TAX NEWSLETTER

SUMMARY OF 2006 TAX LAW CHANGES, VOLUME I

NOVEMBER 28, 2006

Dear Clients and other Friends-

I am calling this "Volume I" since I really do not know what the lame-duck Congress will do in its last month. I may have to issue a "Volume II". There are some expired tax breaks which everyone expected Congress to renew with the last tax act. However, the tax breaks were caught up in the controversial issues of estate tax elimination and minimum wage increases and as a result, never extended.

The two most popular tax breaks are the research and development credit for businesses and the sales tax deduction for individuals. Obviously, the latter is important for those of us in Washington since we do not have the state income tax to deduct on our federal returns.

I expect Congress to extend both of these tax breaks before year end. They normally only extend them for a year or two at a time so they can fool themselves, and attempt to fool us, as to the true lost revenue. As a side note, a late-in-the-year tax change like this creates havoc with the tax system. The IRS has to send all of the forms and instructions to the printers in early November. Therefore, if Congress changes anything after that date the related forms and instructions will be wrong. This will require special communications by the IRS. Also, all of the tax preparation programs used by individuals and professionals will have to be modified to accommodate the changes. This usually results in a late start to the "tax season" and bunches up the work. Oh, woe is me……

Before I get into the 2006 tax law changes I want to give you a little incentive to plan. The following are some interesting statistics:

As reported in a statement issued by IRS Commissioner Mark W. Everson, the IRS has continued its strong enforcement efforts for Fiscal Year 2006.

Individual enforcement- For the 2006 fiscal year that ended Sept. 30, total individual returns audited increased by over 6%. This is the highest number since '98. While correspondence or letter exams increased, there was an even bigger increase of nearly 23% from the previous year in the traditional, sit-down field audits (the unpleasant kind…).

Audits of individuals with income of $1,000,000 and higher increased nearly 33%. This translates into about 1 in every 16 of these taxpayers being audited last year. Audits of individuals with incomes over $100,000 exceeded 257,000, an 18% increase from 2005.

Business enforcement- IRS has placed more emphasis in the area of flow-through returns involving S corporations and partnerships. Audits of S corporation returns increased 34%. Audits of partnerships increased 15%.

Do you still want to play the audit lottery?

As part of your year end tax planning you might want to review my four 2005 year end tax planning newsletters. Much of the information is still applicable. In **Volume I** I discussed general guidelines to use in determining when to defer income into future years and when to accelerate income into the current year. In **Volume II** I discussed specific techniques to use to defer income out of the current year and to accelerate expenses into the current year. In **Volume III** I reviewed the Alternative Minimum Tax. **Volume IV** was a potpourri of items. You can find these on my website – www.tjjcpa.com.

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My goal with this tax newsletter is to recap the material changes in the 2006 tax law that will affect you. For the sake of brevity I am not going to detail each item. I will note if my previous newsletters gave more detail. In any case, please contact me if you need more info.

From my January 19, 2006 newsletter-

Residential Energy Credits: In general, this is an up-to-$500 credit for energy efficient improvements to a taxpayer's principal residence.

Alternative Motor Vehicle Credit: This up-to-$3400 credit for the purchase of hybrid vehicles replaced the previous deduction.

Itemized Deduction Phase-out Reduced: For a number of years itemized deductions have been reduced by 3% of the amount a taxpayer's adjusted gross income (AGI) exceeded a certain threshold. This threshold is indexed for inflation and is $150,500 in 2006. In 2006, this reduction will effectively be 2% of the excess amount instead of 3%.

Personal Exemption Phase-out Reduced: Similar to the above, the deduction for personal exemptions has been reduced by 2% for each $2,500 (or fraction thereof) by which a taxpayer's AGI exceeds an inflation-indexed threshold amount. The threshold for 2006 is $225,750 for joint returns and $150,500 for single returns. For 2006, the exemption phase-out will equal 2/3 of the normal full reduction. Or in other words, the reduction will be 1.33% for each $2,500 of excess income.

Estate & Gift Tax Changes:
- The top estate and gift tax rate has dropped from 47% to 46%.
- The amount exempted from federal estate tax has increased from $1.5 million to $2 million.
- The annual gift tax exclusion has increased from $11,000 to $12,000.

The lifetime gift tax exclusion (which is included in the $2 million estate tax exclusion) remains at $1 million.

Retirement Plan Changes:
- Elective deferrals: 401(k) deferrals are increased from $14,000 to $15,000.
- Catch-up contributions for those of us 50 years or older: increased from $4,000 to $5,000 except for SIMPLE plans where the increase is from $2,000 to $2,500; and IRAs where the increase is from $500 to $1000.
- Maximum contribution to a defined contribution plan: increased from $42,000 to $44,000. The catch-up contribution noted above is in addition to this amount.
- Annual compensation limit: increased from $210,000 to $220,000. This is the maximum amount of salary which can be considered for purposes of computing a retirement contribution.

IRA contributions: remain at $4,000.

Social Security Wage Base: increases from $90,000 to $94,200

Section 179 Expense: For those of you with businesses, you can now write-off $108,000 of equipment purchased in 2006. This is up from $105,000. This is reduced if you buy more than $430,000 of equipment - up from $420,000 in 2005. The SUV Section 179 write-off remains at $25,000.

From my May 11, 2006 newsletter-

Increased 2006 AMT Exemption: The exemption amount (the amount deducted from regular income before computing AMT) was increased to $62,550 (from $58,000) for married taxpayers and $42,500 (from $40,250) for single taxpayers just for 2006.

Lower Capital Gains Rates Extended: The current capital gains tax rates were extended to the end of 2010. They were due to expire at the end of 2008.

Kiddie Tax: The Kiddie Tax taxes the unearned income (i.e. dividends, interest, capital gains) in excess of $1,700 of a child at the parent's marginal tax rate. The cutoff age for this tax is now 18 years old. It used to be 14 years old.

From my September 1, 2006 newsletter-

Tax-free distributions from IRAs for charitable purposes: Taxpayers can exclude from gross income certain distributions of up to $100,000 from a traditional individual retirement account (IRA) or Roth IRA which would otherwise be included in income. The charitable distribution must be made to a tax-exempt organization to which deductible contributions can be made. The change is effective for two years through 2007.

Charitable Deduction Restrictions:

- After August 17, 2006 taxpayers can only deduct contribution of clothing and household items if they are in good used condition or better**.** In addition, the IRS may deny a deduction for any item with minimal monetary value
- Starting in 2007, charitable contributions of money, regardless of the amount, must be supported by a cancelled check, bank record or receipt from the donee organization showing the name of the donee organization, the date of the contribution, and the amount of the contribution.

Other Miscellaneous Changes-

New Mileage Deduction Rates: For 2006 the per mile deduction rates are 44.5 cents for business, 18 cents for moving and medical, and 14 cents for charity. These increase in 2007 to 48.5 cents for business and 20 cents for moving and medical. The charity mileage rate does not change in 2007.

Telephone Excise Tax Refund: Now this is an interesting one. The IRS fought long and hard to keep the excise tax on long distance calls even though numerous courts ruled against it. Finally it gave in. Now they have to give us our money back. How can they compute this? Here is their plan…..

Individuals: If you did not keep your telephone records, you will use a standard amount based on the exemptions claimed on your 2006 return. The standard amounts are $30 for a person filing a return with one exemption, $40 for two exemptions, $50 for three exemptions and $60 for four or more exemptions. If you kept your bills, you can claim the refund of actual taxes paid on long-distance service billed after 2/28/2003 and before 8/1/2006. The refund will be claimed on the 2006 return.

Businesses: No standard amount for you!

Businesses can either determine the actual amount of refundable long-distance telephone excise taxes they paid for the 41 months from Mar. 2003 through July 2006, or use a formula to figure the refunds.

To figure the formula- since the excise tax was assessed on long-distance service (which is no longer valid) and local service (which still is being assessed) the businesses must figure their refund amounts by comparing two telephone bills to determine the percentage of their telephone expenses attributable to the long-distance excise tax. The bills they should use are the statements for the months of April 2006 and September 2006. They must first figure the telephone tax as a percentage of their April 2006 telephone bills (which included the excise tax for both local and long-distance service) and their September 2006 telephone bills (which included only the tax on local service). The difference between these two percentages should then be applied to the quarterly or annual telephone expenses to determine the amount of their refunds. The refund is capped at 2% of the total telephone expenses for businesses and tax-exempt organizations with 250 or fewer employees. The refund is capped at 1% for those with more than 250 employees.

This claim will be filed on the 2006 return. Of course, I will need some info from you to help compute the refund.

Don't blame me – I am just the scribe.

Tax Exempt Interest: Previously tax exempt interest was not reported to the IRS by the payors. It is now required. This is most important for people drawing social security since tax exempt interest is added back to their taxable income to determine how much of their social security will be taxed. Also, certain types of tax exempt interest is taxable for AMT purposes.

Hurricane Provisions: There were numerous tax provisions enacted for people affected by Hurricane Katrina and Rita. Since they will not affect most people up here, I am not going to detail them. If you were affected, be sure to bring it to my attention.

The above is a recap of many of the material tax changes for 2006. There were more. However, their application will be fairly narrow. I will advise my clients if they are affected by them.

Also, tax brackets, exemption amounts, many deductions and limitation amounts are indexed for inflation. These have also changed for 2006.

Although we tend to focus on tax planning at year end, it really is an all-year-long process. It also needs to be coordinated with your general business planning. Please give me a call if I can help.

Thanks,

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.