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OCTOBER / NOVEMBER / DECEMBER 2007

TAXLETTER

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Correction

In an article on the estate tax, on page 1 of the July/August/September 2007 *CPA Client Tax Letter*, we stated that the maximum tax rate of estates is scheduled to go up in 2001. The correct date for that increase is **2011**. We apologize for any inconvenience or confusion this error may have caused.



America Counts on CPAs

Tax Returns: Better Late Than Never

You probably filed your 2006 federal income tax return months ago, but that doesn't mean that you're finished with it. If you paid too little or too much, you can amend your return by filing Form 1040X.

Paid too little. You may discover that you paid too little tax. You might have overlooked some income that you should have reported. If this amount is small and was reported to the IRS on a Form 1099, you may not need to file an amended return. The IRS probably will spot the discrepancy and send you a notice spelling out how much tax you'll owe.

For larger amounts of tax due or income not reported to the IRS, you should file Form 1040X as soon as possible. Your payment will stop the interest from running; currently, the annualized rate is 8%. Making up a shortfall promptly also may keep you from paying a penalty.

Paid too much. On the other hand, you may have overlooked a legitimate deduction or credit and thus overpaid your income tax. If so, you can file an amended return and claim a refund.

You'll get back the tax you overpaid plus interest. Again, the current interest rate is 8%. To get a refund, you generally must file an amended return within three years of your original return's due

date or within two years from the date you paid the tax, whichever is later. The due date of your original return includes extensions.

It might not be worthwhile to file Form 1040X if the amount involved is modest. Amending your return invites more IRS scrutiny and increases the chance the IRS will question other items.

One tactic to consider is to wait and file an amended tax return a few days before the statute of limitations expires, generally three years from the date you filed the tax return. With this approach, the worst that can happen is that the IRS will disallow your claim for a refund of overpaid tax. By the time the IRS gets around to your 1040X, the statute of limitations will have expired, so other items on that return can't be reviewed.

Filling out the form

When you file Form 1040X, you'll fill in the year of the tax return that is being revised. Show the original amounts along with the new numbers you're submitting. One strategy is to attach copies of any documents that support your overpayment claim.

Our office can help you review recent returns and determine whether filing amended returns makes sense.

Make Your Vacation Home Less Taxing

If you own a second home that you use personally and rent to others as well, the tax treatment may vary each year depending on how you use the home. For any given year, the home will be

considered either a residence or a rental property—and taxed accordingly.

Residence or rental?

For the best tax treatment, try to keep

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your personal use of the home down. If you use your vacation home less than the greater of (1) 14 days or (2) 10% of rental days, the home will be considered rental property. If you go over these thresholds, your second home will be classified as a residence and deductions are limited.

If your home qualifies as rental property, you can deduct repairs, maintenance, insurance, and depreciation costs. If your expenses exceed your income, you can deduct the loss, subject to the passive loss rules. In most cases you may deduct passive losses up to \$25,000 if your adjusted gross income (AGI) is under \$100,000. As your AGI increases, your ability to deduct passive losses decreases, phasing out at \$150,000 in AGI.

If you're over the 10% limit, your home is classified as a vacation home and the tax rules are stricter. You can deduct expenses only up to the amount of rental income, so no loss deductions are permitted. What's more, expenses for a residence that's rented to others may be treated unfavorably. Before you can deduct any operating expenses or depreciation, you have to use up a portion of the property's mortgage interest and property tax—based on the number of rental days—effectively wasting deductions.

Losing the numbers game

To see how the tax rules can work against rental use of a residence, consider the hypothetical example of Ann Anderson, who owns a second home

in Arizona. In 2007, she rents the house to vacationers for 150 days, collecting a total of \$20,000. Ann uses the house herself for 20 days. Thus, she's over the 10% threshold and must treat the house as a residence.

Ann is allowed to use \$20,000 worth of deductions to match her rental income. Her mortgage interest and property tax on the house are \$16,000 in 2007. Of that \$16,000, 88%



(150 days out of 170) is allocated to rental use. Thus, Ann can use \$14,080 worth of mortgage interest and property tax deductions to offset her rental income. The other \$1,920 can be deducted on her personal return.

If she hadn't rented the house, Ann could have deducted all \$16,000 on her personal return, so she didn't

benefit by using that \$14,080 to offset rental income.

After deducting \$14,080 for mortgage interest and property tax, Ann can deduct only another \$5,920 in 2007 against her vacation home income. That's true regardless of whether her operating expenses and depreciation are \$6,000, \$10,000, or more.

Pare personal use

If Ann had used her vacation home for only 14 days, she could have treated the home as rental property. Then she could have deducted all related expenses, subject to the passive loss limits.

Therefore, if you have a vacation home you also rent out, your first goal should be to keep personal use to 14 days or less. Then no matter how many rental days you have, you can treat the home as rental property. If your personal use is over 14 days per year, try to rent the property for enough days so that personal use does not exceed 10%.

Enter the AMT

The above example of Ann Anderson assumes she is not subject to the alternative minimum tax (AMT). If she is, her property tax outlays won't be deductible for AMT purposes, which can affect the residence-versus-rental math. Our office can help determine whether you are likely to be subject to the AMT and whether that should impact your vacation home tax strategy.

New Law Makes Adults Into "Kiddies"

In late May, President Bush signed the Small Business and Work Opportunity Tax Act of 2007. This law raised the federal minimum wage from \$5.15 per hour to \$5.85 per hour, beginning in July. Further increases are

scheduled for July 2008 (to \$6.55 per hour) and July 2009 (to \$7.25 per hour).

To reduce the burden on small businesses, targeted tax breaks were included in the bill. To keep the entire

package "revenue neutral," some tax increases also were passed.

Extending the Kiddie Tax

Among those tax hikes is an increase in the age of youngsters whose

investment income is subject to the so-called Kiddie Tax. As recently as 2005, this tax expired after age 13. Now (in 2007) the Kiddie Tax lasts through age 17. Starting in 2008, taxpayers as old as 18 will be affected unless their earned income exceeds one half of the amount of their support. In addition, starting in 2008 the Kiddie Tax will affect individuals as old as 23 if they are full-time students and their earned income does not exceed one half of the amount of their support.

Over the limit

The mechanics of the Kiddie Tax remain the same. Each year, individuals in the specified age group can have a certain amount of tax-free investment income, \$850 in 2007. They also can have a certain amount of low-taxed investment income. In 2007, the next \$850 of unearned income is taxed at rates ranging from 5% to 10% depending on the source of that income. Additional investment income is taxed at the parents' rate.

Therefore, in 2007 a child under age 18 can have \$1,700 in income from bank accounts or mutual funds, for example, and owe only \$42.50 to \$85.00 in tax. Above \$1,700, each additional dollar of investment income is taxed at rates up to 35%. Those \$850 thresholds will be increased periodically to keep up with inflation.

Plugging the loophole

The latest increase in the Kiddie Tax age is not a straightforward revenue raiser. After all, it's relatively simple to shift a young adult's assets from a taxable bank account to a tax-managed mutual fund or an untaxed 529 college savings plan and thus avoid paying any Kiddie Tax.

Instead, this provision was designed to keep families from taking advantage of another tax code provision—the 0% tax bracket available to low-bracket taxpayers for dividends and long-term capital gains received in 2008 through 2010. The new legislation retains the

0% tax rate for low-income taxpayers. However, the change in the Kiddie Tax makes it much more difficult for upper-income families to cash in gains tax free.

Taking gains

To illustrate the strategy this new law addresses, assume a hypothetical Jack and Jill Smith have been using mutual funds to build a college fund for their daughter Kelly. In 2007, the Smiths transfer \$24,000 worth of appreciated fund shares to Kelly. Such transfers do not have any gift tax consequences because Jack and Jill Smith each have a \$12,000 annual gift tax exclusion, per recipient. They had planned to give Kelly another \$24,000 worth of appreciated fund shares in 2008.

Assume that Kelly will be 18 in 2008 and that the transferred funds then will be worth \$25,000 more than her parents invested. Kelly could cash in the shares and use the \$49,000 (or whatever the shares are worth when sold) to pay her college bills. Suppose that Kelly has relatively little income in 2008 other than those long-term capital gains. Under prior law, 18-year-old Kelly would have been treated as a single taxpayer. She could have taxable income up to \$33,000 or so (the actual numbers for 2008 will be published later this year) and owe no tax at all on those gains.

New math

The new law makes this strategy much less appealing. Assuming that 18-year-old Kelly would not earn more than one half of her support in 2008, she would be subject to the Kiddie Tax. Therefore, Kelly would owe no tax on her first \$1,700 in long-term gains. However, on \$23,300 (the \$25,000 realized gain minus Kelly's \$1,700 Kiddie Tax allowance), she would owe tax at her parents' rate, probably 15%.

Thus, the new law has reduced the tax advantages of this giveaway game.

Alternate strategies

If you are the parent of a minor or

young adult, what does the new law mean to you? Some tax-saving tactics are still available:

1. Maximize income-shifting strategies in 2007. The Kiddie Tax change is not retroactive, so all taxpayers who will be at least 18 by December 31 escape the Kiddie Tax this year. Therefore, you can shift appreciated assets to your 18-and-older children if you wish to sell those assets. The children can sell them by December 31.

Such sales won't get the 0% tax rate, but they will get a bargain 5% rate. Assuming your child files as a single taxpayer, the 5% rate on long-term gains will apply as long as taxable income does not exceed \$31,850. (Married youngsters filing joint returns are not subject to the Kiddie Tax.)

2. For the next three years, take full advantage of the zero tax rate. Make sure that your "kiddies" have \$1,700 worth of investment income each year.

If that income is low on interest income and high on dividends and long-term gains, little or no tax will be due. What's more, the \$1,700 threshold likely will be raised—perhaps to \$1,800—during those years.

3. Going forward, low-income taxpayers will get the 0% rate in 2008 through 2010 as long as they are at least 19 and not full-time students earning less than half their support. (18-year-old taxpayers also will get the 0% tax rate if their earned income exceeds half of their support.) So it might pay to transfer assets to recent grads or to youngsters not going to college.

Even if your youngsters are still in school (perhaps graduate school), they can qualify for the 0% tax rate from 2008 through 2010 once they reach age 24, with a low income.

4. The new rules don't affect income-shifting tactics involving other family members. It's still possible to give dividend-paying stocks and appreciated securities to your parents if you're supporting them. Low-income seniors can take full advantage of the 0% tax rate in effect for the next three years.

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Independent thinking

If the earned income of an individual over age 17 exceeds half of that person's support (excluding scholarships),

the Kiddie Tax won't apply. So generally even students 18 or older may be able to use the 0% tax rate if they are not eligible to be claimed as dependents

on their parents' tax return because they provide over half of their own support.

Expanded Equipment Writeoffs

The new Small Business and Work Opportunity Tax Act (SBWOTA) also eased Section 179 of the tax code. Most business equipment must be depreciated over many years, but some users—especially small companies—can “expense” their purchases of new and used equipment, so the costs can be deducted immediately.

For 2007 the tax code (pre-SBWOTA) permitted first-year writeoffs up to \$112,000 worth of equipment purchases. The new law boosts that maximum to \$125,000 retroactive to the start of 2007. What's more, the Section 179 allowance was scheduled to go down to \$25,000 after 2009. The new tax law keeps the \$125,000 base in effect through 2010. For the next three years, the maximum deduction will increase with inflation.

Thus, the 2008 maximum will be around \$130,000, depending on cost-of-living data. Similar increases will take place in 2009 and 2010.

Raising the ceiling

The expensing deduction is meant to be used by small companies, not megacorporations. Therefore, it is not available to businesses that purchase large amounts of equipment. Under the law prior to SBWOTA, taxpayers that buy over \$450,000 worth of equipment in 2007 would start to lose the tax benefit. The new law increases that number to \$500,000. Again, this amount will increase with inflation through 2010.

Suppose, for example, your company buys \$550,000 worth of equipment

this year. The excess \$50,000 is deducted from your Section 179 allowance, so you can deduct only \$75,000 worth of equipment purchases in 2007: the \$125,000 maximum minus the \$50,000 overage. The other \$475,000 worth of equipment (\$550,000 minus \$75,000) must be depreciated over a multi-year schedule.

Dividing the deduction

The \$500,000 limit applies to the entity that purchases the equipment. Suppose, for example, that four people form an equal partnership that purchases \$550,000 worth of equipment in 2007. Only \$75,000 worth of the partnership's equipment can be expensed this year. Divided among the four individuals, each would be entitled to expense \$18,750 on his or her personal tax return.

Multiple methodology

Individuals who are active in multiple activities may have multiple sources of expensing deductions. Suppose a hypothetical Bob Jones participates in the partnership described above. Suppose that Bob also runs a small business as a sole proprietorship. He would be able to deduct up to \$106,250 worth of equipment bought for that business in 2007, bringing the total to \$125,000.

There may be a trap for individuals who participate in multiple entities if they wind up taking excess expensing deductions. Suppose Bob participates in both a partnership and

an S corporation that use different tax preparers. Each tax preparer might elect a Section 179 deduction and allocate Bob a proportionate share, the total of which is \$150,000. However, Bob will be able to deduct only the maximum \$125,000 for 2007; he'll lose the benefit of the additional \$25,000 deduction.

In addition, Bob's basis in both entities will be reduced by a combined \$150,000, not the deductible \$125,000, and the lower basis may result in higher future tax bills. Our office can handle the tax returns for all of your pass-through entities to ensure that excess expensing amounts aren't elected.

The importance of income

The purchaser must also pass a “taxable income limitation” test to get the expensing deduction: the expensing deduction can't exceed the taxable income from the purchaser's active trade or business. This limitation may be an obstacle if your company is structured as a regular C corporation, where corporate income and deductions don't pass through to the shareholders. In this case, the corporation generally buys the equipment.

A corporation that zeroes out its income by paying everything in salaries won't have enough income to cover the expensing election. The corporation may save money by paying less compensation to shareholder employees and keeping enough taxable income to cover a Section 179 election.

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Marital bliss

On the bright side, one spouse might be able to help the other spouse meet the taxable income test, assuming they file jointly. Suppose Bob Jones's wife, Joy, starts a sideline business in 2007. Say this sideline business, which has no taxable income, spends \$25,000 on equipment in 2007. Ordinarily, no taxable income would mean no expensing deduction, but because Bob and Joy file a joint return, his income can be used to top the \$25,000 mark and permit a full expensing election for her equipment purchases in 2007.

Mixed messages

When you buy property that you use for business as well as personal reasons, the rules require careful documentation. Suppose you buy a home

computer that you use for business and that your kids use for homework.

If your business use exceeds 50% the first year, you can use Section 179 to write off that portion of the computer's price and related equipment such as a printer or scanner. If your business use the first year is below 50%, you must use extended depreciation.

What's more, if your business use of that computer falls below the 50% threshold within the next few years, some of your prior tax benefits must be "recaptured"—repaid to the IRS.

Happier endings

Some planning in the year's second half may help you make the most of the Section 179 tax benefit. If your business has bought little equipment this year, you may want to buy as much as \$125,000 worth by year's

end to get a deduction in 2007. On the other hand, if your business has already topped the \$500,000 limit but you expect to spend less next year, you may want to defer some purchases until 2008 when you will be able to expense those items.

If you want to expense equipment in 2007, you must place it in service this year. When you pay for it doesn't matter. Therefore, if you buy some equipment in December 2007 but don't install it until January 2008, you can't qualify for a 2007 writeoff, even if you pay in full in December. Conversely, if you place the equipment in service in December and your obligation to buy is genuine, you can qualify for a 2007 writeoff even if you don't pay until January.

Tax-Favored Ways to Build an Education Fund

As education costs soar, parents of youngsters must start building their college funds as soon as possible. Grandparents who want to help their grandchildren also should begin early. The power of compounding can be extraordinary, especially if you start saving when children are infants. Launch your funding early and you'll have 17 or 18 years to accumulate money for college.

Popular plans

One well-known funding option is a Section 529 plan, named after a portion of the tax code. Most states offer these plans.

Some state plans are investment plans, which carry the risk that the investment will decrease in value. Others are prepaid tuition plans, which offer protection: the individual state will pay for tuition at a state public school. Prepaid tuition plans are designed to provide an investment return that keeps up with increases in tuition levels.

In addition, the Independent 529 Plan, administered by TIAA-CREF, offers

a prepaid tuition plan that can be used at 263 private colleges around the U.S. You don't have to select a college in advance.

"Our plan is the only national 529 plan," says Nancy Farmer, president of the Independent 529 Plan. "People who purchase a tuition certificate from us know that the value of that certificate will increase at the same rate as college tuition." When a student is accepted by and enrolls at a participating college, the appreciated value of the tuition certificate can be redeemed.

Why 529 is the magic number

The advantages of 529 plans are impressive. Any earnings inside the account are tax free, and withdrawals are tax free if the money is spent on higher education. There are no income limits on 529 contributors and no phaseouts. Some 529 plans allow you to contribute many thousands of dollars per student. These tax advantages are now permanent.

Recent tax legislation extended the so-called "Kiddie Tax" to youngsters

through age 18, as of 2008, and through age 23 for full-time students. For individuals aged 18 through 23, the Kiddie Tax will not apply if their earned income exceeds one half of their support. This law makes family income shifting for tax purposes via custodial accounts less attractive and enhances the appeal of 529 plans.

If one child doesn't spend the money for college, you can roll the account into the name of a related individual tax free. For example, if your daughter turns out to be a star basketball player and receives a full scholarship, you can transfer her Section 529 account to her younger brother, maintaining the tax-sheltered buildup.

You can research 529 plans at the College Savings Plans Network's website, www.collegesavings.org. Another excellent website for details on 529 plans is www.savingforcollege.com.

Savvy supplement

Education IRAs, now known as Coverdell educational savings accounts (ESAs),

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offer another way to set aside money for children's education. Coverdell ESAs limit contributions to \$2,000 per student per year, so in most cases they won't fully finance a college education. Nevertheless, they can supplement a 529 plan.

A Coverdell ESA's tax treatment is similar to a 529 plan's. Inside a Coverdell ESA, the investment buildup isn't taxed. Nor is there any tax when money is withdrawn to pay school bills.

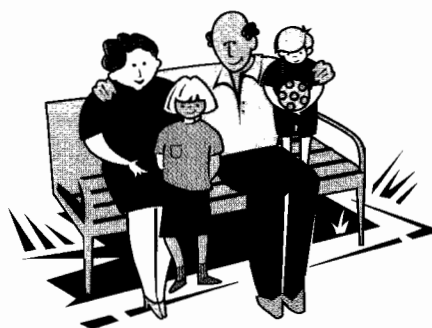
Money held in a Coverdell ESA can be used to pay, tax free, qualified elementary and secondary education expenses and qualified higher education expenses. Qualified education expenses encompass a wide variety of expenses, including private school tuition, tutoring, and appropriate software.

A Coverdell ESA is self-directed. You can shoot for higher returns with speculative investments if you wish or pursue an ultra-low-risk strategy.

Living with the limits

Married couples with an adjusted gross income (AGI) over \$220,000 cannot fund Coverdell ESAs, while those with an AGI of \$190,000 to \$220,000 are limited to less than the \$2,000 maximum. For single taxpayers, the upper limit is an AGI of \$110,000 while the phaseout range is \$95,000 to \$110,000.

In reality, these income limits may have little or no impact because any number of people can contribute to your child's account. For example, if you and your spouse are over the limit, each of the child's grandparents can contribute to the account, subject to the AGI limitations.



In fact, the Coverdell ESA may be established in the child's name, and funds can come from his or her custodial account.

Nice for newborns

The bottom line is that a Coverdell ESA may be especially valuable when the account is fully funded from a child's birth. If the child's family adds another \$2,000 each year, the ESA may be worth a substantial amount by the time he or she is in high school. Then the money can be tapped for education-related expenses, tax free,

or the buildup can continue until the child is in college.

Cloudy future

Although 529 plans have received permanent tax breaks, the same treatment was not extended to Coverdell ESAs. Thus, Coverdell ESAs are in jeopardy of reverting to their prior tax treatment after 2010.

The result of this backward step would be that Coverdell ESAs would no longer offer funding for K-12 expenditures, and Coverdell ESA withdrawals might put some other education-related tax breaks off limits in the year of withdrawal. But don't give up on Coverdell ESAs: tax-free transfers to 529 plans are permitted.

Year Assets in 529 Plans (\$ Billion)

2002	\$18.5
2003	\$35.1
2004	\$52.2
2005	\$68.7
2006	\$90.1

Sources: Investment Company Institute and College Savings Plans Network

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