

# CLEMENT & ASSOCIATES

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## 2006 TAX LAW CHANGES & UPDATES

### Donations – Changes for 2006 & 2007

Congress changed the rules on cash contributions. Effective January 1, 2007, you must have a written record to claim any donation on your return. You must now have a receipt from the charity or, if the donation is under \$250, a cancelled check or credit card receipt will be sufficient. No longer will the IRS accept an estimate for cash contributions. Loose offerings at church will disappear in 2007 as a log will no longer be allowed.

Congress also changed the rules for non-cash contributions which are Goodwill type donations for 2006. Hopefully it doesn't affect us, but they now limit the deduction for clothing and household items, to those items in "good used condition". Effectively, the IRS is tired of finding under-shorts and socks on the donation list which are not useable once worn. While this should not affect most of us, we should probably get into the habit of taking a picture of the items given away to prove that they are in good used condition.

By the way, never leave your non-cash contributions in one of the bins that are unmanned. If you don't receive a receipt, you will not get a deduction. If you are in the 30% combined Federal and State brackets, each \$1,000 of value equals \$300 of additional cash in your pocket!

### The Kiddie Tax – Age Increases to 18

Congress changed the age to 18 before the Kiddie Tax goes away. The Kiddie tax is a rule that requires children under the age of 18 to pay tax at their parent's tax rate when their unearned income exceeds \$1,700 for 2006 or the combination of earned and unearned income exceeds \$5,450. This was a change enacted during 2006 and is retro-active to January 1, 2006. Prior to this the Kiddie Tax went away at age 14.

### Telephone Excise Tax Refund

The IRS has finally abolished a tax on long distance calls that should have gone away years ago and has agreed to provide a refund or credit against your income taxes. You can go back through your old telephone bills and tally up the amount of excise tax paid since February 28, 2003, or opt for a standard refund of \$30 for a single

person, \$40 for a two person household, \$50 for three and \$60 for families of four or more. Different rules apply to businesses other than Schedule C's. Corporations and LLC's can take their April and September, 2006 phone bills (September being the first month without the Excise Tax) and subtract the September percentage from the April percentage. Then that percentage (not to exceed 2%) must be multiplied by phone bills paid between March 2003 & July 2006.

### Energy Credits for 2006-07 – Homes & Autos

Congress passed an Energy Act in 2005, which applies to Vehicles and Home Energy Construction and Improvements in 2006 & 2007.

The Energy Credit available for homes is capped at \$200 for energy related improvements to your home for exterior doors, windows and insulation. There is a lifetime cap including the above of \$500 for installing qualifying heat pumps, furnaces and hot water boilers.

There are new Energy Credits for 2006 & 2007. Most of us have heard about the credits available for purchasing or leasing alternative fuel or Hybrid vehicles. The credit varies by vehicle from \$400-\$2,400 per vehicle, but applies only to the first 60,000 units sold by each manufacturer. As of September 1, the full credit is available for all makes except Toyota and Lexus, which have sold more than 60,000 units and are now in the phase out mode. Go to the dealer to identify how much credit is available for each vehicle. Before you rush out to purchase these vehicles, be aware that it may take more than 5 year to recoup the additional cost of one of these vehicles over what you would pay for a traditional vehicle.

### Sec. 179 Equipment Write-Off

Small Businesses who purchase less than \$430,000 of equipment are allowed to write-off up to \$108,000 worth of equipment for 2006. This still includes trucks or SUV's with a gross vehicle weight (loaded weight) of 6,000 lbs or more, but there is now a cap of \$25,000.

Remember that you will only get a write-off for the business use percentage, not 100% of the truck or SUV and only to the extent that you have a profit in your business. Even if one does not claim the quick write-off of a qualifying truck or SUV, the vehicle can be written off over 5 years in its entirety, with no limitations rather than \$16,000 maximum over the first 5 years. While

this is available for your Federal return, some states limit or do not allow this quick write-off.

### **IRS Mileage Rate Up for 2007**

The IRS mileage rate increases in 2007 to 48.5 cents per mile. Medical and moving mileage goes to 20 cents in 2007, but charitable mileage remains at 14 cents.

### **Capital Gains Rates May Never Be Lower!**

Congress reduced long-term capital gains rates three year ago for stocks, bonds, mutual funds, real estate and business assets and these rates are still in effect through 2007. Long-term capital gains are taxed at a maximum rate of 15%,(5% if you are in the 15% bracket) and applies to installment sale payments as well.

These are the lowest rates we have ever seen for capital gains and who knows what can happen with a change in Congress. Take advantage of these low rates to sell assets which have gains. Don't hold back on selling just because you will be taxed as we never know how long we have these low rates. If you have significant losses, they can be used to lower your total tax. However, if your losses are small, try the strategy discussed in the tax planning section.

Art, antiques, gems, stamps, coins and other collectibles are still taxed at a 28% maximum rate and depreciation recapture on real estate is taxed at up to 25%.

### **Maybe Not!**

While Congress reduced the tax on long-term capital gains, they still left intact the law relating to the Alternative Minimum Tax (AMT). If your income exceeds \$62,550 (\$42,500 for singles) and includes a significant amount of capital gains and dividend income taxed at the 15% rate, you may be subject to the AMT. These thresholds will drop significantly in 2007 unless there are some last minute changes to the tax law, which could mean a higher AMT.

When income exceeds \$150,000 (\$112,500 for singles), certain exemptions begin to phase out and you will more than likely pay the Minimum Tax. Please see our discussion under Year-End moves for more specifics.

### **Have You Considered a HSA?**

Congress created a medical deduction like an IRA which allows us to claim a deduction for medical expenses above the line. It does require some extra steps that may be worthwhile looking into.

It will allow you to deduct preventive care and over-the-counter medicine and supplies (i.e. Band-Aids and Aspirin). It does require you to have a medical insurance plan, either through your employer or purchased on your own, with a deductible of at least

\$1,100 for an individual, \$2,200 for a family and is not available for those participating in Medicare.

The concept is to allow you to invest in an IRA like account (HSA) an amount equal to your deductible, with a cap of \$5,500 (\$11,000 for a family) in 2007. This amount is available for you to reimburse yourself for almost any medical expenses except for health insurance premiums and a number of insurance companies and banks have teamed up together to make these HSA's work smoothly.

The maximum amount one can contribute to an HSA is \$2,850 for an individual or \$5,650 for a married couple. A positive aspect of this is that money contributed to the HSA can be carried over to future years, with no limits and if you turn 65 and begin participating in Medicare, you can withdraw the funds like an IRA. If, however, funds are withdrawn before age 65 for any purpose other than medical expenses, it is not only subject to tax, but also a 10% penalty as well.

Look at [www.hsainsider.com](http://www.hsainsider.com) for good information about HSA including costs and deductibles of some specific plans. Compare the savings on the reduced premiums for your health insurance with the added cost you will be responsible for with the higher deductibles.

### **Education Deductions Went Away in 2006**

Unless Congress makes some last minute changes, the Teacher Deduction (\$250) and the Higher Educational Expense deductions expired at the end of 2005.

If your family income exceeds \$87,000 (\$43,000 for a Single Individual) and you have a student in college, you have not been allowed a Hope or Lifetime Credit. This \$2-4,000 educational deduction was available for those whose family income did not exceed \$130,000 (\$65,000 for a Single Parent).

Teachers have been able to deduct up to \$250 of teaching expenses whether they itemize or not for the last few years. Unless there is a last minute change, this is gone.

### **IRA/Retirement Plan Reform**

Starting in 2007, all or part of your federal tax refund may be direct deposited into a qualifying IRA account. You can now make a donation directly from an IRA to a charity. It will not be reportable as income, but you will also not be able to claim a deduction. This can be a plus when you are under age 59 ½ or if you are claiming miscellaneous itemized deductions.

Employers can now begin to offer Roth 401(k) plans which will operate similar to a Roth IRA. You should begin hearing about Roth 401(k) plan options in the near future.

There are some real advantages to Roth IRA's and Roth 401(k) plans should operate on a similar basis. Your earnings will grow on a tax free basis and will not ever be taxed on the growth if you hold the fund for at least 5 years and withdraw the funds after you are 59 ½. If you need to withdraw funds for college tuition or to purchase a new home before age 59 ½, you can withdraw original contributions without tax or penalty, so long as you do not withdraw any of the earnings.

The maximum contribution to a Roth or Traditional IRA remains at \$4,000 through 2007. If you are not currently contributing to a Roth IRA, begin thinking very seriously about it. If you are over 50, you can increase the maximum contribution to your IRA by an additional \$1,000.

If you are in a 401(k) plan, a 457 plan, or a 403(b) plan, your maximum contribution is \$15,000. If you are over 50, you can add \$5,000 to the maximum contribution.

Contributions to a profit sharing plan for small businesses are now 25% of compensation or 100% of an employee's earnings, up to a maximum of \$43,000 if a "Defined Contribution" Plan is established.

Employees participating in a SIMPLE IRA can contribute up to \$10,000 from their paychecks for 2006. Those age 50 and older can increase this amount by \$2,500.

## IRS Audits & Notices

The IRS and many states are sending out a lot of notices trying to collect additional taxes. If you receive any notices, please fax or scan and send us a copy of the notice before you call. We can usually tell very quickly what the issue is if we have the notice in front of us and it saves all of us time.

## TAX PLANNING STRATEGIES

Tax planning should be done throughout the year, not solely at year end. Unless you will be impacted by the minimum tax (in which case the recommendations are usually reversed), it is often beneficial to accelerate all possible deductions into the current year.

**Contribute the maximum possible** to a 401-K plan, Tax Sheltered Annuity, Deferred Compensation Plan, SEP and/or IRA (preferably Roth IRA). Those who acquaint themselves with our philosophy of Financial Planning understand the long-term value of investing the maximum possible in such a plan. An added plus is that your employer will often match your contributions. This can double your contribution and maximize your future earnings.

In fact, you should contribute to a Roth IRA even if you have a 401K, SEP or 403b plan at work. Unless your

income exceeds \$110,000 for a single individual (\$160,000 for a married couple) or you file as married filing separate, take advantage of the Roth IRA.

**Shift income to children** when taxable income exceeds \$64,700 for a married couple (\$31,850 for singles). Children under 18 can earn \$1,500 of unearned income (i.e. interest, dividends, and capital gains) before having to pay tax at their parent's rate. Children under 18 can be paid a wage from their parents business (proprietorship only) and earn up to \$5,350 without paying taxes as long as they have no unearned income. In addition their parents need not pay social security or unemployment taxes on those earnings.

Don't forget about the ability to make gifts, now at \$12,000 (\$24,000 for couples) per year to as many individuals as you desire.. This provides a way to transfer assets to your children. You also have a combined lifetime estate and gift tax exemption up to \$2,000,000, in addition to the annual \$12,000 gift.

Be aware, there is a potential conflict with shifting income to children. If you are trying to qualify for college scholarships or loans, 35% of a student's assets must be considered available to pay tuition and reduces the ability to qualify for grants and low interest loans. Less than 6% of parents' assets are considered.

**Alternate Capital Gains and Capital losses.** Sell Stocks with gains one year and those with losses in different years, so long as the losses are no more than \$3,000 and you are in the 25-35% brackets. Capital losses up to \$3,000 can be written off against ordinary income taxed at maximum rates. Capital gains on the other hand are taxed at a maximum rate of 15%.

If you have significant capital losses, then take those losses in a year with significant capital gains so that you can realize the benefit of the losses. This way you will be allowed to deduct losses equal to the amount of capital gains in that year, plus \$3,000. If the stock is worthless, sell it to an unrelated party for \$1 and document the sale. Do not repurchase the same stock within 30 days, as the loss will not be allowed.

**Sell real estate on the installment sale method** if you want to receive cash from the sale. Installment sales require only that you receive payment in at least two different years. You are taxed on the profit prorated by the cash received in any year. Be aware that in the year of sale, cash received includes more than the net cash you received. Also any depreciation recapture is taxed in full in the year of sale. One caveat to be aware of—if Congress changes the capital gains tax rules, all capital gains received after the date of the change will be taxed under the new rate.

**Don't sell real estate, Do a tax-deferred exchange.** A tax-free exchange can postpone tax on the sale of real estate until you sell the property received in the

exchange. There are strict time requirements and limits on how you must handle debt and the proceeds from the sale. In addition it will cost \$1-3,000 in Accommodator and Professional fees to handle the exchange.

### **Accelerating Deductions**

Consider the following unless you will be affected by the alternative minimum tax.

**Prepay next year's property taxes** by December 31, if they are due within the first four months of the year.

**Pay your January 1 mortgage payments** for your home and rental properties by Christmas to enable the lender to receive and record the payment by December 31. Unless the lender receives and records the payment by December 31, they will report the payment of interest in the following year.

**Bunch your medical expenses** every other year unless they exceed 7.5% of your AGI by a significant amount each year. For example, if you are making payments for orthodontia work, prepay as much as possible in the current year.

**If miscellaneous deductions exceed 2% of your AGI**, (i.e. \$1,000 for an AGI of \$50,000) accelerate all possible expenses into the current year. Most of our clients have sufficient job related expenses, investment deductions and other deductions (including job-search expenses, continuing education and tax preparation fees) to make it well worth your while to accelerate those expenses into this year.

**Accelerating contributions** from next year into this year can be a very profitable move. This is one area

Congress has never really touched, other than requiring receipts from the charity. Take full advantage of donating to your favorite charity. This includes the clothing and other goods that should be donated by December 31. Do remember to obtain a receipt for any food or clothing donated.

**Pay 4th quarter state income tax estimates** by December 31. This estimate is due on January 15. By paying 15 days early, you receive a deduction a year earlier. This does not apply to the Federal estimate.

### **ALTERNATIVE MINIMUM TAX**

This has become two of the most unbearable words in the tax lexicon. Congress created an alternate way to calculate the tax due for all returns with Adjusted Gross Income exceeding \$62,550 (\$42,500 for Single Individuals) for 2006. It allows you deductions for your home mortgage and charitable contributions and nothing else. Deductions for State Income taxes, property taxes, business expenses, personal exemptions as well as credits for children, childcare or other business credits are ignored. Then the tax is calculated at a flat rate of 26-28% on all income in excess of \$62,550. If this exceeds your regular tax, you pay the higher amount.

This will affect you if you have significant capital gains, investment or employee business expenses. If you have significant capital gains this year or plan to claim a significant amount of investment or business expenses on Schedule A, please call us before accelerating deductions as part of your year-end tax strategy.

## **THIRD-PARTY SERVICE PROVIDERS**

To keep you current with developments at Clement & Associates, we are notifying our clients that we use third-party service providers by our firm to provide professional services for our clients. If you should have any questions concerning this disclosure, please feel free to contact Steve and we will be happy to answer any questions you may have. This notice is in compliance with new professional standards established by the American Institute of Certified Public Accountants (AICPA Professional Standards ET Sections 191.224-.225 & 291.023-.024).

## **IS YOUR E-MAIL ADDRESS CORRECT?**

During tax season, Steve will usually return e-mails when he cannot return phone calls due to the time constraints of his appointment schedule. Please make sure we know your current e-mail address when you return your appointment card or the next time you call us if we do not currently have it on file or it has changed. You can reach us at the following e-mail addresses:

Dawn Henry  
Pattie Hagen  
Steven Clement

(**Appointments**, status of returns)  
(Accounting/Tax questions, missing info.)  
(Tax/QuickBooks®/Financial planning questions)

[receptionist@clementcpa.com](mailto:receptionist@clementcpa.com)  
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## **WEB PAGE AND CHECKLISTS**

Have you checked out our web page at [www.clementcpa.com](http://www.clementcpa.com)? We now have an interactive worksheet for Non-Cash Contributions and other great checklists under Tax Tools. Some of the other checklists include rental property records, Ministers, Law Enforcement as well as those for the Fast Food Industry.

## **NEWSLETTERS**

We send out a periodic newsletter as often as monthly via email in addition to this annual newsletter. Let us know via email to [receptionist@clementcpa.com](mailto:receptionist@clementcpa.com) if you are interested in receiving it. If you have not begun receiving this newsletter by the time we meet for our tax appointment please let us know at that time.

## **ARE YOU INTERESTED IN DIRECT SELLING?**

Are you involved with Mary Kay, Avon, Pampered Chef, Longaberger, Creative Memories, Quixtar (Amway) or a similar Multi-Level Sales organization? If so, the IRS has now provided some guidelines which you can use to help make this a true business. A worksheet listing the highlights of their guidelines are in the Tax Tools section of our web site at [www.clementcpa.com](http://www.clementcpa.com).