THE BERNSTEIN TAX LETTER

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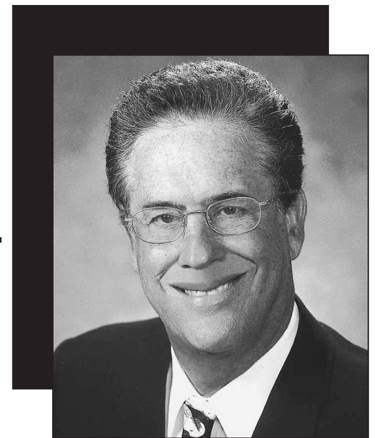

RICHARD S. BERNSTEIN

NOVEMBER 2007

Dear Reader,

Congress did not pass any legislation extending expiring provisions at the time this letter went to the printer. We'll keep you posted if and when any developments occur. The inside report discusses the alternative minimum tax (AMT). Chairman Charles Rangel introduced a bill (H.R. 3970) to fix the AMT problem. This seems unlikely to be adopted before the end of the year, but if such legislation occurs, tax planners will be busy since significant offsetting tax increases are included in the bill.

Some estimates have emerged concerning the inflation-indexed tax numbers for 2008. The IRS isn't required to announce actual numbers until December, and the potential for extender legislation may delay the release until the last minute. Nevertheless, estimates have proven accurate in the past. The standard deduction is expected to rise to $10,900 for joint filers ($5,450 for single taxpayers). The additional standard deduction for individuals aged 65 or older or blind will remain at $1,050 in 2008 for married individuals and surviving spouses, but will increase to $1,350 for single filers. The personal exemption amount will increase by $100 in 2008 to $3,500.

Taxpayers can, however, lose a good portion of the value of personal exemptions and itemized deductions when their incomes rise above certain levels. Those "phase-out" levels are also adjusted for inflation. For 2008, married couples filing jointly will begin to lose some of their itemized deductions when their adjusted gross income (AGI) exceeds $159,950. In a similar phase-out, taxpayers will begin to lose some of their personal exemptions when their AGI exceeds $239,950.

Some relief from these lost itemized deductions and exemptions will be provided in 2008. For next year, the reduction in personal exemptions and itemized deductions is scheduled to be only one-third of what it was in 2005. As a result, both phase-outs, initiated under the Revenue Reconciliation Act of 1990, are themselves now being phased out: by one-third in 2006 and 2007, by two-thirds in 2008 and 2009, and by a complete repeal scheduled for 2010.

Cordially,

Richard S. Bernstein

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YEAR-END TAX PLANNING TIPS FOR 2007

There is always a plethora of ideas to make some last-month adjustments to reduce taxes at the end of a calendar year. The discussion below provides some food for thought for this year and presents some new changes that will affect all taxpayers for next year. The efficacy of the following tax-reduction items will depend on individual facts and circumstances and on estimates of future income levels and taxes.

AMT STILL UNCERTAIN

Will the AMT exemption increase? Although the Tax Increase Prevention and Reconciliation Act of 2005 (passed in May 2006) increased the AMT exemptions for 2006 ($62,550 for a married couple filing a joint return and $42,500 for a single taxpayer), barring new legislation, the AMT exemption amounts are scheduled to revert to year 2000 levels ($45,000 for married couples filing jointly and $33,750 for single taxpayers). The need for a permanent solution to the growing AMT burden is escalating, but it has not been specifically addressed in the 2008 fiscal year budget; revenue proposals simply offer a 1-year extension of the AMT exemption amounts. The exemption amounts discussed this past February for 2007 are $43,900 for single taxpayers and heads of households, $65,350 for married couples filing jointly, and $32,675 for married couples filing separately. The extension would leave the number of taxpayers subject to the AMT at about 2006's four million level. Absent the extension, however, the Treasury estimates that 25 million taxpayers would be subject to the AMT in 2007.

Keep in mind that many common deductions are added back into the calculation of the AMT. Some of the itemized deductions added back are state and local income taxes (including sales taxes), real estate taxes, and miscellaneous itemized deductions in excess of 2 percent of AGI. In addition, for taxpayers who claim the standard deduction in lieu of itemizing, the standard deduction is added back to taxable income in calculating the AMT. Furthermore, in computing the AMT, both personal and dependency exemptions are not allowed. When planning the timing of year-end deductions (that is, taxes), what may seem tax deductible may prove to be an illusion due to an AMT issue.

BUSINESS OPPORTUNITIES

Legislation earlier this year provides the following business tax incentives:

- The Work Opportunity Tax Credit (WOTC) was extended for 3½ years (through August 31, 2011). Its availability to disabled veterans and rural counties with decreasing populations was also extended. Specifically, the threshold for qualified wages for the expanded veterans' group rises to $12,000 as of 2008.

- The Section 179 expensing limit for current deductions for capital expenditures was increased to $125,000 for 2007 and the phase-out threshold was increased to $500,000 (both amounts are indexed for inflation through 2010). However, the new law did not alter the $25,000 expensing limit for business owners who acquire an SUV or truck weighing between 6,000 and 14,000 pounds. The current expense limit increase provides a good opportunity to make an expenditure and take the deduction in 2007.

SHIFTING INCOME TO CHILDREN OR GRANDCHILDREN MORE DIFFICULT

The kiddie tax was expanded to apply to unearned income of children under age 19 (18 in 2007) or to full-time students under age 24 (whose earned income does not exceed one-half of the child's support for the taxable year). The new law is effective for tax years beginning after May 25, 2007, or for year 2008 for almost all taxpayers. A planning technique to avoid the kiddie tax is to transfer assets that have lower tax impact. For example, consider making gifts of tax-exempt securities, growth stocks, and/or low-turnover mutual finds.

CHARITABLE GIVING ISSUES

The Pension Protection Act of 2006 made some specific changes to close the loopholes perceived to exist regarding charitable giving. Taxpayers aged 70½ and older who are taking required minimum distributions from IRAs can opt to do so on a tax-free basis by rolling over the funds to charity. Although no charitable contribution deduction will be allowed for the rollover, the taxpayer will avoid including the distribution in his or her AGI. As a result, the rollover distribution/contribution does not increase the taxpayer's AGI, and there is no corresponding loss of individual and collective itemized deductions, personal and dependency exemptions, and credits. This favorable new rule for "qualified charitable distributions" was available for 2006 and continues until the end of 2007, but no more than $100,000 can be donated under the new rule in either of these years. Although many expect this incentive to be extended, it is quite possible that the opportunity for the charitable rollover will end on December 31 of this year.

Beginning with the 2007 return, cash donations of any amount must be substantiated with either a canceled check, bank statement, or a receipt from the charity. Undocumented cash contributions, such as cash placed in a church collection plate and cash contributed to the Salvation Army, will no longer result in a qualified charitable contribution deduction.

YEAR-END TAX TIMING FOR GIFTS OR DONATIONS, CHECKS, AND CREDIT CARDS

For most income tax purposes, a credit card expense is deemed to be incurred at the time of the transaction. For example, a charitable contribution or business expense by a cash-basis taxpayer is deductible in the year the charge is made, regardless of whether the bill is actually paid in the same year. A payment by check is also deemed to be made when the check is physically delivered, or when it is postmarked if it is sent by mail. Be warned, however, that this rule does not apply for gift tax purposes. Gifts made by check must actually be presented for payment in the current year for the gift to be treated as being made that year for gift tax or annual exclusion purposes. The amount of the gift tax annual exclusion for 2007 is $12,000 per donee (twice that for a joint gift by a married couple). Remember, the annual gift tax exclusion is the simplest method for reducing an estate potentially subject to estate taxes; if the gifts aren't made in any given year, the opportunity is lost.

LOWER TAX RATES ON DIVIDENDS

Most corporate dividends are taxable at a maximum rate of 15 percent for individual taxpayers. What you may not know is that for taxpayers whose marginal rate does not exceed

15 percent (that is, taxpayers whose taxable income does not exceed the 10 or 15 percent tax bracket amounts), the tax rate on dividends is now 5 percent. This presents an opportunity for income shifting by means of transferring dividend-paying stocks (and long-term appreciated capital assets) to lower-bracket family members who are not subject to the kiddie tax (that is, they are not under the age of 19). Be aware, however, that this could cause a kiddie tax in 2008 if the recipient is a full-time student under age 24. For 2007, single taxpayers with taxable income up to $31,850 and married taxpayers filing a joint return with taxable income up to $63,700 will have a marginal tax rate of 15 percent, and will therefore get the benefit of the 5 percent tax on dividend income. To effectively transfer taxation of income, however, the ownership of the asset itself must be transferred to the lower-bracket taxpayer (unless an appropriate form of trust is used), rather than just an income interest in the asset.

LONG-TERM CARE INSURANCE PREMIUMS FOR SELF-EMPLOYED TAXPAYERS

Sole proprietors, partners, and S corporation owner/employees may claim an above-the-line (not subject to the floor on itemized deductions) deduction for 100 percent of qualified long-term care premiums paid on behalf of themselves, their spouses, or dependents. A taxpayer who is a full-time employee but also has a moonlighting business for which the taxpayer files a Schedule C with Form 1040 is also eligible for the deduction, as long as the taxpayer or his or her spouse is not eligible for any employer-sponsored subsidized long-term care insurance plan.

Therefore, if such taxpayers are contemplating the purchase of long-term care insurance, they can reduce their current year's income by paying the premium by the end of the year. Remember, though, that the deductible amount is also subject to the same age-based premium limitation that applies to the Schedule A (or below-the-line) deduction for long-term care insurance premiums. The premium limitations are adjusted annually for inflation. For 2007, the deductible premium limits are $550 for taxpayers aged 40 to 49, $1,110 for taxpayers aged 50 to 59, $2,950 for taxpayers aged 60 to 69, and $3,680 for taxpayers aged 70 and above.

Social Security Wage Base. The wage base for 2007 is $97,500. The amount for 2008 is projected to be $102,600. Taxpayers who have some control over how much money they make may wish to receive additional earned income in excess of $97,500 this year rather than next, especially if the taxpayer expects that income will drop below the wage base next year. Earned income in excess of $97,500 is not subject to the OASDI tax. However, the 2.9 percent Medicare tax (1.45 percent for employees) applies, regardless of income level.

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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