UPDATE

KesslerOrleanSilver
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CERTIFIED PUBLIC ACCOUNTANTS

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Highlights of the Small Business and Work Opportunity Tax Act of 2007

After much horse trading, Congress has passed a small business tax incentives bill coupled with an increase in the federal minimum wage. The Act targets nearly $5 billion dollars in tax incentives principally to small businesses. Revenue raising provisions totaling nearly $5 billion means more taxes for certain taxpayers. One of them, an expansion of the kiddie tax, applies to children who are under the age of 19 or who are full time students up to age 24. This provision will impact a million families. The small business tax incentives are designed to help businesses absorb the cost of a higher federal minimum wage. The new law gradually raises the minimum wage to $7.25 over two years.

SMALL BUSINESS EXPENSING

The dollar investment limitations are increased for small business expensing. Under the new law, the base $100,000 limit, which was scheduled to be $112,000 indexed for inflation for 2007, is increased to $125,000 for tax years 2007 through 2010. The maximum deduction is phased out by the amount by which all qualifying property placed in service during a tax year exceeds an investment limitation. The investment limitation for property placed in service for tax years beginning in 2007 was formerly $450,000 as indexed for inflation. This new law retroactively increases the investment limitation to $500,000 for tax years beginning in 2007 through 2010. The $500,000 amount is indexed for inflation in tax years beginning after 2007 and before 2011. The deduction is disallowed if the taxpayer did not have taxable income in the year in which the property was placed in service. However, the amount of deduction disallowed for this reason can be carried forward to a non-loss year. This deduction is not available to certain estates, trusts and certain non-corporate lessors.

FAMILY BUSINESS TAX SIMPLICATION

Under the new tax act, a married couple who jointly operates an unincorporated business and files a joint individual tax return can elect not to be treated as a partnership for federal tax purposes. This changes the law in which previously the taxpayers had to file a partnership tax return. This new treatment is available for tax years beginning after December 31, 2006. The husband and wife can be the only members of the joint venture. If there are other individuals in the joint venture the provision does not apply. Additionally, both spouses must materially participate in the business. Each spouse would take into account his or her share of income, gain or loss and other items as a sole proprietor. They would report their share of income on Form 1040, Schedule C.

MAJOR KIDDIE TAX CHANGES

The new tax act extends the age limit for the kiddie tax by including all children under the age of 19 (previously under the age of 18) and students under the age of 24. Both changes are effective for most people for years beginning January 1, 2008. This effective date is actually good news because the last change in the kiddie tax was made in the middle of the year and was made retroactive to the beginning of 2006.

The actual computation of the kiddie tax remains the same. The income of the child for 2007, generally unearned income over $1,700, is taxed at the parent's marginal tax rates if the rates are higher than the child's tax rates.

The new age limit for the kiddie tax generally tracks the age test for a "qualifying child" under the uniform definition of a child which was put into place in 2004. At the end of the calendar year a qualifying child is an individual under the age 19 or a student under the age of 24.

If you would like to go over some of the changes in the new law or discuss how it might affect you, please give us a call.

Beware of Rising IRS Audit Rates

The latest data released by the IRS indicates that audits are on the rise. The new IRS Data Book for the 2006 fiscal year shows the number of examinations increased for virtually every category of taxpayer based on type (individual or business entity) and income level.

Furthermore, the IRS intends to keep the pressure on as it attempts to close a perceived $300 billion "tax gap" in revenue. The Data Book shows the following:

- The IRS audited about 1.3 million individual tax returns, 41,646 employment tax returns and 28,799 corporate tax returns.
- Audit rates for individuals with an adjusted gross income between $50,000 and $100,000 increased from .57% in 2005 to .60% in 2006.
- Audit rates for self-employed filers with gross receipts above $100,000 jumped from 3.65% in 2005 to 3.90% in 2006.
- Examinations of S corporation returns increased from 0.30% in 2005 to 0.40% in 2006. But audit rates of non-S corporations remained at 1.20%.

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INSIDE THIS ISSUE

Tax Twists to Capital Gains and Losses

When you sell securities or some other capital asset, you must report the resulting capital gain or loss on your personal tax return. Don't capital gains and losses simply cancel each other out? Actually, it's more complicated than that. In fact, even experienced investors are often perplexed by these tax rules. You should be aware of a significant tax break looming on the horizon.

For simplicity, we will limit this discussion to capital gains and losses arising from sales of securities, assuming you have no other capital asset transactions. (Other special rules apply to sales of collectibles and property that is subject to depreciation recapture.)

STARTING POINT

There are different rules for long-term gains and losses versus short-term gains and losses. A gain or loss is long-term if you have held the security for more than one year before the sale occurs. For example, if you bought stock on July 1, 2006, and sell it at a profit on June 30, 2007, the gain is treated as a short-term gain. However, holding the stock for just two more days – until July 2 – qualifies the transaction as a favorable long-term capital gain.

To net your gains and losses, first put your long-term gains and long-term losses in one basket. This gives you either a net long-term gain or a net long-term loss. Next, put your short-term gains and short-term losses in another basket. This results in either a net short-term gain or a net short-term loss. Finally, combine the net long-term gain or loss with the net short-term gain or loss to arrive at an overall net capital gain or loss.

If your capital gains for 2007 exceed your capital losses, any net long-term gain is taxed at a maximum tax rate of 15%. For a taxpayer in one of the two lowest regular tax brackets – either the 10% or 15% tax bracket – the maximum rate on long-term capital gain is 5%.

FUTURE TAX BREAK

The long-term capital gains rate is zero percent for lower-income taxpayers in 2008. This tax break was recently extended through 2010 by the Tax Increase Prevention and Reconciliation Act (TIPRA) passed last year. However, as this issue goes to press, Congress is debating legislation that would bar the zero percent tax rate for certain dependents.

Conversely, if your capital losses exceed your gains, the net loss can be used to offset up to $3,000 of ordinary income such as salary. Any excess is carried over to future years.

Once you understand the netting rules, analyze your current tax situation and act accordingly. For example:

If you are currently showing a net loss, you can realize capital losses before the end of the year. The capital gains are effectively tax-free up to the amount of your losses.

If you are currently showing a net gain, you can realize capital losses before the end of the year. The losses effectively absorb the tax you would have had to pay on the gains. If the situation dictates, you can realize an excess loss that may be used to offset up to $3,000 of ordinary income.

Caution: If you sell a stock and buy back the same stock within 30 days, you cannot deduct the loss on your tax return. This is called the "wash sale" rule. To avoid this harsh tax result, wait at least 31 days before you reacquire the stock.

Alternatively, if you believe the stock is poised to rebound, you can "double up" your shares and sell the original shares more than 30 days later. This strategy enables you to lock in the current price without forfeiting the tax loss.

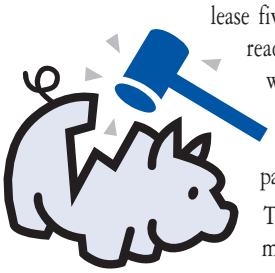
Four Ways to Open Your IRA Early

As a general rule, the contributions and earnings accumulating in your IRA are meant for retirement. That is why the tax law imposes a 10% penalty tax – in addition to the regular income tax owed – on distributions made before age 59½.

However, there are several key exceptions to the penalty for early IRA withdrawals. Here are four ways you may be able to withdraw funds penalty-free:

SUBSTANTIALLY EQUAL PAYMENTS

You are not liable for the penalty if you take "substantially equal periodic payments" based on your life expectancy or the joint life expectancies of you and a designated beneficiary. The payments must last for at lease five years or until you reach age 59½ - whichever comes later. Also, you must receive at least one payment per year.



There are three permissible methods for computing the required payments under IRS-approved life expectancy tables. Consult with us for the best method for your situation.

MEDICAL EXPENSES

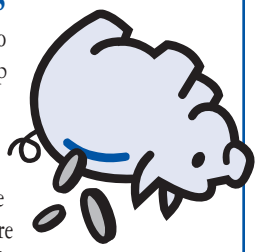
If your family has been hit with some unexpected medical bills, you may not have all the cash you need. In that case, you can withdraw funds from your IRA to pay for those medical expenses. The withdrawals are exempt from the 10% penalty to the extent that the cost qualifies for the medical expense deduction (i.e., unreimbursed medical expenses above 7.5% of your adjusted gross income). Similarly, if you are laid off or fired from your job, any pre-age-59½ withdrawals are exempt from the tax penalty if the funds are used to pay for health insurance coverage.

HOME PURCHASE

The tax law includes a special tax break for "first-time homebuyers." No penalty is imposed on pre-age-50½ withdrawals if the funds are used to buy or build a qualified home. To qualify, the home must be used as your principal residence and you cannot have owned a home within the last two years.

Best of all, the tax break is available for other family members such as your child. However, be aware that there is a lifetime dollar cap of $10,000 on this first-time homebuyer exception.

EDUCATION EXPENSES



Many parents are forced to invade their IRAs to help pay for a child's college expenses. Fortunately, distributions made before age 59½ do not trigger the penalty tax if the funds are used to pay for qualified education expenses. This includes tuition, books, supplies, etc. – even room and board – if your child is a full-time student.

These are just four of the exceptions to the 10% penalty tax on early IRA withdrawals. Have your personal situation analyzed to determine if any other exception applies.

TIPS, TRAPS AND TRENDS

RENTING YOUR VACATION HOME

If you own a vacation home, you may be considering whether renting the property for some of the time could come with a big tax break. More and more vacation homeowners are renting their property. While renting your vacation home can help defray costs and provide certain tax benefits, it also may raise some complex tax issues.

Determining whether to use your vacation home as a rental property, maintain it for your own personal use, or both means different tax consequences. How often will you rent your home? How often will you and your family use it? How long will it sit empty? Depending on your situation, renting your vacation home may not be the most lucrative approach for you.

Generally, the tax benefits of renting your vacation home depend on how often you and your family use the home and how often you rent it. Essentially, there are three vacation home ownership situations for tax purposes. We will go over each and their tax implications.

TAX-FREE RENTAL INCOME

If you rent your vacation home for fewer than 15 days during the year, the rental income you receive is tax-free; you don't even have to report it on your income tax return. You can also claim basic deductions for property taxes and mortgage interest just as you would with your primary residence.

You won't, however, be able to deduct any rental-related expenses (such as property management or maintenance fees). And, if your rental-related expenses exceed the income you receive from renting your vacation home for that brief time, you can't take a loss. Nevertheless, this is an incredibly lucrative tax break, especially if your vacation home is located in a popular destination spot or near a major event and you don't want, or need, to rent it out for a longer period. If you fit in this category of vacation homeowners and would like more information on this significant tax benefit, please call our office.

PURE RENTAL PROPERTY

Do you plan on renting your vacation home for more than 14 days a year? If so, the tax rules can become complicated. If you and your family don't use the property for more than 14 days a year, or 10% of the total number of days it is rented (whichever is greater), your vacation home will qualify as rental properly, not as a personal residence.

If you rent your vacation home for more than 14 days, you must report all rental income you receive. However, now you can deduct certain rental-related expenses, including depreciation, condominium association fees, property management fees, utilities, repairs, and portions of your homeowner's insurance. How much you can deduct will depend on how often you and your family use the property. But, as the owner of investment property, you can take a loss on the ultimate sale of your rental homes, which second-homeowners can't do.

Income and deductions generated by rental property are treated as passive in nature and subject to passive activity loss rules. As passive activity, rental property losses can't be used to offset income or gains from non-passive activities (such as wages, interest, dividends, and gains from the sale of stocks and bonds). They can only be used to offset income or gains from other passive type activities. Passive losses that you can't use one year, however, can be carried forward to future years.

However, an owner of rental property who "actively participates" in managing the rental activities of his or her vacation home, and has an adjusted gross income that doesn't exceed $100,000, can deduct up to $25,000 in rental losses against other non-passive income, such as wages, salaries, and dividends. It's not all that difficult to meet the "active participation" test if you try.

PERSONAL USE FOR MORE THAN 14 DAYS

If you plan on using your vacation home a lot, as well as renting it often, your vacation home will be treated as a personal residence. Specifically, if you rent your home for more than 14 days a year, but you and your family also use the home for more than 14 days, or 10% of the rental days (whichever is greater), your vacation home will qualify as a personal residence, not a rental property, and complex tax issues arise.

All expenses must be apportioned between rental and personal use, based on the total number of days the home is used. For example, you must allocate interest and property taxes between rental and personal use so that a portion of your mortgage interest payments and property taxes will be reported as itemized deductions on Schedule A (the standard form for itemized deductions) and a portion as deductions against rental income on Schedule E (the form for rental income and expenses.) You will only be able to deduct your rental expense up to the total amount of rental income. Excess losses can be carried forward to future years.

PROPER PLANNING

With proper planning and professional advice, you can maximize tax benefits of your vacation home. Please call our office if you have, or are planning to buy, a vacation home and would like to discuss the tax consequences of renting your property.

Four Options for Retirement Plan Payouts

Are you in line to receive benefits from a qualified retirement plan at work? For instance, you might be switching jobs or retiring completely. What should you do with the money? There are four basic options to consider:

TAKE THE MONEY AND RUN

Remember that a lump-sum payout is taxed at ordinary income rates (reaching as high as 35%). Also, you generally are required to pay a 10% penalty tax – on top of the regular income tax – for distributions made before age $59^{1}/_{2}$.

However, if you were born before 1936, you may qualify for special income averaging. In effect, the distribution is taxed as if it were spread out over ten years (plus favorable capital gain treatment may be available).

RECEIVE ANNUITY-TYPE PAYMENTS

By choosing to receive a series of payments, you effectively spread out the tax liability over time. Typically, the payments are based on your life expectancy or the joint life expectancy of you and your spouse. The payments end upon the death of the surviving spouse.

LEAVE THE MONEY IN THE PLAN

If it is permitted, you can leave the money right where it is – in the plan of your former employer. The funds in your account may still provide earnings without any current tax erosion. However, it may be difficult to manage the funds or gain access to them, especially if you are leaving on bad terms.

ROLL OVER TO ANOTHER PLAN OR IRA

Instead of taking out cash, you can elect to roll over all or part of your account balance to another qualified plan (say, the plan at a new employer) or an IRA. If the rollover is completed within 60 days, there is no current tax liability on the transfer. You can then take withdrawals of cash as needed, subject to regular income tax.

The IRS requires your former employer to automatically withhold 20% of a lump-sum distribution to offset your potential tax liability. To roll over your entire account balance, you must come up with 20% of the amount out of your own pocket. You can recoup this amount when you file your tax return.

This result can be avoided by arranging a trustee-to-trustee transfer where the cash never touches your hands. In that case, you avoid the 20% withholding rule.

As you can see, you will be facing some difficult choices on retirement plan payouts. Consult with us regarding your situation.

Beware of Rising IRS Audit Rates

(continued from page 1)

Although the exact process for selecting taxpayer returns for audits is not known to outsiders, be aware of the following areas that could lead to inquiries:

CHARITABLE DONATIONS

The IRS recently tightened the rules for substantiating charitable donations. In particular, the IRS is concerned that taxpayers are overinflating the value of donations of property. Giving large gifts could attract the attention of the IRS, especially if the amount of your donations is disproportionate to your annual income.

SELF-EMPLOYED INDIVIDUALS

The IRS realizes there is a temptation to blur the distinction between business and personal expenses. Thus, it may examine returns of self-employed individuals more closely than most other taxpayers, especially for those with a six-figure income. Be sure you can substantiate sizeable deductions for business automobiles and home offices.

HOBBY LOSSES

Similarly, the IRS may be suspicious of taxpayers who regularly claim losses from sideline business activities. It may claim the "business" is really a "hobby" in disguise. In that case, deductions are generally limited to the amount of hobby income. Note: An activity is presumed not to be a hobby if profits result in three out of five consecutive years.

MATCHING CAPITAL GAINS AND DIVIDENDS

Understandably, IRS computers may zero in on tax returns where capital gains and dividends reported on Forms 1099 do not match up with the income reported on a taxpayer's return. This same principle applies to Schedule K-1 reported by S corporations and partnerships. Such omissions could lead to a subsequent audit.

TRAVEL AND ENTERTAINMENT (T&E) EXPENSES

This area has long been a hot button for audits. The IRS imposes strict recordkeeping requirements for T&E, especially with regard to actual expenses deducted for the business use of vehicles. However, if you maintain the necessary proof, there is no reason to shy away from claiming legitimate deductions.

Other items considered by the IRS to be abusive, such as certain offshore tax shelters and other tax avoidance schemes, are definite red flags to avoid.

It is more important than ever to ensure that all income is properly reported and that deductions and credits can be substantiated. This is the best way to meet any challenges to your return.

NEWS *from* KOS

Larry Krupp was awarded the Decalogue Foundation's Hebrew University Fellowship award at the Decalogue Society Lawyers annual meeting in June. The award is given for service to the Society and the legal community. In addition, over the past few months, he has presented tax/accounting seminars for the Chicago Volunteer Legal Services Foundation, Decalogue Society of Lawyers, and the National University of Health Science.

Congratulations to **Scott Brown** as he now has a third granddaughter, Susannah Grace, born in May. Also, Scott and **Alan Kalfen**'s co-ed softball team finished in first place this year.

Barb Vela's son Steve was promoted to Sergeant (E5) in May. He serves in the National Guard.

Katie Nauert has joined our firm as a staff accountant. She has her bachelor of science in Business Administration with an emphasis in accounting from University of Colorado. She is currently pursuing her Masters of Science in Accounting from Loyola University.

KOS would like to welcome back **Linda Lewis** who re-joined our support staff. In addition to previously working for us, she has also worked for other local public accounting firms.

Jeffrey Butler was appointed to the Flow-thru Entities Committee of the Illinois C.P.A. Society. He will chair the S corporation Sub-Committee. He also was elected Treasurer of Temple Judea Mizpah in Skokie.

BRIEFS

KEEP ON TRUCKING

In a new case, an Ohio trucking firm contracted with drivers to operate as independent contractors. But the firm still had significant control over their activities. For instance, it made all the assignments, supervised all the work and confirmed deliveries. It also took full responsibility for repairs and maintenance. Despite the existence of written contracts, the Tax Court determined that the drivers should be treated as employees, not independent contractors.

SPECIAL SCHOOLS

In some cases, the cost of a special school may qualify for medical expense deductions. The parents enrolled their learning-disabled child in a special school following the recommendation of a neurologist. Unlike the special program at the child's public school, the school focused on auditory strengths, rather than physical presentations. Enrollment in the special school was based on a physician's advice, so the cost could be deducted as a medical expense, subject to the usual limits.

WHAT'S IN A NAME?

According to a new survey, almost 50% of the employees surveyed believe they are underpaid in their current jobs. Yet only 22% of the participants are actually underpaid, based on the fair-market value for their positions. Why the discrepancy? One potential reason is over-tilting. In other words, when someone is given a bigger or fancier title, that person may feel he or she deserves to be paid more. When possible, keep job titles realistic.

JOB FLEXIBILITY

Just because your workers have not requested flexible work hours doesn't mean they don't want them. According to a recent survey by a consulting firm specializing in such work options, 59% of the employees said they were reluctant to ask about flexible working arrangements because they feared it could negatively affect their careers. Of the same group, 66% indicated that they were interested in permanent part-time work while 49% were actively looking for jobs that offered flexible work schedules.

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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