TAX NEWSLETTER

SMALL BUSINESS AND WORK OPPORTUNITY TAX ACT OF 2007

JUNE 7, 2007

Dear Clients and Other Friends,

It has been a little while since I have sent out a newsletter. Obviously, during tax season I am more concerned about "doing" than "talking". It is now time to catch up on a few items including a new tax act that bounced out of the political battles over funding the Iraq war and raising the federal minimum wage.

Before I talk tax, I want to touch on something you can do to cut down on your junk mail and minimize one source of potential identity theft. If you are like me, you receive numerous solicitations for pre-approved credit cards. As explained at the website http://www.ftc.gov/bcp/conline/pubs/credit/prescreen.shtm many of these prescreened offers originate from mailing lists provided by the major credit reporting agencies. I recommend you consider opting out of these solicitations. The pro and cons, and the methods, of opting not to receive these promotions, are described on the website. It will save on the shredder!

On to tax-

I have been in this business many years and I am still somewhat surprised by how much our tax system is weaved into everything we do. It gets comical at times (alright – I have a sick sense of humor). This latest tax act is an example. The discussion must have gone like this. "Well, we need to raise the federal minimum wage. Wait a minute- that is going to hurt some small businesses. We had better give them some tax breaks to ease the pain. Whoops, all of our tax acts are suppose to be revenue neutral. That means we need to raise revenue somewhere else. Oh ya, lets add the funding for the Iraq war to this just to make it even more of a political football."

As a result we have a new tax act that helps some and hurts some, and took a couple of tries to get past the President. Overall there are just a couple of provisions that will affect a broad group of taxpayers. I will summarize the provisions I feel may apply to some of my clients and list the balance of the changes.

Kiddie Tax:

Unfortunately I feel the provision which may affect the most people is one of the revenue raisers. They broadened the application of the "kiddie tax" from children under 18 to include children under 19 (or under 24 if a student). They had just increased the age from 14 to 18 last year.

A child subject to the kiddie tax pays tax at his or her parents' highest marginal rate on the child's unearned income over $1,700 if that tax is higher than the tax the child would otherwise pay on it.

Specifically, it expands the kiddie tax to apply where:

- the child turns age 18, or turns age 19-23 if a full-time student, before the close of the tax year
- the child's earned income for the tax year doesn't exceed one-half of his or her support
- the child has more than the inflation-adjusted prescribed amount of unearned income (i.e., $1,700, as further adjusted for inflation for the applicable tax year)
- the child has at least one living parent at the close of the tax year; and

the child doesn't file a joint return for the tax year.

T.J. JACOBSEN, CPA
381 WALLACE WAY NE, SUITE 101A, BAINBRIDGE ISLAND, WA 98110
(206) 842-8200 (206) 842-8207 fax email@tjjcpa.com www.tjjcpa.com

As is often times the case with tax law this change is a reaction to the taxpayers' reaction to a previous law change. To explain: this expansion of the kiddie tax attempts to offset a strategy some parents used to take advantage of the lowest long-term capital gain tax rates of 5% or 0%.

This year, the top tax rate on long-term capital gains and corporate dividends is 15%. However, to the extent a taxpayer's net capital gain would be taxed in the two regular tax brackets of 10% and 15% if there were not a special capital gains tax rate—it's taxed at 5% for 2007, and 0% for 2008 through 2010. Some families sought to benefit from these rates by gifting appreciated stock and other securities to their low-income children who could then sell the securities tax-free in 2008, 2009, or 2010. The new law changes will eliminate the opportunity to do this in many cases.

Of course, not everyone has given their children investments just to maneuver around the tax laws. However, they will still be affected if their under 19 year old has investment income exceeding $1700 for 2007. This threshold is indexed for future years. Also, remember a child's earned income (i.e. wages) is taxed at the child's tax rate.

Small Business Expensing:

A business taxpayer may elect to deduct as an expense, rather than to depreciate, up to a specified amount of the cost of new or used tangible personal property placed in service during the tax year in their trade or business. Previously, the maximum dollar amount that could be deducted annually was $112,000 for 2007. The taxpayer's maximum annual expensing amount is reduced dollar-for-dollar by the amount of qualified expensing-eligible property placed in service during the tax year in excess of a phase-out amount. Previously, this amount was $450,000 for 2007. The new law increases the expensing limit to $125,000 and the phase-out level to $500,000 for 2007 (indexed for inflation) and extends the enhanced expensing provision through 2010.

The following recaps the balance of the changes in the tax law:

Tax Breaks:

- *Extend and liberalize the work opportunity tax credit.* The credit is extended for 3.5 years with liberalized rules for hiring disabled veterans and workers in rural renewal counties.
- *Extend and enhance certain GO Zone tax incentives.* The GO Zones are the Rita and Katrina hurricane areas.
- *Enhance the tip credit for certain small businesses.* The Federal minimum wage level for purposes of calculating the tip credit is frozen, thereby allowing restaurants to continue claiming the full tip credit despite an increase in the Federal minimum wage.
- *Simplify family business tax.* An unincorporated business that is jointly owned by a married couple in a common law state is permitted to file as a sole proprietorship. Under prior law, unless the married couple was located in a community property state, both the married couple and the business were subject to penalties for failing to file as a partnership. The new law also ensures that both spouses receive credit for paying Social Security and Medicare taxes.
- *Waive individual and corporate AMT limitations on work opportunity tax credits and tip credits.* Prior law limited a small business' ability to claim the work opportunity tax credit and the tip credit by imposing a limitation that such credits could not be used to offset taxes that would be imposed under the alternative minimum tax (AMT). The new law provides a permanent waiver of the individual and corporate AMT limitations for the work opportunity tax credit and the tip credit. *Liberalize several S corporation rules.* The new law also contains several provisions beneficial to S corporations although I do not see the changes affecting my clients.

Revenue provisions (offsets):

- *Extend—from 18 to 36 months—the period in which IRS must notify a taxpayer of the taxpayer's liability with respect to a tax return before IRS must suspend the accrual of interest and penalties relating to that liability*.
- *Eliminate the requirement that IRS hold a collection due process hearing before issuing a levy on delinquent employment taxes.*
- *Expand preparer penalties to all types of tax returns (e.g., employment, excise, exempt orgs, estate and gift tax) and increase the penalty amounts*.
- *Create a new penalty on claims for refund that are filed without any reasonable basis.*

Increase the penalty for bad checks and money orders.

Enough about the new – I want to now remind you about some of the old-

Charitable Donations:

Two recent changes were made concerning the ability to deduct charitable donations. First, you must have some form of documentation for any cash donation. So, no more of this "I am a pretty benevolent person – I must have given, oh, about $500 last year." You need to have a check, receipt or some form of notification from the charity if the donation is under $250. Also, as has been the case for a couple of years, if the donation is more than $250 you must have written acknowledgment from the charity.

Second, for non-cash donations the goods donated must now be in "good used condition or better." That is pretty subjective and difficult to prove after the fact. We will have to see what regulations come out. Probably the more important issue to take away from this change is Congress is concerned about the size of the deductions being claimed for the donation of household goods. They feel the claimed values are inflated. When Congress is concerned the IRS reacts. My recommendation is to detail what is given to the Goodwill type organizations. Do not just lump it into one sum. List the items and estimate the original cost and the current fair market value. As with cash donations, you must have an acknowledgement from the charity for any donations over $250.

I expect we will have numerous tax law changes over the next couple of years. We have had a change of control in Congress. We have considerable posturing going on for the presidential campaign. Many of the Bush tax cuts are scheduled to expire in 2010. Ah, the perfect storm……..

Tim

Disclaimer: By nature of a newsletter, this information is in summary form and does not necessarily detail every requirement, restriction or tax planning opportunity. Prior to executing any tax strategy, you should consider non-tax implications - you may cost yourself more than you save in taxes. Please use this information with these limitations in mind. If you are considering executing a particular tax strategy, please contact me so we can discuss the specifics.

Any tax advice in this communication is not intended to be a "covered opinion." Therefore this communication cannot be used by any party to avoid penalties which may be imposed by the Internal Revenue Service.