UPDATE

KesslerOrleanSilver
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CERTIFIED PUBLIC ACCOUNTANTS

A Quarterly Tax, Business and Financial Planning Newsletter Spring 2007

Planning for Next Year's Filing Season Starts Now

For most folks, April was the end of the filing season, but it's not the end of tax planning. Now, more than ever, you need to take a careful look at your tax situation. Your just-finished 2006 returns can be a great roadmap to future planning.

First, it's very important to keep in mind that everyone's tax strategy is different. There's not one tax plan that fits everyone. Maybe you want to retire early or maybe you're planning to start a second career after retirement. School or travel could be in your future. Maybe you want to start that business you've always dreamed about. That's why tax planning typically requires customization and consideration of your personal as well as financial goals. We can help you develop a tax plan that suits your needs and goals.

IMPORTANT DEVELOPMENTS FOR 2007 AND BEYOND

Over the past 10 years, the tax laws have probably changed more often than anytime before. A deduction you took last year might not be available this year. You can't keep up with all the changes. Fortunately, we're here to do that for you.

Many recent tax breaks have been temporary and some have expired for 2007. If you took one or more of them last year, you won't be eligible this year. These include the additional exemption for housing individuals displaced by Hurricane Katrina, tax-favored treatment of qualified hurricane distributions from eligible retirement plans and certain energy credits, among others.

The good news is that there are new and expanded tax breaks for 2007. You might be able to take advantage of a new deduction for the cost of premiums for home mortgage insurance. Teachers can claim a deduction for out-of-pocket classroom expenses. There are also some tax incentives for energy-efficiency improvements to your home.

Additionally, there are many proposals in Congress to expand or create new tax breaks. We could see new tax breaks for retirement savings, new energy-efficiency tax credits, more special tax breaks for military personnel, and more generous education tax incentives among others.

(continued on page 2)

No Bright Line Between Businesses and Hobbies

Businesses benefit from many tax breaks. If you are in business with the objective of making a profit, you can generally claim all your business deductions. If your deductions exceed your income for the year, you can claim a loss for the year, up to the amount of your income from other activities. Remaining losses can be carried over into other years.

These are very generous tax breaks and sometimes people establish a business to generate losses. They have no intention of ever earning a profit. Other times, they genuinely hope to earn a profit, but never do.

The IRS calls these activities "hobbies." Expenses from these activities are never deductible in excess of any income that is declared earned from them. Recently, the IRS issued a new warning in the form of a Fact Sheet (FS-2007-18) to educate taxpayers about the differences between a for-profit business and a hobby.

NO BRIGHT LINE

There's no bright line to distinguish a genuine business with a profit motive from a hobby. Over the years, the IRS and the courts have developed a list of factors to determine if an activity has a profit motive or is a hobby. No one factor is greater than the others and the list is not exhaustive. That means the IRS and the courts have great leeway in their analyses.

Let's take a quick look at the factors:

- How is the business run? Is the activity carried on in a businesslike manner? Do you keep complete and accurate business records and books? Have you changed business operations to increase profits?
- Expertise. Do you have the necessary expertise to run the business? If you don't, do you seek help from experts?
- Time and effort. Do you spend the time and effort necessary for the business to succeed?
- Appreciation. Will business assets appreciate in value over time? A profit motive can exist if gain from the eventual sale of assets, plus any other income, will result in an overall profit even if there's no profit from current operations.
- Success with other activities. Have you engaged in similar activities in the past?
- History of income or loss. This factor looks to when the losses occurred. Were they in the start-up phase? Maybe they were due to unforeseen circumstances. Losses over a very long period of time could, but not always, indicate a hobby.
- Amounts of occasional profits. Are your occasional profits significant when compared to the size of your investment and prior losses?

(continued on page 4)

INSIDE THIS ISSUE

Create Tax Breaks: Buy Parents' Home, Rent It Back to Them

Your aging parents live in a home that has soared in value but they're no longer reaping any of the homeownership tax breaks during their retirement years. Sound familiar?

GOOD NEWS

With one stroke of the pen, both you and your parents can win: they'd gain instant access to their home equity (without moving) and you'd pick up some generous new tax deductions.

How? Buy your parents' house and then rent it back to them – at the going rate.

REASONS FOR THE SALE/LEASEBACK

Under the current home-ownership setup, your combined family unit is overpaying the IRS.

Your parents' mortgage is either paid off or the payments represent mostly principal at this point. Even if they still have interest deductions your parents' tax bracket might be low in retirement, so those deductions don't provide much tax savings. In fact, many retirees take the standard deduction rather than itemizing.

Here are two good reasons for your parents to opt into this plan:

- First, it puts cash in their pockets without having to refinance or dip into a home-equity loan.
- Second, it allows them to put their money into safer investments than the real estate market.

TRANSFERRING THE HOUSE

To avoid gift-tax complications, pay a fair price for the home. Support the buying price with newspaper listings of similar homes or an appraisal of the home.

Then, both sides should enter into a lease at a fair rental value.

One benefit: courts have said that landlords can reduce their fair-market rent by 20 percent when renting to relatives. That lower rent reflects the savings in maintenance and management costs (L.A. Bindseil, TC Memo 1983-411).

But don't set the rent too low; the IRS might say the rental home is really for your personal use. In that case, your deductions might be limited to mortgage interest and property tax, the same as if you owned a vacation home.

TAKING DEDUCTIONS

Once you own your parents' house, you're entitled to reap the tax benefits of owning rental property. That includes taking write-offs for operating expenses such as utilities, maintenance, insurance, repairs and supplies.

You can also claim depreciation deductions for the home but you can't depreciate the cost of the property apportioned to the land.

So obtain an appraisal allocating the price paid between the depreciable structure and the nondepreciable land.

You can use these deductions to offset the rental income received from your parents. Any allowable tax loss will phase out for people with adjusted gross incomes between $100,000 and $150,000. You can take any suspended losses when you sell the house.

Once you own the house, you can write off travel expenses you incur when visiting the house (your rental investment). As a result, you can secure generous deductions for your usually nondeductible trip to Mom and Dad's for Christmas.

ENDGAME

Eventually, your parents won't be able to live in the house. Then you can sell it, rent it to another tenant or move in. If you move in and make it your principal residence for at least two years, you can sell it and shelter another $250,000 or $500,000 worth of capital gains: a true tax bonanza!

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(continued from page 1)

AMT PROBLEMS

Almost 40 years ago, Congress passed the alternative minimum tax (AMT) to make sure that the wealthiest Americans pay their fair share of taxes. Today, the AMT has become the "regular" tax for millions of middle-income people. Everyone in Washington knows that something needs to be done. They just can't agree on what to do.

In the meantime, Congress has tried to keep many middle-income folks out of the AMT by increasing exemption amounts and tinkering with credits. Last year, that helped a lot of people. In 2006, the AMT exemption amounts were $42,500 for single individuals and $62,550 for married couples filing jointly.

The news isn't so good for 2007…so far. The exemption amounts are much less. They are $33,750 for single individuals and $45,000 for married couples filing jointly. Congress may extend the higher 2006 amounts into 2007; but at this point, nothing is a shoo-in. Preparation can help even the odds.

Moreover, certain credits are no longer allowed against AMT. These include the credit for child and dependent care expenses, the credit for the elderly and disabled and some residential energy credits, among others.

YOUR RETIREMENT SAVINGS

Some of the biggest challenges for most people center around retirement planning. We know that you've heard time and time again to start planning for retirement early. Last year's pension overhaul law, the Pension Protection Act of 2006, includes many provisions that help you save more for retirement.

How healthy is your 401(k), IRA or other retirement arrangement(s)? You can contribute up to $4,000 to an IRA in 2007. After 2008, this amount is indexed for inflation in $500 increments. Individuals who are age 50 and older can make even larger contributions thanks again to the catch-up rule. They can contribute an additional $1,000 to an IRA. A spousal IRA and an IRA for a child who has a weekend or summer job are other great tools to help reduce your tax bill.

The pension law also increased the benefit and contribution limits for elective deferrals to 401(k) and some other plans to $15,000 in 2006 and after, subject to a cost-of-living adjustment. If you work for a state or local government, the pension law also enhanced your elective deferrals if you have a 457 plan. And don't forget that individuals age 50 and older can make "catch-up" contributions of up to $5,000 for 401(k)s and some other plans.

MORE TO PLAN FOR

There's a lot more to plan for:

- Education tax breaks…These are among the most complex in the tax law, but can give you some generous tax savings if you plan ahead.
- Hybrid vehicle incentive…Many hybrid vehicles, cars and SUVs qualify for a tax deduction, but not all amounts are the same.
- Military tax breaks…Servicemen and women serving in a combat zone not only get more time to file their returns, they also are eligible for some special tax breaks.
- Charitable giving…Last year, Congress cracked down on abuses in charitable giving. Don't let the IRS deny your deductions.
- Estate planning…Tax planning is an important part of your estate plan. Not only should large estates plan for the federal estate tax, many family businesses and family farms should too. State tax considerations add to the complexity.

Give us a call and we'll sit down when it's convenient for you and go over your 2006 return. There's a lot of information we can use to start planning for your 2007 return while there's time for you to do something about the bottom-line tax you'll be paying.

How Do I Calculate the Required Minimum Distribution for My Traditional IRA?

Although you may want your traditional individual retirement accounts (IRAs) to keep accumulating tax-free well into your old age, the IRS sets certain deadlines. The price for getting an upfront deduction when contributing to a traditional IRA (or having a rollover IRA) is that Uncle Sam eventually starts taxing it once you reach 70½. The required minimum distribution (RMD) rules under the Internal Revenue Code accomplish that.

If distributions do not meet the strict minimum requirements for any one year once you reach 70½, you must pay an excise tax equal to 50 percent, even if you kept the money in the account by mistake.

REQUIRED MINIMUM DISTRIBUTION

The traditional IRA owner must begin receiving a minimum amount of distributions (the RMD) from his or her IRA by April 1 of the year following the year in which he or she reaches age 70½. That first deadline is referred to as the required beginning date.

If, in any year, you as a traditional IRA owner receive more than the RMD for that year, you will not receive credit for the additional amount when determining the RMD for future years. However, any amount distributed in your 70½ year will be credited toward the amount that must be distributed by April 1 of the following year. The RMD for any year after the year you turn 70½ must be made by December 31 of that year.

DISTRIBUTION PERIOD

The distribution period is the maximum number of years over which you are allowed to take distributions from the IRA. You calculate your RMD for each year by dividing the amount in the IRA as of the close of business on December 31 of the preceding year by your life expectancy at that time as set by special IRA tables. Those tables are found in IRS Publication 590, "IRAs Appendix C."

Say you were born on November 1, 1936, are unmarried, and have a traditional IRA. Since you have reached age 70½ in 2007 (on May 1 to be exact), your required beginning date is April 1, 2008. Assume further that as of December 31, 2006, your account balance was $26,500. Using Table III, the applicable distribution period for someone your age as of December 31, 2007 (when you will be age 71) is 26.5 years. Your RMD for 2007 is $1,000 ($26,500 ÷ 26.5). That amount must be distributed to you by April 1, 2008.

The RMD rules do not apply to Roth IRAs; they only apply to traditional IRAs. That is one of the principal estate planning reasons for setting up a Roth IRA or rolling over a traditional IRA into a Roth IRA. The downside of a Roth IRA, of course, is not getting an upfront deduction for contributions, or having to pay tax on the balance when rolled over from a traditional IRA into a Roth IRA.

Please contact this office if you need any help in determining a RMD or in deciding whether a rollover to a Roth IRA now to avoid RMD issues later might make sense for you.

How to Spread Out Estate-Tax Payments

Although you may have spent years building up a business, your family may be forced to sell it soon after your death to pay the federal estate-tax bill. The full amount of the estate tax is generally due nine months after an individual's death. Although the federal estate tax is scheduled to be repealed in 2010, it will be revived in 2011 unless subsequent legislation is enacted. However, there is some possible estate-tax relief if a family inherits a small business.

KEY POINT

Assuming the estate qualifies, an election can be made to pay no tax on the business interest for five years. What's more, subsequent payments can be stretched out over ten years. The family can take up to 15 years to pay the tax. (Actually, it is a 14-year period, since the due date for the last installment of interest coincides with the first installment of tax.)

There is one catch. Interest must be paid each year on the unpaid portion of the tax. But the estate pays only 2% interest on the amount attributable to the first $1 million (adjusted for inflation) of the taxable value of the business interest. For 2007, the adjusted figure is $1.25 million. The interest rate for tax underpayments applies to amounts in excess of the $1.25 million threshold.

QUALIFICATION

When does an estate qualify for the estate-tax deferral? Generally speaking, the business must comprise at least 35% of the adjusted gross estate. Your adjusted gross estate is the gross estate less any expenses, debts and losses.

In addition, you must have operated the business as one of the following: (1) a sole proprietor; (2) a partner with an interest of 20% or more in the partnership, or with an interest in a partnership that has no more than 45 partners; or (3) a corporate stockholder owning 20% or more of the voting stock, or owning stock in a corporation with no more than 45 shareholders.

Finally, a proper notice of election must be attached to a timely estate-tax return.

The benefit of this special provision may be lost if all the technical rules are not observed. Consult us before proceeding.

Can You Deduct All of Your Mortgage Interest?

If you are like most established individuals, the biggest asset you own is the home where you live year-round or most of the time. Of course, you don't exactly "own" your home if you are still making mortgage payments to the bank. So it stands to reason that one of the biggest tax deductions on your personal tax return is the one for mortgage interest.

How much mortgage interest can you deduct? Answer: it depends. Here is a quick review of the current rules.

TERMS

You may fully deduct the mortgage interest paid on loan proceeds used to buy, build or substantially renovate a home if the loans are secured by either your principal residence or one other home (e.g., a vacation home). The total principal amount of the acquisition debts cannot exceed $1 million.

When it is permitted by state law, you also may fully deduct the interest on home equity loans secured by a qualified residence. But the total amount of such loans is limited to $100,000. Also, these amounts cannot exceed your equity in the residence (the home's value less other loans). With a home equity loan, you can use the loan proceeds any way that you see fit.

Any mortgage debt existing prior to October 14, 1987, known as "grandfathered debt," is treated as acquisition debt regardless of the amount. The mortgage interest on post-October 13, 1987 acquisition debt is deductible on debts up to $1 million; the interest on home equity debt on debts up to $100,000.

If a grandfathered debt is refinanced, it is treated as acquisition debt up to the amount of the existing debt. This amount is treated as grandfathered debt only for the remaining term of the original debt. Any excess may be treated as acquisition debt or home equity debt, but the total debt cannot exceed the fair-market value of the home.

POINTS

You may be required to pay "points" up front when you take out a mortgage. The points are currently deductible as mortgage interest only if paid to purchase, build or improve a home. For example, if you pay points on a home equity loan used to buy a new car, the points must be deducted over the loan period. But if the proceeds are used to finish your basement, the points are currently deductible.

Of course, when you refinance an existing mortgage, any points you are required to pay must be deducted over the life of the loan.

There is another major tax limit to contend with. If your adjusted gross income (AGI) for the year exceeds a specific threshold ($150,500 on your 2006 return), your total itemized deductions (other than those for medical expenses, casualty and theft losses, gambling losses and investment interest) are reduced.

The reduction generally is equal to 3% of your AGI above the threshold. However, in no case can the overall reduction exceed 80%.

No Bright Line Between Businesses and Hobbies

(continued from page 1)

- Financial status of owner. Is the activity your only source of income?
- Personal pleasure or recreation. Is your business of a type that is not usually considered to have elements of personal pleasure or recreation?

YOUR FINANCIAL STATUS

If the activity is your only source of income, you would think that the IRS would automatically treat it as a for-profit business. That's not true. Every case is different and the IRS and the courts look at all the circumstances.

A few years ago, there was a case in the U.S. Tax Court involving a married couple. The husband owned a house framing business. His income was about $33,000 a year. The wife worked as a secretary in an accounting department of a big corporation. Her income was about $28,000 a year.

Together, they also operated a horse breeding and racing activity. They had no experience in breeding or racing horses. They didn't have the best of luck either. Several of their horses suffered injuries and they were involved in a legal dispute over the ownership of one. They did seek help from experts and also kept good financial records.

The Tax Court looked at all of the nine factors. It recognized that the couple had a very modest income from their employment and this factor weighed in their favor. However, some of the other factors went against them, especially the fact that they never made a profit after 16 years and lost nearly $500,000. The court knew that the couple "hoped" to make a profit, but hope wasn't enough and the court found their business was not engaged in for-profit.

PRESUMPTION

Generally, the IRS presumes that an activity is carried on for profit if it makes a profit during at least three of the last five years, including the current year. If it appears that the business will not be profitable for some years, you won't be able to come within the presumption of profit motive. You'll have to rely on qualifying under the nine factors.

The IRS has a form on which you can officially elect to have the agency wait until the first five years are up before examining the profitability of your business. While it's generally not necessary to file the form in order to take advantage of the presumption, it's usually a good idea.

TYPES OF BUSINESSES

Although the IRS is not limited in the kind of businesses that it can challenge as being hobbies, businesses that look like traditional hobbies generally face a greater chance of IRS scrutiny than other types of businesses. These include horse breeding and racing, "gentlemen farming" and craft businesses operated from the home. There are many court cases about these activities and usually the taxpayers lose.

This is a very complicated area of the tax law and many people, like the secretary and her husband, honestly believe they are operating a for-profit business. But as we've seen, the IRS and the courts can, and often do, determine otherwise.

Don't hesitate to contact us if you have any questions about the differences between a business and a hobby…and how you can set up your operations to have a better chance of falling on the right side of any argument with the IRS.

BRIEFS

PASS THROUGH ENTITIES

According to a recent report by the U.S. Treasury Inspector General for Tax Administration (TIGTA), we are experiencing substantial growth in the number of S corporations and partnerships. For the period between 2000 and 2004, S corporation and partnership returns increased from 4.96 million to 6 million (up 21%). The annual returns for these pass-through entities are projected to reach 8.49 million by 2012 (up 42% from 2004).

IMPROVED TAX MILEAGE

The IRS has announced the annual increase in the standard mileage rate for business drivers. For the 2007 tax year, you can deduct a flat rate of 48.5 cents for every business mile traveled (up from 44.5 cents per mile in 2006) plus business-related tolls and parking fees. This deduction may be claimed in lieu of deducting your actual expenses for business use of a vehicle such as depreciation, oil and gas, insurance, repairs, etc.

NEWS *from* KOS

During the tax season **Geoff Harlow** appeared on four episodes of "Your Money," a weekly personal finance show on CLTV, to help viewers navigate the obstacle course that we call the Internal Revenue Code. Observant viewers may have recognized the KOS conference room, as the segments were taped in our office. Geoff also was a guest on WGN radio's "The Money Show." Away from the office, Geoff finished in a three-way tie for the North Shore Corvette Club's 2006 "Male Driver of the Year" award. The award is based on the results of racing events sponsored by the Club, including autocross and drag racing.

In order to continue to provide our clients with the highest level of business advice and expertise, **Steve Roiland**, one of our Accounting and Auditing Managers, has recently achieved the designation as a Certified Fraud Examiner and is a member of the Association of Certified Fraud Examiners (ACFE). A Certified Fraud Examiner (CFE) is a globally accepted designation and is a leader in the anti-fraud community, noted as a specialist in the prevention and deterrence of fraud. They represent the highest standards held by the ACFE and possess expertise in all aspects of the anti-fraud profession.

We are pleased to report that one of our clients, Shakespeare Squared LLC, was named one of the 25 best small companies to work for by Working Mothers Magazine. **Jeffrey Butler's** son, Scott, graduated from University of Wisconsin-La Crosse. He will be attending Marquette University Law School this fall. He also became engaged to Rachel Karpinsky. **Bonnie Zivin's** daugher, Lori, became engaged to Randy Ramsay. They are planning a November 2007 wedding. **Lynn Steer's** grandson, Justin, is in graduate school at De Paul. Her granddaughter, Candice, was honored in Philadelphia by having an article and map published pertaining to her studies in Geology.

ABOUT *UPDATE*

If you have any questions or comments about articles featured in this issue or about the newsletter in general, please call one of the principals at Kessler Orlean Silver & Company, or the Update editors, Jeffrey Arnol or Jeffrey Butler.

Do you have any associates or friends who would benefit from receiving our Update Newsletter? If so, please call Lynn Steer in our office and we will be glad to add their name to our mailing list. If you need to update your e-mail address, please send it to **info@koscpa.com**.

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