every single line on the tax forms. Folks were asked to prove why most lines are left blank! Taxpayers complained the program was too harsh and time-consuming, so Congress shut it down.

They're back. Same goal – learn how well we comply with the system. The new audits are shorter, and focus on one or two areas of the return. To gather enough information IRS needs more audits – 13,000 each year for 3 years. Chances *you* will see one – 1 in 9,000. We won't know details until reports come in from folks who have faced the new audits. The program is set to begin in October. It probably will be 6-10 months before we hear any real details on what happens at the meetings. Stay tuned.

Mother's *estate* or *trust* making the donation? If so, the deduction is not yours. If the furniture was now *yours* (that is, you *inherited* it), you may definitely claim a deduction for its fair market value.

Q Forgot A Stock Sale. I just realized that I forgot to report a small stock sale on my last return. The sale caused a tiny \$20 loss. Is it worth worrying about this?

A We Probably Need To Amend Your Return. The \$20 loss is not important. There's another problem. IRS receives Form 1099-B listing "gross proceeds" for any stock sale. Since no sale appears on your return, IRS will say the full amount may be income. If this was a "penny stock" you bought for \$50 and sold for \$30, we might be OK to

ignore it. IRS is not likely to bother you over a possible \$30 of income. But, suppose you bought the stock for \$10,000, and sold for \$9,980. The IRS computer will spot you, and IRS will presume you have an additional \$9,980 of income. We can clear this up, of course. However, you have just given IRS a chance to say "let's take a close look at this return before we send a letter". Bad move! You *never* want to invite them to inspect your tax return. If your case is like this, I suggest we file an amended return as soon as possible.

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Tips For You

Donated Property – No IRS

Help. On August 16, 2006 we got a new rule on deductions for donated household items. No deduction is allowed unless items are in “good used condition or better”. We’ve been waiting for IRS help in making this determination. IRS Publication 561, *Determining the Value of Donated Property*, was re-written in April 2007. No real help. They tell us the value of such items is far less than the price paid when new. They say the items may have little or no market value because of their worn condition, or they may be out of style, or no longer useful. They do not explain “good used condition or better”. IRS says the “value list” offered by Goodwill, Salvation Army, and others is *not* an accurate valuation method. Looks like we’re on our own here. I still recommend (a) don’t try to claim deductions for junk, (2) make a fairly detailed list, with descriptions, and (3) take some snapshots.

College Savings Programs. The new “kiddie tax” rules on the front page may scare parents out of trying to save for a college education for a youngster. We still have two “tax-favored” programs that avoid the issue.

Coverdell Education Savings Accounts are much like an IRA for education. An account is set up for a

specific child’s benefit. The most one may contribute for a given child is \$2,000 per year. Also, anyone may contribute, not just parents.

Section 529 Plans. Each state has one of these. Many colleges also have one. Contribution limits are much higher – over \$100,000 total in most cases.

Both plans allow income to build up without tax. When money is withdrawn, even the growth is tax-free if the funds are spent on the proper education costs. There are many other differences. For a clear and readable explanation, look at the website www.collegesavings.org. The big news – neither program generates kiddie tax problems.

In-Home Day Care Providers.

If you run a day care center at home IRS uses an allowance for meals and snacks. No need to keep receipts. The 2007 figures for each meal or snack served are:

- Breakfast – \$1.11
- Lunch or dinner – \$2.06
- Snacks – \$0.61

You must record names of the children, hours of care, and meals and snacks provided. The allowance often exceeds actual costs, but you are still allowed to use it. Rates are higher for those living in Alaska and Hawaii. Complete details are at www.fns.usda.gov under “Child and Adult Care Food Program”.

Volunteer Work. If you do work for your church, library, or other charitable group you are entitled to

charitable deductions for your direct contributions, but not for your time. Direct expenses could include office or hobby supplies, telephone or fax expense, photocopying, or the cost to provide refreshments at meetings.

Mileage and Travel for such work are deductible, as long as there is no significant element of leisure or vacation involved. For out-of-town events, include all fares, lodging and meals. Local transport usually is just mileage. The allowance is only 14¢ per mile for charity, but the value can add up quickly. Be sure to make note of all the driving you do for the group, including shopping and preparation for the events.

“You must pay taxes. But there’s no law that says you gotta leave a tip.”

Advertisement on New York City bus

Your Tax Calendar

Sept. 17	3 rd quarter estimated tax payments due.
Oct. 15	Extensions to file 2006 Form 1040 expire.
Oct. 31	3 rd qtr. payroll returns due. (Nov. 10 if tax paid in full and on time.)
Dec. 31	Last chance for deductions in 2007.
Jan. 15	4 th quarter estimated tax payments due.

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