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To Our Clients and Friends:

Although the year is only about half over, we've already seen one major new tax law (the fourth one in a 13-month period), and stay tuned, because we will almost certainly see more before year-end. Despite confusion created by these repetitive law changes, the current federal income tax environment is actually quite favorable. This letter presents some planning ideas to consider this summer and fall while you have time to mull them over – some of the ideas may apply to you personally and others to your business.

Make Your Standard Deduction Worth More by Bunching Deductible Expenditures

This year, the standard deduction for married joint filers is $10,700. The magic number for single filers is $5,350, while the figure for heads of households is $7,850. If your 2007 itemized deductions are likely to be just under or over this amount, it may pay to adopt the strategy of bunching together expenditures for itemized deductions every other year, while claiming the standard deduction in the intervening years. Examples of items that often work well for this strategy include the interest on your January home mortgage payment, charitable contributions, property taxes, and state income tax payments.

For example, say you're a joint filer whose only itemized deductions are $4,000 of annual property taxes and $7,000 of annual home mortgage interest. If you prepay your 2008 property taxes by December 31, you could claim $15,000 of itemized deductions on your 2007 return ($4,000 of property taxes for this year, plus another $4,000 for the 2008 bill, plus $7,000 of mortgage interest). In 2008, you would only have the $7,000 of mortgage interest, but you can claim the standard deduction which will probably be around $11,000 after an inflation adjustment. This strategy allows you to cut your taxable income by a meaningful amount over the two-year period. You can then repeat the drill all over again in 2009 and 2010.

Consider Deferring Income

It may also pay to defer taxable income from this year to next year, especially if you expect to be in a lower tax bracket in 2008. For example, you can postpone taxable income by putting off client billings until late in the year so you don't receive payment until 2008 (assuming you are a cash method taxpayer) and by prepaying deductible business expenses near year-end. Deferring income may also be helpful if you're affected by unfavorable phase-out rules that reduce or eliminate various tax breaks (such as your itemized deductions, the child tax credit, the education tax credits, and so forth). By deferring income every other year, you may be able to substantially increase your eligibility for these tax breaks every other year.

Time Investment Gains and Losses

As you evaluate investments held in your taxable accounts, consider the impact of selling appreciated securities. Regular federal income tax rates for 2007 can go as high as 35%, whereas taxes on long-term capital gains (LTCGs) from 2007 sales are generally taxed at no more than a 15% federal rate. The preferential LTCG rates are only available for securities held for over one year and they expire after 2010. Therefore, it makes more sense than ever to hold appreciated securities for at least a year and a day before selling.

However, if you expect to be in the 10% or 15% bracket for regular income taxes next year (2008), you might benefit from postponing LTCGs until then. Why? Because LTCGs will be taxed at 0% to the extent they fall within the income limits for the lowest two regular income tax brackets. Obviously, 0% is the best tax rate you'll ever see! For 2008, you should be in this sweet spot (where LTCGs will be taxed at 0%) if your taxable income (your income reduced by all your deductions and exemptions) doesn't go over about $64,000 for joint filers, $43,000 for heads of household, and $32,000 single taxpayers.

Selling some loser securities (currently worth less than you paid for them) before year-end can be a good idea too. The resulting capital losses will offset capital gains from other sales this year (including shortterm gains from securities owned for one year or less). If capital losses exceed capital gains, the excess losses can be used to shelter up to $3,000 of your high-taxed ordinary income from salaries, bonuses, self-employment, and so forth ($1,500 if you're married and file separately).

Kiddie Tax Alert: Will Your Child Be 18 or Older at Year-end?

When the dreaded Kiddie Tax hits part of your child's unearned income (typically from investments), it gets taxed at your higher marginal rate rather than at your child's lower marginal rate. For 2007, the Kiddie Tax won't affect a child who is age 18 or older as of year-end. Next year, however, the Kiddie Tax can hit part of the unearned income of a child who will be age 18 and a student who will be age 19–23 as of 12/31/08 if the child's earned income (such as, wages) for the tax year doesn't exceed one-half of his or her support.

As you can see, your child could be exempt from the Kiddie Tax this year (because he or she will be 18 or older at year-end), but not next year (because he or she will be a student age 19–23 without sufficient earned income). In this scenario, consider having your child trigger some taxable gains and income this year. They will be taxed at your child's lower rate. Next year, that might not be true due to the new Kiddie Tax age rules. Keep in mind that, for this year, the Kiddie Tax only hits unearned income in excess of $1,700. The threshold for next year will probably be higher due to an inflation adjustment. Also, the student's earned income is not subject to this tax.

Consider Giving Appreciated Securities to Younger Family Members

A great way to reduce the tax hit on an appreciated security is to give it your child or grandchild. The child can hold the security until a year when the Kiddie Tax doesn't apply and then sell. (Take care to avoid the new Kiddie Tax rules that will kick in next year.) The resulting capital gain may well be taxed at 0% if the sale takes place in 2008–2010 (assuming the current rate structure is left in place). For example, in 2008, the 0% LTCG rate will apply if the child isn't subject to the Kiddie Tax and his or her taxable income doesn't go over about $64,000 for joint filers, $43,000 for heads of household, and $32,000 singles.

Remember that giving the security to your child is considered a gift. However, you can use your annual $12,000 gift tax exclusion to shelter the transaction from any gift tax. For larger gifts, you can use up part of your $1 million lifetime gift tax exemption to avoid any gift tax hit. However, dipping into your $1 million exemption could result in a higher estate tax bill upon your death.

Take Advantage of Favorable New Provisions

Several taxpayer-friendly changes kicked in this year. They include the following.

- *Bigger Section 179 Deduction.* For its tax year beginning in 2007, your business may be able to take advantage of the increased Section 179 deduction. The maximum deduction is now a whopping $125,000 (up from $112,000). Under the Section 179 privilege, an eligible small business can often claim first-year depreciation writeoffs for the entire cost of most new and used equipment and software additions. If you are thinking about purchasing equipment, furniture, or other tangible property for use in your business, now may be the perfect time to do so. However, restrictions apply. Call us for details.

- *Expanded Work Opportunity Tax Credit (WOTC).* The WOTC is intended to encourage employers to hire members of certain targeted groups. A law passed earlier this year makes the WOTC available for wages paid to more individuals, which could affect your hiring decisions. If you want more information, call us.

Liberalized Health Savings Account (HSA) Rules. Deductible contributions can be made to HSAs set up for individuals who are covered by qualifying high-deductible health plans (HDHPs). You can then take federal-income-tax-free withdrawals from your HSA to reimburse yourself for qualifying out-of-pocket medical expenses. A law passed late last year generally allows bigger deductible HSA contributions for 2007. In addition, you may qualify to roll over amounts from your employer's health care flexible spending account (FSA) plan or health reimbursement arrangement (HRA).

Take Advantage of Expiring Tax Breaks before They Become History

As the tax law currently reads, a host of valuable breaks are scheduled to expire at the end of this year. While the odds are good that some, or even most, of them will be extended by future legislation, don't bet the farm on it. The prudent course is to take action before year-end to cash in on breaks that are meaningful to you or your business. Here's a brief rundown on expiring provisions (this is not a complete list).

- *Itemized Deduction for State and Local Sales Taxes.* The optional deduction for state and local sales and use taxes (in lieu of deducting state income taxes) will expire at the end of this year unless Congress takes further action. If you live in a state with low or no state income tax, you may want to make some big-ticket purchases (such as a new car or boat) before year-end to increase your sales tax deduction.

- *Credit for Nonbusiness Energy Expenditures.* The up-to-$500 tax credits for nonbusiness energy efficiency improvements such as qualifying exterior windows and doors, insulation, and heat pumps will expire at the end of 2007 unless Congress extends them. The credit amounts are modest, but they could make it worth your while to make some energy-saving changes to your principal residence. Improvements must installed by 12/31/07 to qualify.

- *Charitable Donations from IRAs.* If you've reached age 70_, a law change from last year allows you to arrange to distribute up to $100,000 of otherwise taxable IRA money to specified tax-exempt charities. These so-called qualified charitable distributions (QCDs) are federal-income-tax-free to you, but you don't get to claim any itemized deductions on your Form 1040. However, the tax-free treatment equates to a 100% writeoff and you don't have to itemize your deductions to get it. This favorable provision will expire at the end of this year unless Congress extends it.

- *Faster Depreciation for Leasehold and Restaurant Improvements.* Favorable 15-year depreciation is allowed for qualified leasehold improvements and qualified restaurant improvements that are placed in service by 12/31/07. However, this break will expire at the end of this year unless Congress extends it. If that happens, the cost of these improvements in future years would generally have to be depreciated over 39 years.

- *Breaks for Business Charitable Donations.* Enhanced deductions are allowed for certain types of charitable donations made through 2007 by businesses. There are two enhanced deductions available to C corporations—one for donations of computer equipment and technology and another for qualified book contributions. Non-C corporation businesses get an enhanced deduction for donations of food inventories. Last, but not least, is a rule that provides favorable treatment for S corporation donations of certain appreciated assets. These enhanced deductions and special rules will be unavailable in tax years beginning after 2007 unless Congress extends them.

- *Special Rules for Qualified Conservation Donations.* Rules that provide extra-favorable treatment for qualified conservation contributions by individuals and farm businesses to charitable organizations will be unavailable in tax years beginning after 2007 unless Congress extends them.

Watch for These Unfavorable Changes

Some unfavorable changes also kicked in this year or in the middle of last year when you might not have noticed. They include the following:

All Cash Donations to Charity Must Be Documented (No Exceptions). You're no longer allowed any writeoffs for contributions of cash, checks, or other monetary gifts unless you retain either a bank record that supports the donation (such as a cancelled check or credit card receipt) or a written statement from the charity that meets tax-law requirements. For cash donations of $250 or more, a bank record is not enough. You must obtain a charity-provided statement that meets tax-law standards.

- *Stricter Rules for Donated Used Clothing and Household Items.* You're no longer allowed to claim deductions for charitable donations of used clothing and household items that are not in good condition or better. The term *household items* include items such as furniture and furnishings, electronics, appliances, linens, and the like. Be sure to keep a list and photo (to help establish the item's condition) of donated items.

Watch Out for the Alternative Minimum Tax Too

While recent tax law changes have been helpful in reducing your regular federal income tax bill, they didn't do much to reduce the odds that you'll owe the dreaded alternative minimum tax (AMT). Therefore, it's critical to evaluate all tax planning strategies in light of the AMT rules before actually making any moves. Because the AMT rules are so complicated (and because they will probably be changed again this year), you may want our assistance in understanding their effect on your specific income tax circumstances.

Don't Forget about Your Estate

The current federal estate tax exemption is $2 million. It's scheduled to increase to $3.5 million in 2009 and then be completely repealed in 2010—but just for that one year. It now seems quite clear that if the promised repeal ever happens at all, it will just be for 2010. The more likely scenario is that we will continue to have a federal estate tax for 2010 and beyond, but possibly with a somewhat larger exemption than the current $2 million figure. Therefore, planning to avoid or minimize the federal estate tax should still be part of your overall financial game plan.

Whittling your estate down by making annual gifts continues to be a tax-smart strategy. If you have some favorite relatives or unrelated persons, you can give each of them up to $12,000 this year and your spouse can do the same. These gifts will reduce your estate tax exposure without any adverse gift tax effects. Making multiple gifts over multiple years can dramatically reduce your estate tax exposure. So, the sooner you start an annual gifting program, the better. Contact us for more information on the best ways to avoid estate taxes.

Conclusion

As we said at the beginning, this letter is intended to give you just a few ideas to get you thinking about tax planning for 2007. Please don't hesitate to call if you want more details or would like to schedule a tax planning strategy session. We can also assist you with estimating your projected 2007 income tax liability if you are concerned about what your eventual tax liability will be before the year is over.

If you haven't already done so please take a minute and visit our website and if you would let us know what you like about it and what you might like to see offered on it in the future – you can find us at **www.wittenbergcpa.com**. Also, please let us know if you would prefer to receive future correspondence via email, rather than or in addition to receiving it via standard mail. Hopefully by now you have had a chance to meet or speak with Katie, our newest staff member. We want to remind you that we are open to your ideas and appreciate your patronage as we continue to be at your service!

Our Best wishes,

Michael Wittenberg, CPA, PS

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