

# Federal Tax Course Letter

## TAX PRACTICE AND PROCEDURE

### 2007 Year-End Tax Planning Tips

Year-end tax planning affords taxpayers the opportunity to take steps prior to year-end that will minimize their 2007 tax bills. When taxpayers file their tax returns, it is often too late to take advantage of most tax-saving opportunities that may have been available prior to December 31.

Year-end tax planning in 2007 will be fraught with uncertainty because we don't know if or how Congress will increase the AMT exemption amount so millions more taxpayers are not subject to this stealth tax. In addition, we don't know if Congress will extend the following tax breaks that expire on December 31, 2007: (1) the research tax credit, (2) the option to deduct state and local sales and use taxes, and (3) the above-the-line deduction for qualified tuition expenses and educator expenses.

In addition, the following tax breaks expire at the end of 2007 and should be considered before they are no longer available: (1) the tax credit for

making qualifying energy saving improvements (windows and insulation) to a home; (2) taxpayers at least age 70 1/2 may exclude up to \$100,000 of otherwise taxable IRA (or Roth IRA) distributions that are paid directly by the IRA trustee to a qualifying charitable organization; (3) enhanced deductions for charitable contributions of food inventory by any business; (4) enhanced deductions for charitable contributions of books and computer technology by C corporations; and (5) faster write-offs for leasehold and restaurant improvements.

Classic year-end tax planning advice typically focuses on timing the receipt of income so that income is claimed in years when it will be taxed at the lowest tax rate and claiming deductions in years when taxpayers are in the highest tax bracket. The overriding objective of all tax planning, of course, is to postpone the payment of tax whenever possible. Taxpayers should therefore accelerate or defer the receipt

of income with these basic tax principles in mind. This article provides an overview of steps taxpayers should take prior to year-end to take advantage of the existing as well as the new laws in order to minimize their 2007 tax bill.

#### Steps Individual Taxpayers Should Consider At Year-End Standard Deduction or Itemize.

Taxpayers must decide each year whether they want to deduct itemized deductions or claim the standard deduction amount. Taxpayers may not do both. Typically, taxpayers should itemize if their deductions exceed the standard deduction amount. The 2007 standard deduction amounts are listed in Chart 1.

**Bunching to Avoid Itemized Deduction Phase-out.** The time-honored technique called bunching may help a taxpayer with an adjusted gross income (AGI) in 2007 of just over \$156,400 (\$78,200 if married filing separately) and therefore subject to the AGI-based phase-out of itemized deductions. When AGI exceeds

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the phase-out amounts, the taxpayer's total itemized deductions otherwise allowable are reduced by three percent of AGI in excess of \$156,400. When this occurs, taxpayers should move the receipt of just enough income into next year so taxpayers can take full advantage of their itemized deductions this year.

**Pay Deductibles Prior to Year-End.** One way to increase 2007 deductions is to pay deductible expenses such as charitable contributions, medical and dental expenses before year-end. Keep in mind that making a charitable contribution (or a medical care payment) with a credit card will yield a current deduction even though payment is not made until next year. Note that a donor's pledge or promissory note does not qualify as a deductible payment this year.

**Donate Used Clothing and Household Items to Charity Mindful of Rules.** In order to boost charitable deductions for 2007, taxpayers should spend some time before year-end in their attics, basements and closets looking for used clothing and household items that are in good condition or better to donate to charities. Taxpayers need to keep in mind that a deduction for charitable contributions of clothing or household items may only be claimed by an individual, partnership or corporation if the items are in good used condition or better [Code Sec. 170(f)(16)(A)]. This restriction does not apply if a deduction of more than \$500 is claimed for a single piece of clothing or household item, and the taxpayer includes a qualified appraisal for the item with the

tax return on which the deduction is claimed [Code Sec. 170(f)(16)(C)].

Donors must also be sure to obtain a receipt from the charity, showing the name of the charity, the date and location of the gift and a detailed description of the property donated. If it is impossible for the donor to obtain a receipt, the donor must maintain reliable written information about the contribution. Gifts of \$250 must be substantiated by a contemporaneous written acknowledgment from the charity containing a description of the contribution, whether the donor received any goods or services in consideration for the contribution and a good-faith estimate of the value of any goods or services received by the donor. If the claimed deduction exceeds \$500, donors must include Form 8283, *Noncash Charitable Contributions*, with their return.

**Donate Appreciated Property to Charity.** Taxpayers with appreciated assets should make year-end gifts of those assets to charity, rather than sell them. By donating the appreciated asset, they will avoid paying capital gains tax and sales fees and will be able to claim a full deduction for the fair market value of the property on the date of the gift. Gifts to consider include appreciated stock, bonds, collectibles, art and real estate. If the property has decreased in value, however, taxpayers may be better off selling the property, taking a deductible loss, and then donating the sale proceeds to the charity.

**Consider Impact of AMT As Revised.** Before accelerating an expense or deferring income

in an effort to reduce taxable income, taxpayers should consider the impact of the alternative minimum tax (AMT), which is a separate and parallel tax system directed at certain taxpayers who offset their income either wholly or partially through the clever use of deductions and other items that receive preferential tax treatment. The AMT is calculated by applying a two-tier graduated rate structure to alternative minimum taxable income (AMTI). The rates are 26 percent on net AMTI up to \$175,000 (\$87,500 for married filing separately) and 28 percent on remaining AMTI. The taxable excess is the amount of the AMTI that exceeds the exemption amount.

Without much-hoped-for legislative relief before year-end, the AMT is expected to affect more taxpayers in 2007 than ever before because in 2007 (1) the AMT exemption levels drop to where they were before 2001; and (2) certain nonrefundable credits (except for the adoption credit, the child credit and the saver's credit) are no longer allowed against the AMT.

**AMT Exemption Amounts Reduced in 2007.** The AMT exemption for 2007 is reduced to:

- \$45,000 (down from \$62,550) for married individuals filing a joint return and surviving spouses;
- \$33,750 (down from \$42,500) for unmarried individuals other than surviving spouses; and
- \$22,500 (down from \$31,275) in the case of married individuals filing a separate return.

Congress is expected to provide some adjustment to the AMT exemption amounts to

prevent millions from being subject to the AMT tax. At the time this publication went to press, such relief had not yet been provided. We will keep you posted.

Taxpayers may be subject to the AMT if they claim itemized deductions, such as interest on home equity loans used for nonresidential purposes, medical expenses, and miscellaneous job and investment expenses. In addition, tax benefits such as tax-exempt interest, accelerated depreciation, and incentive stock option benefits may trigger the AMT. A taxpayer should make estimates of his or her taxable income and AMT income for the current year and next year and calculate the taxes for both years. If the taxpayer expects to be subject to the AMT in one year and not the next, he should shift deferral-type preferences into the non-AMT year. This would save taxes over the two-year period by increasing the regular tax in the non-AMT year (at least to the point where the regular tax is equal to the tentative minimum tax). Examples of deferral-type preferences that should be shifted to the following year are prepaid real estate taxes, miscellaneous expenses, such as professional fees, and state and local tax payments.

**Use Annual Gift Tax Exclusion to Fund 529 Plans.** Parents and other relatives in most states have until year-end to make contributions of \$12,000 (\$24,000 if married couple) to a 529 plan and have it treated as a completed gift of a present interest for purposes of the annual gift tax exclusion. (Check the deadline in your state. Some states have April 15 deadlines.)

The gift will also be excluded for purposes of the generation-skipping transfer tax. If the contribution exceeds \$12,000 (\$24,000 if married couple), the contributor may elect to "frontload" the gift or to have the contribution treated as if made ratably over five years beginning in the year the contribution is made.

According to the five-year averaging rule, a donor may contribute up to \$60,000 every five years (\$120,000 in the case of a married couple) with no gift tax consequences, assuming no other gifts are made to the beneficiary in the five-year period. A gift tax return must be filed with respect to any contribution in excess of the annual gift-tax exclusion limit, and the election for five-year averaging must be made on the contributor's gift tax return. Funds invested in a qualified tuition program will be excluded from the donor's and beneficiary's estate unless the donor dies during the special five-year averaging period discussed above.

**Planning Pointer.** 529 Plan or UGTA Gift? When compared with the other savings vehicles available to parents and grandparents searching for a tax-deferred way to save for a child college education, the clear winner is the college savings plan offered under Code Sec. 529. Here's why. If parents/grandparents invest in mutual funds or stocks in their own names, the adults presumably in higher income tax brackets will be taxed on investment income at their individual tax rates. On the other hand, even though all 50 states and the District of Columbia have enacted laws simplifying the often complicated procedure of making gifts to minors, especially gifts of securities, when parents invest in custodial accounts under the Uniform Gifts/Transfers to Minor's Act, the children

will have control of the money at age 21 and the parents will still pay tax on the investment income as a result of the kiddie tax (discussed in detail below). If parents invest in a Coverdell Education Savings Account (CESA), the dollars will grow tax-free and be exempt from tax when distributed, but parents may only contribute \$2,000 annually to a CESA and it will be difficult to accumulate sufficient funds to pay most college tuitions [Code Sec. 530]. In addition, the \$2,000 annual contribution limit is phased out for joint filers with MAGI at or above \$190,000 and less than \$220,000 (at or above \$95,000 and less than \$110,000 for all filers other than joint filers).

The best part about the 529 plan is that Code Sec. 529(c) provides that no amount will be included in the gross income of a designated beneficiary or contributor to a 529 plan with respect to distribution or earnings under the program. An exception only exists for unrelated business income of the plan.

**Make Year-End Annual Gift.** If transferring income-producing assets to the next generation is one of the taxpayer's long-term objectives, before December 31, 2007, taxpayers should take advantage of the annual gift tax exclusion that entitles donors to give \$12,000 annually to an unlimited number of donees. The gifts will not be subject to gift tax provided they are gifts of a present interest. Moreover the donee pays no income tax upon receipt of the gift. A gift of a "present interest" means that the enjoyment or possession of the gift is immediate or in the present rather than postponed to a later time as a result of some contingency. Gifts of "future interests," which are

gifts where possession or enjoyment of the property is postponed until some future time (as is the case with a remainder interest in a trust) do not generally qualify for the annual gift tax exclusion unless a number of technical requirements are satisfied. Gifts that qualify as present interests are money, property such as stocks or bonds, or even a life insurance policy, provided the recipient receives even a temporary (30-day) right to withdraw the property.

The per donee gift tax exclusion renews annually and there is no carryover of any unused amount. Failure to use up the entire exclusion amount will result in loss of the unused amount. The annual per donee exclusion operates by permitting the first \$12,000, transferred to any number of individuals, including unrelated individuals to be excluded from current taxable gifts for federal gift tax purposes [Code Sec. 2503(b)]. There is no limit on the number of donees who may receive gifts, or on the number of years in which it may be used. Wealthy taxpayers, who want to reduce the amount of estate and gift tax their family will owe, may make an unlimited number of annual exclusion gifts per year without owing a dime of gift tax.

**Example.** Father gives Daughter \$24,000 in 2007. The first \$12,000 of the gift is not subject to the gift tax because of the annual gift tax exclusion. The remaining \$12,000 is a taxable gift.

**Example.** Rich Uncle gives \$12,000 in cash to 16 family members in 2007. The total transfer is \$192,000. Because each transfer is a present interest gift of

not more than \$12,000, all the gifts qualify under the annual per donee exclusion and none are considered taxable gifts for the year.

**Gift-Split to Double Value of Gift.** Even if spouses don't have sufficient funds in their own name to take advantage of the annual gift tax exclusion, their individual gift tax exclusions need not go to waste. Married donors are allowed to give away up to \$24,000 a year because each spouse is treated as if he or she had made one-half of the gift. The tax code allows a married couple to treat a gift to a third person as if each spouse had made one-half of the gift. In other words, when one spouse makes a gift to a third party with his or her own money, the nondonor spouse may join in the gift as if the nondonor spouse had supplied the money for one-half of the gift. This is called gift-splitting. The gift splitting option provides an excellent opportunity for spouses to double the amount of the annual exclusion available for a gift. An annual lifetime giving program can be an effective way of reducing the value of one's taxable estate.

**Example.** Father gives Daughter \$24,000. Mother agrees to split the gift with Father. The entire \$24,000 gift is free of tax.

**Observe Gift-Splitting Requirements.** The gift-splitting provisions require the filing of an election for each calendar year in which a married couple decide to gift-split. If the spouses consent to gift splitting, all qualifying gifts made by either spouse during the year of the election must be split. Gifts made in previous or subsequent years may not be

split unless gift splitting applies for those years. There are five requirements that must be satisfied in order to take advantage of the gift splitting provisions:

- The donor and nondonor spouse must be alive and married to each other at the time of the gift. If they are divorced during the year, they may still split the gift provided neither is married to anyone else at the end of the calendar year in which the gift takes place.
- Each spouse must be a United States citizen or resident at the time of the gift.
- The gift must be made to a third party (*i.e.*, not between the spouses).
- The nondonor spouse must not receive a general power of appointment over the property transferred.
- Both spouses must make or consent to the election on the gift tax return in question. An election to split gifts is made when the gift tax return (Form 709) is due (generally April 15 of the year following the year of the gift) and the election is irrevocable after that date.

**Consider Basis of Gift for Appreciated Property.** An often-overlooked point about gifts is that the carry-over basis rule applies to gifts. This means that the donee takes the donee's basis in the property. As a result, when the donee sells the property, any gain on the sale will be measured using the donor's basis in the property, not the basis at the time of the gift. Taxpayers should be mindful of these rules when giving away property that has appreciated in value because the donee's tax bill could be significant if he sells the property. If how-

ever, the property qualifies as a capital asset, the reduced capital gains rates will diminish the impact of the tax burden imposed on those capital gains. In 2007, most long-term capital gains and corporate dividends are taxed at 15 percent. But for taxpayers in the two lowest income tax brackets (10 percent and 15 percent), the taxpayer's capital gains are taxed at five percent for 2007, and zero percent for 2008 through 2010.

### **Kiddie Tax Planning in Light of Recent Legislative Changes**

The kiddie tax was created by Congress to eliminate the transfer by wealthy parents of income-producing investment property from the parents' high marginal tax rate to the child's generally lower tax bracket, thereby reducing the family's overall income tax liability. The kiddie tax put the kibosh on this scheme by applying the parents' highest tax rates on the child's unearned income.

It is important to note that only a child's "unearned income" is subject to the kiddie tax. Earned income includes wages, tips, contract service income, self-employment net income and other payments for personal services performed. By contrast, unearned income is generally a taxpayer's investment income, *e.g.*, interest, dividends, capital gains, rents, royalties, Social Security and beneficiary distributions. Thus, even if a child has unearned income subject to the kiddie tax, any earned income from part-time employment or summer jobs will be taxed at the child's own tax bracket which is typically lower than their parents' tax bracket.

**Law Effective in 2006 and 2007.** In 2006 and 2007, the unearned income of a child is subject to the kiddie tax in the following situations:

- The child's unearned income exceeded twice the child's standard deduction of \$850 (*i.e.*, \$1,700)
- The child was under age 18 at the end of the year
- One of the child's parents was alive at the end of the year
- The child was required to file a tax return and did not file a tax return

**Law effective January 1, 2008-Reach of kiddie tax expanded to 18-year olds and Students Under Age 24.** The Small Business and Work Opportunity Tax Act of 2007 made significant changes to the kiddie tax effective for tax years beginning after May 25, 2007. Thus, beginning in the 2008 calendar year (since most taxpayers report income on the calendar-year basis) the new expanded kiddie tax applies to all children age 18 and to children aged 19–23 if (1) the child is a full-time student before the close of the tax year; and (2) the child's earned income does not exceed one-half of his or her support [Code Sec. 1(g)(2)(A)(ii)(II)]. When determining the amount of support that a qualifying student provides, scholarships are not taken into account [Code Sec. 152(f)(5)]. This means that a child will not be subject to the kiddie tax if he works and earns enough income to cover half of the amount of support he receives from his parents. When this occurs, however, the parents cannot claim a dependency deduction for him.

If a parent has more than one child subject to the kiddie tax, the net unearned income of all

children is combined, and a single kiddie tax is calculated. Each child is then allocated a proportionate share of the hypothetical increase, based upon the child's net unearned income relative to the aggregate net unearned income of all of the parent's children subject to the tax.

The following list summarizes when the net investment income of a child will be subject to the kiddie tax beginning in 2008, assuming that he or she has a living parent and does not file a joint return:

- 17 years old or younger—will continue to be subject to the kiddie tax regardless of the amount of his or her own support provided with earned income
- 18-year-old—subject to the kiddie tax unless the child provides more than half of his or her own support with earned income
- 19- to 23-year-old—subject to kiddie tax unless the child is a student and provides more than half of his or her own support with earned income

### Practice Pointers

- Since the new expanded kiddie tax does not apply until January 2008, students under the age of 24 and 18-year-olds affected by this change have a short window of opportunity to sell investments before December 31, 2007, without having their investment income subject to the kiddie tax and taxed at their parent's highest marginal tax rate. In 2007, the top tax rate on long-term capital gains is 15 percent except for individuals in the 10-percent and 15-percent federal income tax brackets. Those in the 10-per-

cent and 15-percent federal income tax brackets are subject to only a five-percent tax rate in 2007 and zero percent for 2008 through 2010. Those students and 18-year-olds will only be able to take advantage of the zero-percent tax on capital gains in 2008 through 2010 if their earned income exceeds one-half of their support and they aren't subject to the kiddie tax.

- The child must file a separate return on Form 8615, *Tax for Children Under Age 18 Who Have Investment Income of More Than \$1,700*, to report his or her income unless the parent elects to include the child's income on the parent's return.
- Parents should file Form 8814, *Parent's Election to Report Child's Interest and Dividends*, if the parent elects to report the child's unearned income on the parent's return. If the election is made, the child is treated as having no income and does not have to file a return for the tax year.
- To avoid kiddie tax exposure on a child's investments, parents should consider investments for children that will appreciate in value but generate little or no taxable income. Candidates would include the following: (1) undeveloped or vacant land with growth potential but generating no rental income; (2) high-growth, low-dividend stocks and funds that pay few dividends; (3) stocks in closely held family businesses; (4) tax-free municipal bonds; and (5) U.S. series EE savings bonds where the interest is deferred until the bond is cashed in.

- Parents should consider employing their children in a family trade or business and paying them a reasonable wage so that the income received by the children is earned income and not subject to the kiddie tax. A child's wages are always taxed at the child's tax rate. This strategy may also help children toward earning one-half of their support and thus exempt them from the kiddie tax under Code Sec. 1(g)(2)(A)(ii)(II). In addition, the business could claim deductions for the amount of ordinary and necessary wages paid to children who are working in the business. Moreover, self-employed individuals can employ their own children under age 18 and do not have to pay FICA [Code Sec. 3121(b)(3)(A)]. If the child is under 21, they do not have to pay FUTA taxes [Code Sec. 3306(c)(5)].
- Consider making contributions to alternative tax-deferred investments such as traditional/Roth IRAs, CESAs or college savings plans (529 plans) because these nest eggs do not generate taxable investment income. Although a child must have earned income to contribute to a traditional or Roth IRA, there is nothing to stop a savings-oriented parent from supplying a portion of the \$4,000 maximum contribution in 2007. Parents and their children who had summer jobs should note that they have until April 15, 2008, to make their 2007 contributions to either a traditional IRA or Roth IRA.

- Under the new expanded kiddie tax rules, in 2008 college age students will no longer be able to sell off their appreciated investment accounts set up by their parents to cover tuition without triggering a kiddie tax. To avoid this tax, students may have to take out student loans and pay interest until the year the student turns 24 and can access the accounts without being subject to the kiddie tax.

**Avoid Underpayment Penalties.** Taxpayers will not be subject to an underpayment penalty if the balance due on the tax return (total tax liability for the year, less tax withholding and timely estimated payments) is \$1,000 or less. If the balance due is more than \$1,000, the taxpayer will be subject to interest and penalties on unpaid taxes unless the taxpayer satisfies a safe harbor. Any taxpayer making quarterly estimated tax payments should make sure that by year-end they have paid sufficient estimated tax to avoid being subject to interest and penalties for 2007. No estimated tax is required if the taxpayer had no tax liability last year and was a U.S. citizen during the year. A taxpayer can avoid an estimated tax penalty if tax payments are at least the lesser of (1) 90 percent of the tax that will be shown on the return for the current year, or (2) 100 percent of the tax that was shown on the preceding year's return (the safe harbor). If a taxpayer's adjusted gross income for the prior year exceeds \$150,000 (\$75,000 for married filing separately), the safe harbor percentage is increased to 110 percent of the tax that was shown on the preceding year's return.

**Year-End Retirement Plan Tips Make Contributions to Retirement Plans.** Taxpayers who make tax-deductible contributions to a tax-deferred qualified retirement plan before year-end will benefit from a tax deduction as well as tax-deferral on the income earned by the investment for the long-term. The funds will typically be taxed when withdrawn, but most taxpayers anticipate a lower tax bracket at that time. In 2007, taxpayers can contribute up to \$15,500 to a 401(k), 403(b), 457 or Simplified Employee Pension (SEP) IRA plan. Taxpayers who are age 50 and older can contribute an additional \$5,000 under the catch-up provisions for a total contribution of \$20,500.

**Open Keogh by Year-End.** Self-employed taxpayers must open their Keogh plans by December 31, 2007 in order to claim a deduction on their 2007 tax return. The business need not be a full-time business to be eligible to open a Keogh plan. All the taxpayer needs to make a contribution is net earnings from self-employment. These taxpayers have until April 15, 2008 (plus extensions) to make the actual contribution funding the Keogh plan. A SEP plan can be established and funded as late as the self-employed person's return due date (including extensions).

**Make IRA Contributions.** For 2007, taxpayers may contribute a combined total of \$4,000 to a traditional IRA or a Roth IRA. In addition, taxpayers who are at least 50 years old by year-end may make an additional catch-up contribution of \$1,000 for a total contribution of \$5,000. They have until April 15, 2008, to make their 2007 contribution to either

a traditional IRA or a Roth IRA. Taxpayers who are under age 70 1/2 may be able to deduct contributions to a traditional IRA up to the lesser of \$4,000 (\$5,000 if age 50 or older) or 100 percent of compensation. If they are covered by a retirement plan at work, their deduction for contributions to a traditional IRA is reduced (phased out) if their MAGI is:

- more than \$83,000 but less than \$103,000 for a married couple filing a joint return or a qualifying widow(er);
- more than \$52,000 but less than \$62,000 for a single individual or head of household; or
- less than \$10,000 for a married individual filing a separate return.

For 2007, if they are not covered by a retirement plan at work, their deduction for contributions to a traditional IRA may be reduced (phased out) if they either live with their spouse at any time during 2007 or file a joint return for 2007.

If they either live with their spouse or file a joint return, and their spouse is covered by a retirement plan at work but they are not, their deduction is phased out if their MAGI is more than \$156,000 but less than \$166,000. If their AGI is \$166,000 or more, they cannot take a deduction for contributions to a traditional IRA.

**MAGI Limit for Roth IRA Contributions Increased.** For 2007, a taxpayer's Roth IRA contribution limit is reduced (phased out) in the following situations:

- Filing status is married filing jointly or qualifying widow(er) and MAGI is at least \$156,000. The taxpayer cannot make a Roth IRA contribution if his or her MAGI is \$166,000 or more.

- Filing status is married filing separately, the taxpayer lived with his or her spouse at any time during the year, and MAGI is more than -0-. The taxpayer cannot make a Roth IRA contribution if his or her modified AGI is \$10,000 or more.
- Filing situation is different than either of those described above and MAGI is at least \$99,000. No Roth IRA contribution can be made if MAGI is \$114,000 or more.

#### **Taxpayers Over 70 1/2 Must Take RMDs to Avoid Penalty.**

Taxpayers who are over the age of 70 1/2 and have invested in a qualified retirement plan, must remember to make their annual required annual minimum distribution (RMD) from their retirement accounts by year-end. Failure to do so will subject them to a 50-percent penalty. The RMD rules apply to distributions from:

- all traditional IRAs, SEP-IRAs and SIMPLE-IRAs;
- all qualified retirement plans—e.g., profit sharing, money purchase, 401(k), defined benefit plans; and
- certain other tax-deferred retirement accounts—e.g., 403(b) and 457 plans.

Taxpayers who turn age 70 1/2 this year have until April 1, 2008, to make that first required minimum distribution.

**Last Chance to Make Tax-Free IRA Distributions to Charities.** December 31, 2007, is last day that individuals aged 70 1/2 or older can distribute up to \$100,000 of their IRA balance to charitable organizations without recognizing income and without claiming a charitable deduction [Code Sec. 408(d)(8)]. The distribution counts toward

the required minimum distribution. Distributions may be from a traditional or a Roth IRA. The recipient of the IRA funds must be a “50-percent organization” described in Code Sec. 170(b)(1)(A) (so named because they can be deducted up to 50 percent of the taxpayer’s contributions base in the contribution year). Code Sec. 170(b)(1)(A) specifically includes a church or a convention or association of churches in its list of eligible charitable organizations. Other eligible charitable organizations include educational institutions; hospitals; medical research organizations; organizations supporting governmental schools; governmental units; publicly supported organizations; common fund organizations; private operating foundations; and conduit foundations [Code Sec. 408(d)(8)]. Note that not all 50-percent organizations qualify. Distributions to supporting organizations described in Code Sec. 509(a)(3) (*i.e.*, organizations that support churches, educational institutions, hospitals, medical research organizations, organizations supporting government schools and publicly supported organizations) are not qualified distributions.

#### **Year-End Advice for Business Owners**

**Take Advantage of Expensing Opportunity.** Business owners should make an election to deduct immediately under Code Sec. 179, rather than depreciate, up to \$125,000 of depreciable personal property placed in service in their business at any time before December 31, 2007. The expensing deduction is not prorated for the time that the assets are in service during the year. This means

that qualifying property could be purchased on December 31, 2007, and up to \$125,000 of the cost could be expensed on the 2007 return without proration.

The expensing deduction is not an item of AMT tax preference or adjustment. Therefore, it makes sense for taxpayers that may be subject to the AMT to consider expensing depreciable property rather than claiming depreciation that would trigger an AMT adjustment. When computing the expensing deduction, keep in mind that the \$125,000 maximum expensing deduction is reduced (but not below zero) by the amount that the cost of qualifying property placed in service during the year exceeds \$500,000.

Qualifying property for purposes of the expensing deduction is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business and includes off-the-shelf computer software. Generally, an election to expense these items is made on the taxpayer’s original return for the tax year to which the election relates. Taxpayers may make or revoke the election on an amended return without IRS consent.

**Avoid Mid-Quarter Convention.** Under the half-year convention which is used to determine the amount of depreciation deductions for most property (other than residential rental property, nonresidential real property, and railroad grading and tunnel bores), all property is treated as if it were placed in service at the year’s midpoint regardless of when during the year the property was actually placed in service [Code Sec. 168(d)(4)(A)]. For example, if you place an item of property into ser-

vice on April 1 of year one, you can claim only a half-year of depreciation that year (even though the property is used for three-fourths of the year). As a result, assets placed in service at any time during the year are treated as placed in service in the middle of the year and you are entitled to claim only one half of the normal first year's depreciation deduction [Code Sec. 168(d)(2)]. The half-year convention applies unless the mid-quarter convention applies.

Code Sec. 168(d)(3) generally provides that if the total cost basis of all depreciable assets placed in service during the last three months of the tax year exceeds 40 percent of the total basis of all property placed in service during the entire year, the taxpayer must use the mid-quarter convention. Property that the taxpayer does not depreciate under MACRS (for example, certain public utility property, films and video tapes, and sound recordings) should not be counted when applying the 40-percent test. On the other hand, a taxpayer should take into account "listed property" (for example, cars, entertainment property, computers and cellular phones) [Reg. §1.168(d)-1(b)(2)]. Reduce the basis of property placed in service during the year by any expensing deduction claimed for the property.

Taxpayers should avoid application of the mid-quarter convention whenever possible because when this convention is used, assets are depreciated beginning in the middle of the quarter when placed in service and the amount of the depreciation deduction is vastly reduced. As a result, taxpayers should time the acquisition of property to avoid application of the mid-

quarter convention. To avoid having the mid-quarter convention apply, be sure that the aggregate bases of property placed in service in the last quarter do not exceed 40 percent of the aggregate bases of all property placed in service during the first nine months of the year. The following example illustrates why taxpayers should avoid the mid-quarter convention.

**Example.** Taxpayer buys and places in service equipment costing \$10,000 in the first quarter, equipment costing \$10,000 in the second quarter, and equipment costing \$100,000 in the third quarter. Taxpayer also wants to buy and place in service additional equipment costing \$85,000 in the fourth quarter. Since \$85,000 exceeds 40 percent of the aggregate bases of all equipment placed in service during the year, the mid-quarter convention applies and taxpayer would have to use the mid-quarter tables to compute his depreciation deduction. If all the equipment is five-year property, taxpayer's depreciation deduction would total \$25,250 computed as follows: \$3,500 ( $\$10,000 \times 40\% \times 87.5$  percent) for first quarter purchases, \$2,500 ( $\$10,000 \times 40\% \times 62.5$  percent) for second quarter purchases, \$15,000 ( $\$100,000 \times 40\% \times 37.5$  percent) for third quarter purchases and \$4,250 ( $\$85,000 \times 40\% \times 12.5$  percent) for fourth quarter purchases. If however, the fourth quarter equipment had been \$80,000 rather than \$85,000, the mid-quarter convention would not have applied and the half-year convention would have yielded a total first year depreciation deduction of \$40,000 ( $20\% \times \$200,000$ )—a \$14,750 increase.

**Planning Tip.** Before buying a car, equipment or other depreciable property for use in a trade or business

before the end of the year, taxpayers should take out a calculator to be sure that they will not be trapped by the mid-quarter convention. One way around the mid-quarter convention is to make an election to expense up to \$125,000 of the cost of eligible property in 2007. The Code Sec. 179 expensing election is available for property that is used for personal as well as business purposes if the business use predominates [Reg. §1.179-1(d)(1)]. You may not claim an expensing deduction for air conditioners, heating units or property used outside the United States. Once you have made the election to expense part or all of the basis of business property, that basis is no longer considered in computing whether or not the mid-quarter convention applies.

**Harvest Losses.** Taxpayers who lost money in the stock market this year should use the loss to their advantage by harvesting the losses now before year-end in order to realize tax savings on their 2007 return. The idea behind this move is to make the best of a bad situation. If stock investments have declined this year, consider selling the losers now in order to lock in a capital loss. Taxpayers should sell enough of the losers to cover any capital gains realized earlier in the year plus \$3,000 of ordinary income. They will be able to use up to \$3,000 of their capital losses to offset a like amount of ordinary income from wages, bonus and interest each year. If they are searching for capital assets to sell off, they should avoid antiques and other collectibles that are still taxed at the maximum long-term tax rate of 28 percent. Any extra capital loss can be carried over indefinitely to future tax years.

### **Beware of Wash-Sale Rules.**

The wash-sale provisions were designed to prevent investors holding stock that has declined in value from selling the loser and claiming a tax loss, while at the same time maintaining the investment by repurchasing the same or substantially identical stock. A wash sale occurs when taxpayers sell a stock or some other security and within 30 days before or after the transaction, buy substantially identical stock or securities. Taxpayers engaging in wash-sale transactions will be unable to deduct losses from that sale. Instead, they will have to add the disallowed loss to their basis in the newly acquired securities, which increases their loss or reduces their gain when they eventually sell those shares. Taxpayers can avoid the wash-sale rules by simply not buying the exact same stock that they initially sold, or they should wait at least 31 days to repurchase the same stock. Note that bond swaps can be useless to investors seeking to reduce their tax bills. Taxpayers can sell some bonds at a loss to lock in the tax loss and then buy back similar bonds. They can then repurchase bonds of the same issuer without fear of the wash-sale rules as long as the replacements have different maturities or interest rates.

**Year-End Advice for Mutual Fund Owners.** When investors sell, exchange or redeem mutual fund shares (unless selling shares in tax-deferred retirement plan) they must calculate gain or loss on the transaction. In fact, every time the investors write a check on their mutual fund account or withdraw cash, they are redeeming shares and must calculate a

capital gain or loss reportable on their tax return. The amount of gain or loss is equal to the amount realized from the transaction less the adjusted basis of the fund shares that were sold. Figuring a taxpayer's basis in mutual fund shares can be complex. To begin with, a taxpayer's basis in any share is more than just the share's quoted price at the time of purchase. Investors must add to the cost any load and redemption fees, reinvested dividends, and undistributed capital gains. In addition, if they bought shares at different times and don't sell all of their shares in a fund at one time, their basis depends on whether or not they can identify the shares sold. When mutual fund shares are sold, the gain or loss will be long-term capital gain if the shares were held for more than 12 months. The holding period begins on the day after the shares were purchased and includes the day the shares were disposed of. If, at the time of the sale, the investor specifies to the mutual fund company which shares he or she wants to sell, the investor can use the adjusted basis (cost plus add-on amounts) of those particular shares to figure taxable gain or loss.

**Important.** Taxpayers must obtain written confirmation from their mutual fund to use this method. If they don't specify which shares they are selling, they can choose one of the IRS methods to determine their basis. They make their choice on their tax return for the year of sale.

**Avoid Year-End Mutual Fund Share Purchases.** Before investing in a mutual fund at year-end, taxpayers are well

advised to ask whether the fund is about to pay a year-end capital gain distribution or dividend distribution. Why? These distributions will be fully taxable to the investor as if he had owned shares in the mutual fund for the entire year. Mutual funds are required to distribute their net capital gains to shareholders each year. Fund managers therefore declare an annual distribution in December based on who owns shares on the so-called "record date," which is usually in late December. If investors buy shares before or on a fund's "record date," they will receive a portion of the money they just invested in the form of a taxable distribution (unless the account is tax-deferred, such as an IRA). This is not wise and it would be more prudent for investors to avoid buying shares of a mutual fund on or before the "record date" because they will be taxed on the distribution even though they only owned shares in the fund a short time. Before investing call the mutual fund manager to determine the record date and then invest with confidence after that date.

**Claim Tax Credit for Purchase of Alternative Motor Vehicles.** The Energy Policy Act of 2005 replaced the clean-fuel burning deduction with the alternative motor vehicle credit [Code Sec. 30B]. A tax credit is better than a deduction because it is subtracted directly from the total amount of federal tax owed, thus reducing or even eliminating the taxpayer's tax obligation. A tax credit is available for hybrid passenger cars or light trucks placed in service in 2007. The credit is only available to the original purchaser of

a new, qualifying vehicle. If a qualifying vehicle is leased to a consumer, the leasing company may claim the credit. Hybrid vehicles have drive trains powered by both an internal combustion engine and a rechargeable battery. The following hybrid vehicle models have been certified for the credit in the following amounts:

**Model Year 2008**

- Chevrolet Malibu Hybrid—\$1,300
- Ford Escape 2WD Hybrid—\$3,000
- Ford Escape 4WD Hybrid—\$2,200
- Honda Civic Hybrid CVT—\$2,100
- Mazda Tribute 2WD Hybrid—\$3,000
- Mazda Tribute 4WD Hybrid—\$2,200
- Mercury Mariner 2WD Hybrid—\$3,000
- Mercury Mariner 4WD Hybrid—\$2,200
- Saturn Aura hybrid—\$1,300

**Model Year 2007**

- Chevrolet Silverado 2WD Hybrid Pickup Truck—\$250
- Chevrolet Silverado 4WD Hybrid Pickup Truck—\$650
- Ford Escape Hybrid 2WD—\$2,600
- Ford Escape Hybrid 4WD—\$1,950
- GMC Sierra 2WD Hybrid Pickup Truck—\$250
- GMC Sierra 4WD Hybrid Pickup Truck—\$650
- Honda Accord Hybrid AT—\$1,300
- Honda Accord Hybrid Navi AT—\$1,300
- Honda Civic GX—\$4,000 ††
- Honda Civic Hybrid CVT—\$2,100
- Lexus GS 450h—\$775†
- Lexus RX 400h 2WD and

4WD—\$1,100†

- Mercury Mariner 4WD Hybrid—\$1,950
- Nissan Altima Hybrid—\$2,350
- Saturn Aura Hybrid—\$1,300
- Saturn Vue Green Line—\$650
- Toyota Camry Hybrid—\$1,300†
- Toyota Prius—\$1,575†
- Toyota Highlander Hybrid 2WD and 4WD—\$1,300†

**Model Year 2006**

- Chevrolet Silverado 2WD Hybrid Pickup Truck—\$250
- Chevrolet Silverado 4WD Hybrid Pickup Truck—\$650
- Ford Escape Hybrid (Front) 2WD—\$2,600
- Ford Escape Hybrid 4WD—\$1,950
- GMC Sierra 2WD Hybrid Pickup Truck—\$250
- GMC Sierra 4WD Hybrid Pickup Truck—\$650
- Honda Accord Hybrid AT w/updated calibration and Navi AT w/updated calibration—\$1,300\*
- Honda Civic GX—\$4,000 ††
- Honda Civic Hybrid CVT—\$2,100
- Honda Insight CVT—\$1,450
- Lexus RX400h 2WD—\$1,100†
- Lexus RX400h 4WD—\$1,100†
- Mercury Mariner Hybrid 4WD—\$1,950
- Toyota Highlander 2WD Hybrid—\$1,300†
- Toyota Highlander 4WD Hybrid—\$1,300†
- Toyota Prius—\$1,575†

**Model Year 2005**

- Ford Escape 2 WD Hybrid—\$2,600
- Ford Escape 4 WD Hybrid—\$1,950
- Honda Accord Hybrid AT and Navi AT—\$650
- Honda Civic GX—\$4,000 ††

- Honda Civic Hybrid MT and CVT—\$1,700
- Honda Insight CVT—\$1,450
- Toyota Prius—\$1,575†

\* 2006 Honda Accord Hybrid AT and Navi AT without updated calibration qualify for a credit of \$650.

† This reflects a decrease in the credit amount as of October 1, 2006, due to the manufacturers' meeting quarterly sales of 60,000 qualified hybrid cars—See Quarterly Sales.

†† This credit amount does not phase out. The full amount of the alternative fuel vehicle credit would be available for vehicles purchased on or before December 31, 2010.

**Last Year to Claim Above-the-Line Deduction for Expenses of Elementary and Secondary School Teachers.** Barring a retroactive extension, 2007 is the last year that an individual who is an elementary or high school teacher for at least 900 hours during a school year may claim an above-the-line deduction for up to \$250 of the educator's expenses for books, supplies (other than non-athletic supplies for courses of instruction in health or physical education), computer equipment (including related software and services) and other equipment, and supplementary materials used by the educator in the classroom [Code Sec. 62(a)(2)(D)]. The Tax Relief and Health Care Act of 2006 extended this deduction, which was scheduled to end after the 2005 tax year, to amounts paid or incurred for a tax year beginning in 2006 or 2007. Educators must file Form 1040 in order to claim this deduction; it cannot be claimed on Form 1040A.

**Last Year to Install Energy-Saving Property and Claim Tax Benefits.** Barring a retroactive

extension, 2007 is the last year that homeowners may claim a tax credit of up to \$500 for energy-efficient improvements or adding certain residential energy property to their homes [Code Sec. 25C]. The credit offsets individual taxpayers' regular tax liability but does not reduce AMT, and no credit carryovers are permitted if regular tax liability is not sufficient to use the full credit.

The energy-efficiency improvement or property must be installed in or on a dwelling unit in the United States that is owned and used by the taxpayer as the taxpayer's principal residence and originally placed in service by the taxpayer [Code Sec. 25C(c)(1) and (d)(1)]. There must be a reasonable expectation that the qualified energy efficiency improvements (exterior doors and windows, insulation, and certain metal roofs) will remain in use for at least five years [Code Sec. 25C(c)(1)(C)]. Residential energy property expenditures (heat pumps, furnaces, central air conditioners and water heaters) include labor costs [Code Sec. 25C(d)].

The maximum \$500 energy-efficient home credit that is available for property placed in service in 2007 equals the sum of (1) 10 percent of the cost of energy-efficiency improvements; and (2) the amount of residential energy property expenses [Code Sec. 25C(a)]. The residential energy property credit is limited to a maximum of \$500 for all tax years, and no more than \$200 of the credit can be based on expenditures for windows [Code Sec. 25C(b)]. The residential energy property credit applies to qualified energy-efficiency improvements and qualified energy property placed in service on or

before December 31, 2007 [Code Sec. 25C(g)].

Eligible improvements include: insulation materials that are primarily designed to reduce heat loss or gain; exterior windows, including skylights; exterior doors; storm doors in combination with a wood door; metal roofs with special pigmented coatings designed to reduce the heat gain of a dwelling unit; electric heat pump water heaters; electric and geothermal heat pumps; central air conditioners; natural gas, propane, or oil water heaters or furnaces; hot water boilers; and advanced main air circulating fans. Only the following residential energy items qualify for the credit:

- \$50 for each advanced main air circulating fan;
- \$150 for each qualified natural gas, propane, or oil furnace or hot water heater; and
- \$300 for each item of qualifying energy-efficient building property which include heat pumps, air conditioners, water heaters, furnaces and fan components carrying specific efficiency ratings.

Use Form 5695, *Residential Energy Credits*, to claim the credit.

**State and Local General Sales Tax Deduction.** Barring a retroactive extension, 2007 is the last year that taxpayers have the option to claim state and local sales taxes instead of state and local income taxes when they itemize deductions [Code Sec. 164(b)(5)]. Taxpayers also may add to the table amount any sales taxes paid on big tickets items such as

- a motor vehicle, but only up to the amount of tax paid at the general sales tax rate; and
- an aircraft, boat, home (including mobile or prefabricated),

or, in certain cases, a substantial addition to or major renovation of a home, if the tax rate is the same as the general sales tax rate.

The option to deduct state and local general sales tax is available to all taxpayers regardless of where they live, though the deduction will definitely favor residents of the seven states (Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming) that do not have state and local income taxes. However, even taxpayers who live in a state with a state income tax can take advantage of this deduction if they make big-ticket purchases on or before December 31, 2007.

**College Tuition and Fees Deduction.** Barring a retroactive extension, 2007 is the last year that taxpayers may claim an above-the-line deduction for payments of qualified tuition and related expenses required for the enrollment or attendance of the taxpayer, the taxpayer's spouse, or any claimed dependent at an eligible educational institution for courses of instruction [Code Sec. 222]. Generally, any accredited public, nonprofit or proprietary post-secondary institution is an eligible educational institution [Code Sec. 222(d)(1)]. The deduction is allowed for expenses paid during a tax year, in connection with enrollment during the year or in connection with an academic term beginning during the year or the first three months of the following year [Code Sec. 222(d)(3)].

This deduction was scheduled to end after the 2005 tax year, but the Tax Relief and Health Care Act made it available for tax years beginning in 2006 or

2007. The maximum amount of the deduction is \$4,000 for taxpayers with a MAGI that does not exceed \$65,000 (\$130,000 if they file a joint return) and \$2,000 for taxpayers with a MAGI that does not exceed \$80,000 (\$160,000 if they file a joint return). No deduction is allowed a taxpayer with a MAGI that exceeds \$80,000 (\$160,000 if the taxpayer files a joint return), a married individual who does not file a joint return or an individual who is claimed as another taxpayer's dependent.

Taxpayers must file Form 1040 to claim this deduction; it cannot be claimed on Form 1040A. Taxpayers may claim a deduction for "qualified tuition and related expenses" paid by December 31, 2007 [Code Sec. 222]. The taxpayer must include the name and taxpayer identification number (TIN) of the student for whom the expenses were paid on the taxpayer's return in order to claim the deduction [Code Sec. 222(d)(2)]. As an above-the-line deduction, it can even be taken by taxpayers who do not itemize deductions.

**Enhanced Deductions for Donations of Food and Books.** Barring a retroactive extension, 2007 is the last year that a C corporation can donate inventory to charity to be used for the care of the ill, needy or infants

and qualify for an enhanced deduction. The deduction will be equal to the lesser of (1) basis plus half of the property's appreciation, or (2) twice the property's basis for contribution before January 1, 2008 of:

- food inventory that is apparently wholesome and meant for human consumption and satisfying certain quality and labeling standards; and
- qualified contributions of book inventory to certain public schools if donee certification requirements are met [Code Sec. 170(e)(3)(C)].

**Enhanced Contributions of Computer Technology.** Barring a retroactive extension, 2007 is the last year that a C corporation may claim an enhanced deduction equal to the lesser of (1) basis plus half of the property's appreciation, or (2) twice the property's basis, for contributions of computer technology or equipment (software, computer or peripheral equipment, and fiber optic cable) to schools or libraries for use in the United States for educational purposes that is related to the donee's purpose or function [Code Sec. 170(e)(6)].

**Fast Write-offs for Leasehold and Restaurant Improvements.** Barring a retroactive extension, 2007 is the

last year businesses can place qualified leasehold improvement property in service in their trade or business and claim write-offs over a 15-year recovery period [Code Sec. 168(e)(3)(E)(iv)]. The qualified leasehold improvement property must be recovered using the straight-line method. The improvements must be made to the interior portion of nonresidential real property. Leasehold improvements that are not qualified leasehold improvement property are generally depreciated as either 39-year real property or 27.5-year residential rental property.

Also expiring at the end of 2007 is the statutory 15-year recovery period for qualified restaurant property placed in service in a taxpayer's trade or business [Code Sec. 168(e)(3)(E)(v)]. Qualified restaurant property means any improvement to a building if placed in service more than three years after the date the building was first placed in service and more than 50 percent of the building's square footage is devoted to the preparation of, and seating for, on-premises consumption of prepared meals. The qualified restaurant property must also be recovered using the straight-line method. ■