

TAX NEWSLETTER

SUMMARY OF 2006 TAX LAW CHANGES, VOLUME II

DECEMBER 12, 2006

Dear Clients and other Friends-

In "Volume I" I said I thought Congress would pass another tax bill as they walked out the door – and they did. The Tax Relief and Health Care Act of 2006 extended some tax breaks as expected. However, they were a couple of surprises also.

First the extenders- for the most part Congress followed their recent pattern of only extending these for one or two years. So we will be revisiting all of this in 2008.

Itemized Deduction for Sales Tax:

The ability to deduct sales tax as an itemized deduction is extended for two years – 2006 and 2007. A taxpayer can deduct the higher of their sales tax or state income tax as an itemized deduction.

Caution: before you run out and buy that \$300K boat to generate a \$25K sales tax deduction, remember taxes (property, sales tax, and income tax) are not a deduction for Alternative Minimum Tax. So, you may lose some or all of the benefit of the sales tax deduction due to AMT.

Research Credit:

The research credit is extended for two years – 2006 and 2007. In addition, they added a new "alternative simplified credit".

Above-the-Line Deduction for Educators:

The up to \$250 deduction for books or supplies purchased by an educator for use in the classroom is extended for 2006 and 2007.

Above-the-Line Deduction for Tuition:

The up to \$4,000 deduction for higher education expenses for the taxpayer or dependent is extended for 2006 and 2007. The deduction is limited to \$4,000 if your adjusted gross income (AGI) is less than or equal to \$130,000 for joint filers or \$65,000 for single filers. The deduction is limited to \$2,000 if your AGI is more than the preceding limits, but less than or equal to \$160,000 for joint filers or \$80,000 for single filers. No deduction is allowed if your AGI is above the \$160,000/\$80,000 limits.

Accelerated Write-off for Qualified Leasehold Property and Restaurant Improvements:

You can write off (depreciate) qualified improvements over 15 years instead of the normal 39 years for improvements purchased in 2006 or 2007.

Misc. Extenders: I will just list these here since they will not affect many of you. If they do affect you, please contact me for more information. These were all extended for 2006 and 2007 unless noted.

- Work Opportunity Tax Credit for employers hiring members of certain target groups
- Indian Employment Credit
- Qualified Zone Academy Bond Credit (for lending businesses)
- First-time Homebuyer in the District of Columbia Credit
- New Markets Credit extended for 2007 (a low-income community credit)
- Election to include combat pay as earned income for credit purposes
- Enhanced deduction for computer donations by C corporations
- Quicker write-off for business property on Indian reservations

T.J. JACOBSEN, CPA

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

- Suspension of the net income limit on percentage depletion on marginal oil and gas wells
- Expensing of environmental remediation expenses
- Credit for wages paid in American Samoa
- Many of the credits and deductions for residential and business energy efficient property are extended through 2008.

You didn't know there were so many crazy credits and deductions out there, did you? And these are just the ones that needed extending now. Social engineering through the tax code gets very complicated very quickly!

Now, a couple of surprises-

Refundable Credit for Unused AMT Credit:

First an AMT primer-

You normally fall into the AMT trap in one of two ways. One is from the loss of certain deductions taken for regular tax purposes that are not allowed in computing AMT. The common ones are personal exemptions, taxes taken as an itemized deduction, and miscellaneous itemized deductions. These are called exclusion items. The second way is due to the timing difference from when certain income or deductions are reported for regular tax as compared to AMT. Common examples are the exercise of incentive stock options (no income for regular tax until sold, immediate income for AMT) and depreciation (different rates for AMT than regular tax.)

If you pay AMT due to exclusion items, you are just out of luck. You will never get it back. However, if you pay AMT due to timing differences you are given a credit for the "extra" AMT paid. You can use this AMT credit in subsequent years when your regular tax is more than your AMT in that subsequent year. The theory is the timing differences will reverse sometime in the future and your AMT should be less in that year than your regular tax.

However, since the AMT tax rates and exemptions do not mirror the regular tax regimen this perfect reversal does not usually happen. This was really evidenced when the dot com'ers paid considerable AMT when they exercised their incentive stock options but did not get it back in later years when they sold that same stock for a loss that equaled or even exceeded the income they had reported for AMT. They were going to take that AMT credit to their grave (I doubt it helps on the other side...).

To address this inequity, starting with the 2007 tax year, Congress is allowing the taxpayer to take a greater portion of this credit carryover than previously allowed. Previously the taxpayer could only take the credit up to the amount that the regular tax exceeded the AMT. Now the taxpayer can claim the greater of the preceding amount or the "AMT refundable credit amount". The "AMT refundable credit amount" is the greater of (1) the lesser of \$5,000 or the long-term unused minimum tax credit, or (2) 20% of the long-term unused minimum tax credit. Basically the long-term unused minimum tax credit is the carryover credit that is more than 3 years old. Remember, I am just the scribe – I did not create this.

What they giveth, they taketh away- this new benefit is phased out if your adjusted gross income is over certain limits. Since these limits are indexed for inflation I am not sure what they will be in 2007 when this goes into effect, but the 2006 limits are \$225,750 for joint filers and \$150,500 for single filers.

Liberalized Rules for Health Savings Accounts (HSAs):

This tax act liberalizes the HSA rules by:

- Allowing one-time-only rollovers from health FSAs and HRAs into HSAs (if you understand all of these abbreviations, you really need to get a life....)
- Eliminating the provision that deductible contributions to HSAs could not exceed the underlying health insurance plan deductible. The contributions are still subject to other maximum limits (\$2,850 for self-only coverage or \$5,650 for family coverage in 2007). This is effective in 2007.
- Providing for earlier indexing of cost-of-living adjustments to HSA limits.
- Allowing a full contribution for months preceding the month a taxpayer becomes an eligible individual under the HSA.
- Liberalizing the rules for highly compensated employees.
- Permitting one-time rollovers from IRAs to HSAs after 2007.

Deduction for Mortgage Insurance Premiums:

If you do not make a sufficient down payment when you purchase your home, you may have to pay a premium for mortgage insurance. Previously this premium was not deductible. This Act allows the deduction of this premium. HOWEVER, the deduction is only good for 2007 (unless extended) and phases out if your adjusted gross income is over \$100,000. Oh, let's make a long term home purchase decision based on a one year deduction.

As you might expect, there are many other aspects to this tax act. However, unless you are a non-military intelligence officer, a whistleblower, an underground mine operator or are making frivolous tax submissions you probably do not want to read about them.

As always, please contact me if you need further clarification of this new tax act. Once again Congress has reassured me that my chosen profession is not about to become obsolete.

Thanks for getting this far,

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.