

THE BERNSTEIN TAX LETTER

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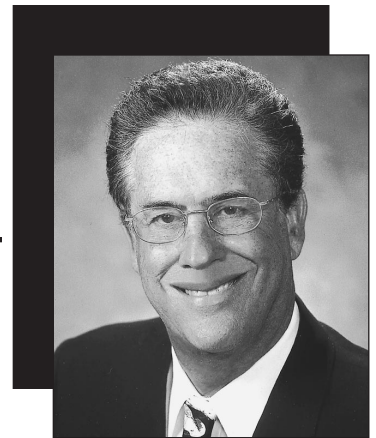
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Dear Reader,

The inside report in this letter includes a summary of some recent tax changes in the minimum wage increase package. Many tax items that have been discussed were not incorporated into this legislation. Notably, the solution to the ongoing problem of the alternative minimum tax (AMT) appears to be destined to be incorporated in some fall legislation. It is most likely to be addressed by further extension of increased exemption amounts, rather than some major overhaul. However, a fiscally conservative group of House Democrats, the Blue Dog Coalition, opposes the short-term patch approach because the result inflates the tax revenue projections over the 5- and 10-year horizons on which tax legislation is based. Simply, the revenue projections are based on the expiration of the AMT relief; Congress has been preventing the expiration on a short-term basis, and the patch approach does not project the tax revenue loss into the long-term forecasts.

Another important piece of legislation due to expire is the IRA charitable rollover provision. This has proved to be a popular contribution for donors and charitable organizations. A bill was introduced earlier this year (Public Good IRA Rollover Act of 2007) to make the qualified charitable distribution provisions permanent. In addition, the bill would remove the \$100,000 limit on charitable rollovers and add the ability to make contributions to charitable remainder trusts, pooled income funds, and charitable gift annuities, beginning at age 59^{1/2} in some instances. This legislation, if enacted, will probably end up in a combined tax bill and almost certainly require revenue-raising offset provisions.

The Tax Reform Act of 1976 requires the IRS to maintain statistics and publish reports of high-income tax returns reporting income of \$200,000 or more. The most recent year in the report (2004) includes the data from over 3 million returns in this category. Taken inflation-adjusted constant dollars into consideration, the number of returns in this category is 7.6 times the number in 1976. Of these returns, over 2,800 reported no U.S. income tax liability and over 2,400 reported no worldwide income tax liability. The report looks at adjusted gross income and an expanded income statistic that includes tax-exempt interest, nontaxable Social Security benefits, excluded foreign income, and AMT preference items. The primary reason (61.9 percent) for nontaxability of the expanded income group was the exclusion for state and local government interest.

Cordially,

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SMALL BUSINESS AND WORK OPPORTUNITY ACT OF 2007: A SUMMARY OF SELECTED PROVISIONS

The long-debated bill increasing the minimum wage to \$7.25 by July 24, 2009, finally passed on May 25 and included a subtitle that changed several important tax provisions. Some of the provisions were tax benefits to small businesses and others were incorporated as revenue-raisers to offset the costs of the bill. The Act's \$4.8 billion in tax incentives is projected to absorb the cost of a higher federal minimum wage. We'll discuss some select provisions that we hope you can use for your planning purposes.

"KIDDIE TAX" RULES EXPANDED TO THWART INCOME SHIFTING

One revenue raiser in the bill is an increase in the age for the application of the kiddie tax. The kiddie tax provides that the unearned income of a child above an inflation-adjusted amount (currently \$1,700) will be taxed at marginal rates as if included in the parent's return, if a higher tax results from the parent's rate. The new law increases the child's age for the tax to 18, and adds children who have not reached age 24 if they are full-time students.

For children above age 17 at the close of the tax year, the kiddie tax rule will apply only if (1) the child's earned income for the year doesn't exceed one-half of his or her support, (2) there is at least one parent alive at the close of the tax year, and (3) the child doesn't file a joint tax return. The support requirement is defined by the dependency deduction requirements under the tax code. College scholarships the child receives are not treated as part of support for the child for this test.

This provision was designed not only to raise revenue, but also to prevent a tax planning technique that was beginning to attract attention. One component of the reduced long-term capital gains tax from earlier tax legislation is a special long-term gain rate for individuals in the lowest (10 and 15 percent) tax brackets. For these individuals, instead of 15 percent, long-term gains will be taxed at 5 percent in 2007 and zero percent in 2008 to 2010. Many individuals transferred (or were considering the transfer of) appreciated assets to family members in the lowest brackets to effectuate gain recognition at the 5 or zero percent rate. This technique will be effective only if (1) the child who sells the property falls outside the expanded grasp of the kiddie tax and (2) the gain doesn't bump the child above the lowest two brackets. This change will become effective in 2008 for calendar-year taxpayers.

ENHANCED EXPENSING PROVISIONS FOR SMALL BUSINESSES

One attractive tax provision for small businesses is the Sec. 179 expensing election that permits a current deduction (rather than depreciating) of tangible personal property used in a trade or business. The amount that can be expensed currently is subject to a maximum dollar amount and reduced when the taxpayer places property above a threshold amount into service in a given tax year. Both thresholds are indexed for inflation. The new law increases the amount that can be expensed currently to \$125,000. However, this amount will be reduced dollar for dollar by the amount of property exceeding \$500,000 placed in service for the year (i.e., if property exceeding \$625,000 is placed in service in 2007, a Sec. 179 deduction is unavailable). Sec. 179 also limits the current deduction to the amount of the taxpayer's annual income from a trade or business. Amounts not deducted due to the income limitation can be carried forward indefinitely. Before the new law,

the limitations for 2007 were \$112,000 and \$450,000, respectively, for the expensing and limitation phaseout.

The changes were made somewhat complex since they both enhance and extend recent tax incentives that are designed to sunset. The new rules apply to tax years beginning after 2006 and before 2011. Prior incentives were designed to sunset after 2009. This applies to the provisions of the previous incentives. Thus, the inflation indexing of the \$125,000 and \$500,000 thresholds will continue through 2010. In addition, Sec. 179 expensing will be available for "off-the-shelf" computer software placed in service in a tax year before 2011.

NEW PROVISION FOR HUSBAND AND WIFE BUSINESSES

A tax simplification provision was added permitting a husband and wife who operate an unincorporated joint venture to avoid partnership tax reporting and file their income on Schedule C's. The new rule generally applies to a qualified joint venture. A qualified joint venture is a trade or business where (1) the only members of the joint venture are a husband and wife, (2) both spouses materially participate in the trade or business, and (3) both spouses elect to have the provision apply. This change treats the tax reporting as if each spouse was operating a sole proprietorship and the share of items of income, gain, loss, deduction, and credit will be divided between the spouses in accordance with their respective interests in the venture.

Corresponding changes were made to the definitions of net earnings from self-employment for employment taxes and Social Security benefit purposes. The committee reports indicate that the new rule does not prevent the courts or the Social Security Administration from reallocating the net earnings from self-employment to the extent permitted by prior law. The change applies to tax years beginning after 2006.

S CORPORATION CHANGES

One type of trust eligible to be a shareholder of an S corporation is an electing small business trust (ESBT). The income from the S corporation held by the ESBT is taxed solely to the trust at the highest marginal rate (35 percent). The Act provides that interest on debt incurred by the ESBT to acquire S corporation stock will be deductible from the S income of the ESBT. This change applies to tax years beginning after 2006.

S corporations are not generally subject to corporate-level taxes unless the S corporation derives more than 25 percent of its gross receipts from passive investment income. In addition, the S corporation election will terminate if more than 25 percent of its gross receipts is passive investment income and the S corporation had accumulated earnings and profits from years of operating as a regular corporation. The Act eliminates gains from the sale of stock or securities from the definition of passive investment income for an S corporation. This change applies to tax years beginning after May 25, 2007.

REVENUE-RAISING PROVISIONS RELATED TO TAX COMPLIANCE

Expanded Return Preparer Penalties. The new law also adds preparers of estate, gift, employment, and excise tax returns, as well as exempt organization returns, to the preparer penalty

provisions of the code previously applicable only to preparers of income tax returns. In addition, the penalties have been increased for preparers of returns and refund claims. The penalty is the greater of \$1,000 or 50 percent of the income earned by the tax return preparer for preparing the return or claim for refund. The penalty applies only if there was an unreasonable position taken by the return preparer. Basically, this means that the return preparer (1) knew or should have known the issue, (2) had no reasonable belief of the success of the position, and (3) failed to disclose the position on the tax return. There is a good faith exception for the preparer penalty. Under a recent transitional relief provision (IRS Notice 2007-54), these penalty provisions generally apply to all returns due on or before December 31, 2007.

The new law also increases the penalty to the greater of \$5,000 or 50 percent of the income earned by the tax return preparer for preparing the return or claim if the tax understatement is due to willful or reckless conduct on the part of the preparer. This requires the intent to understate tax liability and an intentional or reckless disregard of tax rules or regulations. The preparer penalties due to willful or reckless conduct apply to returns prepared after May 25, 2007.

Increase in Penalty for Bad Checks. There is a 2 percent penalty under the law for payment of tax liability with a bad check or money order. There is a small check provision; under the new law, for checks under \$1,250 (increased from \$750) the penalty is the lesser of \$25 (up from \$15) or the amount of the check. The Act retains the good faith and reasonable cause exception to the penalty. This provision applies to checks and money orders received after May 25, 2007.

IRS Given More Time to Impose Interest and Penalties. Although the statute of limitations on most returns is generally 3 years after a tax return is filed, the IRS had to suspend the imposition of interest and penalties if the taxpayer wasn't given notice specifically stating the taxpayer's liability and the basis for the liability within 18 months. The Act changes the notice requirement to 36 months; hence, the IRS can continue to impose interest and penalties for double the amount of time without informing the taxpayer of the deficiency. This applies to notices 6 months after May 25, 2007.

IRS User Fees Now Permanent. The IRS generally charges a fee for requests for a private letter ruling, determination letter, opinion letter, or other similar ruling or determination. The fees can be substantial (as high as \$15,000 for some issues) and are sometimes prohibitive for smaller tax disputes or questions. Prior law authorized the IRS to collect such fees only until September 30, 2014. The authorization to impose the fees is now permanent.

This Tax Letter is intended to assist you to conserve your estate and to protect the interests of your family and business associates. Estate planning involves the joint services of a competent Trust Officer, Attorney, Accountant, and Life Underwriter. The experience and advice of each is generally essential.

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