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2007 Tax Update

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Dear Client,

As with last year, I have decided to send a year-end tax update letter. In this letter, I comment on the tax law changes that are most likely to impact my clients.

Alternative Minimum Tax (AMT): At the end of 2006, the 1-year AMT relief passed by Congress last year expired. If it is not extended, the Joint Committee of Tax estimates that 23 million tax returns will be subject to AMT for 2007 (up from 4.2 million in 2006). For a number of clients I have run 2007 tax projections assuming no AMT relief. The results showed substantial ($3000 to $8000) increases in alternative minimum tax relative to tax year 2006.

Congress is still expected to extend the AMT relief through 2007. On December 6, 2007, the Senate approved such a plan. The Bill still needs to be reconciled with a House version that was passed earlier. **Any AMT Relief Bill signed into law may delay the IRS in processing 2007 tax refunds as significant tax legislation takes the IRS six weeks to update their computer software.**

Non-Cash Charitable Contributions: Effective for contributions made on or after August 17, 2006, you cannot claim a deduction for donations of clothing or household items unless the item is in “good used condition or better”. The law does not define “good condition” so you will need to be more discriminating with the items you are donating and *you may want to take photos of large items to help verify their condition.*

Cash Contributions: Starting in 2007, a receipt or cancelled check is required for all cash contributions. This means that you will no longer be able to deduct the cash in the church collection basket (unless the Church acknowledges the contribution in writing).

IRA Charitable Contributions: In 2006 and 2007, if you are at least 70-1/2, you can make a charitable contribution directly from your IRA. Although you will not be able to claim a deduction for the contribution (to the extent it was made with “pre-tax” dollars), you will not be taxed on the withdrawal of the money from your IRA.

Age of Children Increased for “Kiddie Tax”: Special rules, called “kiddie tax” apply to the unearned income of children. Generally for 2007, the “kiddie tax” applies to a child if (1) the child is under age 18 as of 12/31/07 and (2) the child’s unearned income (interest, dividends, capital gains, etc.) exceeds $1700 ($1800 in 2008). Under these rules, the unearned income of a child above $1700 is taxed at the parents’ tax rates. For 2008, the Small Business Tax Act expanded the “kiddie tax” to apply to children who are 19 years old or who are full-time students over age 18 but under age 24.

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The effect of the “kiddie tax” law change is to substantially eliminate the Federal tax benefit for a parent to establish a custodial account to take advantage of a child’s lower bracket. The State of California has not conformed to the change. For CA tax purposes, “kiddie tax” only applies to children under age 14.

Qualified Tuition Program (Section 529 Plans): The expansion of the “kiddie tax” rules increases the appeal of 529 Plans. While contributions to a 529 Plan are non-deductible, all appreciation is tax free as long as the money is used to pay qualified college expenses. The Pension Protection Act of 2006 permanently extended the tax-free treatment of qualified withdraws. Previously, for withdrawals after year 2010, the appreciation was to be taxed to the child. By year 2007, Section 529 assets are expected to reach $100 billion and to reach $300 billion by year 2010. While about 75% of Section 529 plans are sold through investment advisers, parents can set up accounts directly. For more information, see www.collegesavings.org and www.savingforcollege.com.

Minimum Tax Credit Relief Begins in 2007: Certain taxpayers who have unused AMT credits (typically from a prior year stock option exercise) are allowed to claim a refundable credit at 20% of the long-term unused AMT credits per year for calendar years 2007 through 20112. The credit is phased out for individuals with adjusted gross income (AGI) over $156,400 ($234,600 for married filing joint).

15% Tax Rate on Qualified Dividend and Long-term Capital Gains: The 2006 Tax Increase Prevention and Reconciliation Act extended the 15% qualified dividend and long-term capital gains rate through year 2010. For years 2008 through 2010, taxpayers in the 10% and 15% bracket have a 0% capital gains rate (down from 5% for 2007). This means that low-income taxpayers could have qualified dividends and long-term capital gains of up to $30,000 and pay no tax! Unfortunately, the “kiddie tax” rules (see above) prevent parents from taking advantage of this break by transferring highly appreciated assets to their kids.

My expectation is that the next President, particular if it is a Democrat, will increase the capital gains rate. A couple of the Democratic presidential candidates have suggested a long-term capital gains rate of 28% (up from 15%). This change could occur as early as 2009. It is possible that 2008 will be the last year for the low rate on qualified dividends and long-term capital gains.

IRA (Regular & Roths) Contribution: The annual amount that can be contributed has increased as follows:

	2002-2004	2005	2006	2007	2008
Taxpayers Under Age 50	$3000	$4000	$4000	$4000	$5000
Taxpayers Over Age 50	$3500	$4500	$5000	$5000	$6000

Roth IRA Conversions for 2010: Roth IRAs are very appealing because no tax is paid when qualified distributions are received. Contributions to Roths, though, are only allowed for taxpayers below a certain income limit. In addition, for taxpayers with modified adjusted gross income below $100,000, a regular IRA can be converted into a Roth IRA. Income is taxed to the extent that the amount converted is with pre-tax dollars. For instance if a $25,000 IRA with no tax-basis is converted to a Roth, the $25,000 must be recognized as ordinary income in the year of conversion.

Starting in 2010, the existing $100,000 income test for converting a traditional IRA to a Roth IRA will no longer apply. In addition, under the 2006 Tax Act, taxpayers who convert an IRA to a Roth IRA in 2010 can elect to defer the related income inclusion and recognize the income ratably over the two years, 2011 and 2012.

The tax planning this law provides is for high-income taxpayers to make non-deductible IRA contributions in years 2006 through 2010, and then convert the IRA to a Roth IRA in 2010. The income realized by the conversion will be the value of the IRA, less the basis in the IRA (which is based on the amount of the non-deductible contributions). *There is a very significant catch, though. If a taxpayer has other IRAs, the taxable basis must be allocated over all IRA assets.* For instance, if someone who has only one $25,000 IRA with a basis of $20,000 (due to non-deductible contributions), converts it to a Roth, only $5000 will be taxed as a result of the conversion. If instead she also has another IRA worth $100,000 with no basis (from a 401(k) rollover), the $20,000 basis is allocated between the two IRAs. In this case, only $4000 of the basis is attributed to the converted IRA, and $21,000 will be taxed as a result of the conversion.

Medicare Premium Surcharge Starting in 2007: Included in the 2003 Medicare prescription drug bill was a little noticed provision that added a premium surcharge to be paid in addition to the normal Part B premium. Staring in 2007, the premium for Medicare Part B can increase substantially for high income individuals. It is projected that about 2.3 million people will see the increase and that this provision greatly impacts first-year retirees.

The surcharge will be charged to Social Security recipients who are married and for year 2005 had "modified adjusted gross income" greater than $160,000, or are single and for 2005 their income was greater than $80,000. The base Medicare B premium for 2007 will be $93.50 per month before the imposition of any premium surcharge. Depending on the level of income, the surcharge for high income taxpayers will range from $12.30 to $67.90 per month. *This premium surcharge will dramatically increase in the future*, as in 2008, the surcharge will double from 2007 and will be based on 2006 income, and in 2009, the surcharge will triple from 2007, and be based on 2007 income.

Credit for Energy-Efficient Improvements to a Personal Residence by a Homeowner: During 2006 and 2007 individuals can make energy-conscious purchases that may provide a Federal tax credit. Manufacturers offering energy efficient products can assure their customers, and homeowners may rely on these claims, that their energy efficient items will qualify for the tax credit if certain energy efficiency requirements are met. Only expenditures for a taxpayer's primary residence qualifies. The maximum credit <u>for all taxable years</u> is $500 and no more than $200 of the credit can be attributable to expenses for windows. Eligible expenditures include insulation systems that reduce heat loss, exterior windows and skylights (limited to $200), exterior doors, metal roofs, advanced main air circulating fan (limited to $50), hot water heater (maximum $150), central air conditioners (maximum $300). *Taxpayers who claimed the maximum credit in 2006 will not be eligible for any further credit in 2007.*

Gift Tax Annual Exclusion: A very effective estate planning tool for taxpayers with large estates is to annually gift a portion of their assets to their heirs. For years 2007 and 2008, donors can gift up to $12,000 annually (up from $11,000 in 2005) to any one donee and not be subject to gift tax.

Please let me know if you have any questions regarding these tax law changes.

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