More Tax and Financial News

BY **MELVIN H. DASKAL, C.P.A., M.B.A.**; EDITED BY **MORRIS SPECTOR, C.P.A.**

"Your most unhappy customers are your greatest source of learning." —Bill Gates

Small Business and Work Opportunity Tax Act of 2007

This is another one of the almost countless tax acts that add layer upon layer to the already incredibly complex Internal Revenue Code, without any attempt at overall simplification. One of the major provisions is the final change (apparently) in the so-called "Kiddie Tax," that we somewhat explained in the November 2007 issue of *Financial Fax*. Here are some more changes:

- The favorable Section 179 write-off is generally increased to a $125,000 *immediate* federal tax deduction, for normally depreciable assets acquired anytime in *2007*. For 2008-2010 the $125,000 amount is indexed for inflation.
- The deduction phase-out threshold is generally increased to $500,000 of qualifying property for 2007. For 2008-2010 the $500,000 amount is indexed for inflation.
- The current Section 179 deduction for the cost of off-the-shelf software is extended through 2010.
- The current rule allowing Section 179 elections to be changed or revoked on amended tax returns is extended through 2010.
- As always, the deduction is disallowed if the taxpayer did not have taxable income in the year in which the property is placed in service. *However*, the amount of the disallowed deduction may be carried forward and used in a future non-loss year. Thus we usually recommend that the deduction be claimed in every possible year regardless, as any current disallowance is then similar to a net operating loss carry-forward.
- The Section 179 deduction is not available for estates, trusts, and certain noncorporate lessors.
- A number of liberalized technical changes for S Corporations.
- Husband and wife partnerships now have the option of electing out of the partnership filing rules and filing two separate Schedules C. (Because of the much higher frequency of IRS audits of Schedules C, we doubt if we will ever recommend this.)
- Stricter and higher penalties for paid tax preparers.
- A new 20% penalty on taxpayers filing erroneous claims for refunds or tax credits — when there is no "reasonable" basis for the taxpayer's position.
- And a bunch of other changes less significant for our average reader.
- In California, the Section 179 *state* tax deduction is limited to an annual maximum of $25,000. (This creates accounting, book, and tax complexities that can increase both your state income taxes and your accounting fees quite a bit!)

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More on the New Kiddie Tax Rules

To try and simplify the even more complex new law, keep in mind that this tax *only applies IF*, you meet *all* of the following requirements:

FOR 2007

1. One or both parents are alive at year-end and in a *higher* marginal federal income tax bracket than the child.
2. The child does not file a joint tax return (with spouse) for the year.
3. The child's unearned income exceeds $1,700. However, if this income exceeds $1,700, only the *excess* income is taxed at the parents' higher marginal tax rate.
4. The child is age 17 or younger at December 31, 2007.

FOR 2008

1. The preceding sections 1), 2) and 3) still apply; however the $1,700 limit is indexed for inflation. Section 4) is changed as follows:
2. **Under Age 18:** The Kiddie Tax will apply if the other three requirements (see above for 2007) are met. It does not matter if the child is or is not claimed as a dependent on the parents' tax return.
3. **Age 18:** Unless the child has *earned* income in excess of 50% of his or her support — the Kiddie Tax will *still* apply if the other three requirements (see above for 2007) are met. It does not matter if the child is or is not claimed as a dependent on the parents' tax return.
4. **Age 19-23:** If the child is: (a) a *student* and (b) does not have *earned* income in excess of 50% of his or her support; the Kiddie Tax will *still* apply if the other three requirements (see above for 2007) are met. It does not matter if the child is or is not claimed as a dependent on the parents' tax return.

Can you believe that Congress expects the average taxpayer to easily comprehend these new Kiddie Tax rules? The only solution is a law that forces all members of Congress to prepare their *own* tax returns, without the help of an outside expert. That should do it.

A Favorable New Ruling From the IRS — Local Lodging Expenses

For as long as I have been practicing (contrary to vicious rumors, I first started *after* the Civil War — and not before) the IRS has adamantly taken the unreasonable position that lodging expenses *not* incurred *away* from home were a nondeductible personal expense (Code Sec. 262). In a breath of fresh IRS air, they have now reversed that position (IRS Notice 2007-47).

They have announced that they will no longer contest an employee's tax deduction of the cost of employee lodging that is located in the *same town* as the employer. To clarify:

- The lodging must be on a temporary basis.
- The lodging must be necessary for the employee to participate in or be available for a business meeting or function of the employer.
- The expenses must be otherwise deductible by the employee, or would be deductible if paid by the employee.
- If the employer pays for the lodging, the cost will be excluded from the employee's income as a working-condition fringe benefit.

This change may be of considerable benefit, particularly to sales representatives, as well as others who can now fit into this new category.

Terrible Tax Planning — Leaving Everything to Your Spouse

There is an easy way to *double* the amount of estate taxes that you and your spouse will ultimately pay. Unfortunately, you can fall into that tax trap by doing absolutely *nothing*. To avoid this double payment — you must do *something* about your estate planning. At this writing there is a $2 million estate tax exemption when a person dies. Since everything you leave is taxed at current *market* value, (houses, securities, retirement plans, etc.) — estate tax will be levied on any total *over* $2 million. With a little tax planning, you can *double that estate tax exemption to $4 million!*

- If you don't have a will — forget it.
- If you leave everything in your will to your spouse — forget it.
- If almost everything you own is in either joint tenancy, or names your spouse as beneficiary — forget it.
- The trick is to leave $2 million of your estate to a so-called "by-pass trust" and only the *rest* to your spouse.

EXAMPLE: Here is how it works. Assume you die and leave an estate of $4 million. If you leave everything to your spouse there will be no tax due under the "unlimited marital deduction" part of the law. However, when the *remaining* spouse dies, assuming she (frugally) still leaves an estate of $4 million — her exemption then shields $2 million from estate taxes and the other $2 million will be subject to a federal estate tax of about $900,000.

The solution is to instead leave $2 million to a by-pass trust and the remainder to your spouse. The terms of the by-pass trust provide that it pays *income* for life to the surviving spouse and then (eventually) distributes the principal to the children. At the first death: The $2 million left to the by-pass trust is sheltered by the *decedent's* exemption of

that amount, while the remainder to the spouse is sheltered by the unlimited marital deduction.

To continue: Assume the surviving spouse later dies and leaves an estate of $2 million. *Her* estate tax exemption avoids any tax on *her* $2 million estate, while the $2 million in the by-pass trust has *already* escaped taxes by use of the *husband's* tax exemption at his previous death. Voila! A savings, in this example, of $900,000 in federal estate taxes, and everything has ultimately gone to the children without any federal estate taxes at all!

What to do? Go to any good lawyer who *specializes* in estate planning — and everything I have described can be easily accomplished by him or her. You just follow instructions and do as you are told. This is "kid stuff" to the average estate attorney who does this all day long. Since we are all mortal, may I strongly suggest that you do this no later than today or tomorrow.

Update on Medicare Part D

This is the prescription drug coverage on which I first wrote a bitter description about the time it became law. At that time, both many members of Congress and the AARP (particularly) urged passage of the law. Their assurances then were: "We know it's not a great law, but pass it now, and we will fix it later by amendment." So the law was passed, and they never kept their promises for later.

We are stuck with this strange and convoluted law with three different parts and coverage (2007 amounts). (1) After an annual deductible of $265, the plan pays 75% of the next $2,400; (2) then comes the dreaded "donut hole" where *you* must pay *100%* of the next $3,850 of both brand name and generic prescriptions; (3) and after that the plan pays 95% of prescriptions from then on.

Many seniors are stunned by the facts that there even *is* a donut hole (little understood) and also how quickly it arrived. The latest estimate is that *at least half* of all seniors hit the donut hole by late July or early August of 2007, and a total of about three million seniors will be caught in all of 2007.

EXAMPLE: Assume a senior has total *retail* prescription costs of $6,505 in 2007. He or she would pay $265 (deductible), plus $600 (25% of the next $2,400), plus $3,850 (100% of donut hole) — a total of *$4,715*. Even at retail, the insurance company only paid *$1,800* (75% of $2,400)! So, in this example, the senior paid *72%* of the total prescription costs, while the insurance company paid *28%*.

It's really an unfair; overly complex, and little understood law! And remember, even if you are not a senior today — you will be tomorrow! Of course the insurance companies that sell this insurance are not complaining (one of the big advertisers now selling this coverage is AARP-United Health Insurance). **Probably the single worst part of this law**: The government is *forbidden* to negotiate lower drug prices, and the drug companies can charge Medicare Part D any prices they want! (According to *60 Minutes*, there were over 1,000 lobbyists from the drug companies present at the all-night session of Congress when this bill was passed.)

CAUTION: Seniors are also being offered *private* so-called "Medicare Advantage" plans. They are really *HMOs*, and a *replacement* for their *entire* Medicare plan. If they sign up for such a private plan, regular Medicare will no longer cover them *at all*. (This is an effort by the federal government to reduce costs by shifting seniors to private managed care plans, i.e., "privatizing," just like their original plans for social security.) These private plans also include Medicare Part D coverage, to further confuse them. Many seniors who changed to these plans now hate them, and *some* found out they *cannot switch back to a regular Medicare supplement plan*. They are stuck.

Changed Limits for 2008

- The Social Security wage base is now $102,000. The tax rates stay the same. Employees pay 6.2% for FICA and 1.45% for Medicare on the first $102,000 of salary and 1.45% above that. Their employers pay the same amounts. Self-employeds pay 15.3% on the first $102,000 of their net earnings and 2.9% above that. An estimated 164 million workers will pay Social Security taxes in 2008.

- Individuals who turn 66 in 2008 can earn up to $36,120 before reaching that age — without losing any Social Security benefits. Those between the ages of 62 and 66 by the end of 2008 can earn up to $13,560 — without losing any Social Security benefits. Once you turn age 66 there is no limit on your earnings and no effect on your Social Security.

- The nanny tax threshold is increased $100 to $1,600.

- Social Security checks are only 2.3% higher, to cover the *supposed* inflation increase. However, food and gasoline costs are *not* used in this calculation — or the increase might be about 6% to 8%. This trick is how those generous folks in Washington keep down the cost of Social Security. It's the smallest increase in four years — and will mean only an extra $24 a month for the average check.

- Maximum contributions to regular and Roth IRAs are increased $1,000 to $5,000. For those born before 1959, the maximum is $6,000.

- Maximum contributions to defined-contribution plans are increased $1,000 to

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MEL DASKAL

Mel Daskal has spent his entire professional life specializing in manufacturers' sales agencies and their financial, tax and accounting problems and has represented more than 400 such firms during his career. He spent more than 15 years as the former accountant for both MANA and ERA National, and was a speaker at all MANA regional seminars and ERA national conferences during that time. His accounting firm, Daskal/Spector Accountancy in Tarzana, California, currently has over 100 sales agencies as clients. He can be reached at **818·907·1800** or **310·556·1800**.

$46,000. This covers Keoghs, profit-sharing plans and the like.

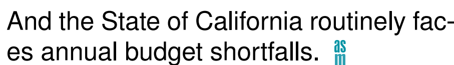
- No change in the contribution limit for 401(k) plans. They stay at $15,500, or $20,500 for those born before 1959.
- No change for SIMPLEs at $10,500, or $13,000 for those born before 1959.

California is Looking for Their Money!

The California Franchise Tax Board (the state's equivalent to the IRS) has announced that the top 250 delinquent tax debtors owe more than $249 million in back state income taxes. Each year the state loses more than $6.5 billion in unpaid taxes. Among the celebrity names and amounts of such individuals are:

- O. J. Simpson — $1.44 million.
- Dionne Warwick — $2.67 million.
- David "Sinbad" Adkins — $2.14 million.

And the State of California routinely faces annual budget shortfalls.



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