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TAX AND BUSINESS ADVISOR

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TAX AND BUSINESS Alert™

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Section 199 Revisited

When you hear the term Section 199, one of several things might come to mind: an area of a department store near the back of the building, a new perfume or cologne, a portion of the latest cookbook, or a section of the Internal Revenue Code. In this case, you would be correct if you picked "a section of the Internal Revenue Code."

Section 199 was established by the American Jobs Creation Act of 2004 and gave us the Domestic Production Activities Deduction, also known as the "Producer Deduction." The Producer Deduction is just that, a business tax deduction based on income attributable to certain manufacturing and production activities conducted in the U.S.

We are revisiting this topic because the Producer Deduction doubles for tax years beginning in 2007 when compared with 2005 and 2006. For 2007 tax years, the deduction is 6% of qualified domestic production activities, or a 100% increase from the 3% allowed in 2005 and 2006. So, if you qualified for this deduction in prior years, your federal tax bill should decrease a little in 2007 if you continue to qualify. If you did not qualify in prior years or you did qualify, but the benefit was minimal, you might want to reanalyze your financials in light of the increased deduction available. Incidentally, the producer deduction rate will increase once again to 9% for tax years beginning in 2010.

The definition of *qualified production activities* is very broad. These activities include, but are not limited to, traditional manufacturing of tangible personal property; domestic construction, civil engineering and architectural services for U.S. projects; production of electricity, gas, and potable water; software production; film and videotape production and licensing; growing of agricultural products and food (farming); and processing agricultural products for food.

This Producer Deduction is available to individual business owners as well as C corporations, S corporations, and partnerships, among other entities. Please call us to discuss this opportunity to reduce your federal taxes or if you have questions about any individual or business tax compliance or planning issue.

Medicare Part B Premiums Increase

As individuals age 65 and older may already know, Medicare Part B (Part B) premiums have gone up. Part B covers doctor bills, lab tests, and other outpatient services. Prior to 2007, the Federal government paid 75% of the monthly Part B premium ($374 in 2007) and the covered individual paid the remaining 25% ($93.50 in 2007). However, starting this year, premiums are based on your income—higher income equals higher premiums.

Taxpayers at the higher income levels, starting with modified adjusted gross income of $80,000 for single filers and $160,000 for joint filers, will now have less of their premiums subsidized by the government. Since your 2006 income tax information was not available in January, the Federal government used your 2005 tax information to compute your 2007 Part B premiums. So, higher income individuals have seen their premiums increase to one of four new levels (starting at $105.80 and ending at $161.40 per month or from 28% to 43% of the total monthly premium) in 2007.

This is the first year of a three-year program to increase Part B premiums for higher income individuals. In 2009, these taxpayers will be required to pay *up to* 80% of the monthly Part B premium. At the 2007 monthly Part B premium rate of $374, that's $299.20 per month compared to the standard 25% rate of $93.50 in 2007; and that's without adjusting for inflation.

Deducting Tournament Poker Losses Is Limited

In a recent Tax Court case, a taxpayer contended that her professional tournament poker playing was not a "wagering activity" but a sporting event and, as such, was not subject to the IRS' long-standing limitation on claiming losses from wagering only to the extent of wagering gains. In this case, the taxpayer reported $11,708 in poker tournament winnings during 2000, which she offset with $41,641 of poker tournament losses and claimed a net business loss of $29,933 for the year. The IRS concluded that the rule allowing gambling losses only to the extent of gambling winnings applied, requested an additional tax payment, and applied an accuracy-related penalty.

In rejecting taxpayer's contention and ruling for the IRS, the Tax Court admitted that there are differences between tournament poker and other types of poker. But, none rose to the level of meaningful, substantive differences that would warrant different tax treatment under the Internal Revenue Code.

IRS Releases Its *Dirty Dozen* for 2007

The IRS recently issued its *Dirty Dozen* for 2007, which is the latest installment of the annual tally of the most notorious tax scams, and warned people not to fall for schemes peddled by scamsters. This year's *Dirty Dozen* has five new scams that IRS examiners have uncovered: abuses related to the special telephone excise tax refund available this filing season, along with abuses pertaining to Roth IRAs, the American Indian employment credit, domestic shell corporations, and structured entities. We are always available to address inquiries you receive or questionable activity concerning your tax information. In addition, suspected tax fraud can be reported to the Internal Revenue Service by calling (800) 829-3676.

New Charitable Contributions Rules

For cash contributions, it's not unusual to give small amounts without expecting a receipt. Previously, if these donations were less than $250, you could either keep cancelled checks or reliable records, such as a list showing the dates, amounts donated, and charity name as proof of the donation. Under the new rules effective this year, however, it's no longer sufficient to simply keep good records of these donations to claim them as charitable contributions. Instead, cash contributions of less than $250 given in a single donation are only deductible if you keep a bank record (most likely a cancelled check, wire transfer acknowledgement, or credit card record) or written acknowledgement from the charity showing the name of the charitable organization, the date of the contribution, and the amount of the contribution.

So, if you are likely to itemize deductions on your income tax return and typically make cash contributions of less than $250, you should make donations by check rather than cash, because that will easily satisfy the documentation requirements. Simply keeping good records of the donations will no longer be enough to claim the deduction.

Substantiation rules for larger contributions of cash or other property (those that are more than $250) were not changed by the new rules, but, as a reminder, they require a little more effort to substantiate. A written acknowledgement from the charity must be obtained, showing the description of the property or amount of cash donated and a statement as to whether the donor received any goods or services in return for the property donated. If goods or services were received, a good faith estimate of their value should be obtained. A cancelled check or other reliable records are not sufficient proof. (You can obtain one written acknowledgement for multiple gifts of $250 or more to the same charity.) The acknowledgement must be received contemporaneously; that is, it must be obtained no later than the due date (or extended due date, if applicable) of the tax return for the year the contribution was made.

If you typically donate used clothing or household items to charities, such as Goodwill, the items must be in "good condition or better" unless the items were worth more than $500 and a qualified appraisal report is attached to your tax return. The IRS has not yet defined what is meant by "good condition or better." Thus, you might consider keeping a detailed list and photos of contributed items (unless the property is appraised). No new documentation is required, but to protect yourself in case of an IRS audit, you should, at a minimum, document that the donations were in good condition.

For any amount (even if it's less than $250) of contributions made by payroll withholding, you're now required to keep an official pledge card from the charity and documents from your employer (for example, a pay stub or Form W-2) showing the amount donated.

If you're planning to contribute property (other than publicly traded securities) for which a deduction of more than $5,000 will be claimed ($10,000 for closely held stock), please discuss these plans with us as soon as possible. Although the rules for substantiating this type of property haven't changed, there are now stricter rules for what is considered a "qualified appraisal" and who is considered a "qualified appraiser." You must have the appraisal done not earlier than 60 days before the donation and received by the due date (including extensions) of your tax return.

We hope this information is helpful as you plan for your charitable contributions. It's important to follow these recordkeeping requirements if you hope to claim the deduction for your donations because the IRS can and will disallow charitable deductions if these requirements aren't met. If you would like more details about these or any other aspect of the new rules, please don't hesitate to call us.

Don't Overlook Nondeductible IRAs

The chances are good that if you participate in an employer-sponsored retirement plan, you may not qualify to make *tax deductible* contributions to an individual retirement account (IRA). Although you can always make a contribution to a *nondeductible* IRA (assuming that you or your spouse have earned income at least equal to the contribution), most people don't bother doing this. Such a contribution doesn't yield a tax deduction and although the *earnings* inside the account build up tax deferred, they're fully taxable as ordinary income when they're distributed.

Instead, people who want to maximize their retirement savings beyond what they're saving at work typically use a Roth IRA account if they qualify (the Roth IRA doesn't provide an upfront deduction, either, but it does allow earnings to build up tax-free, rather than tax-deferred) or invest in a taxable account such as a tax-efficient mutual fund that will yield mostly lightly taxed capital gain income.

Based on a recent law change, the use of a nondeductible IRA now looks more appealing for taxpayers who can't qualify to make a Roth IRA contribution (because their income is too high). The new provision allows taxpayers, beginning in 2010, to convert traditional IRAs (such as a nondeductible IRA) to a Roth IRA regardless of the taxpayer's income level. Currently only taxpayers with modified adjusted gross income of no more than $100,000 can convert a traditional IRA to a Roth IRA. At the time of the conversion, ordinary income tax is due on the income portion of the IRA, but future earnings accrue tax-free. In addition, for conversions in 2010, the new law allows the resulting tax to be paid over two years—2011 and 2012.

Why are we bringing this to your attention more than two years before 2010? Because, if you're not yet age 70½ and want to maximize the funds that can go in a Roth IRA in 2010 or later, you should be funding nondeductible IRAs now—up to the lesser of your earned income or $4,000 (or $5,000, if you are age 50 or older by the end of the year for which you're making the contribution). It's not too early to fund for 2007 provided you know you'll have at least $4,000 (or $5,000) of earned income for the year.

Please feel free to call us if you'd like to know more about this opportunity for maximizing the tax efficiency of your retirement savings.

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