



TAX ALERT

NOVEMBER 17, 2006

TAX REFORM AFTER THE ELECTIONS

Last week some members of Shepard Schwartz & Harris LLP attended the American Technion Society 2006 Annual Tax and Estate Planning Seminar. The keynote speaker was Russ Sullivan, the Minority Staff Director of the U.S. Finance Committee. Mr. Sullivan shared his opinions on the direction of new tax legislation during the current lame-duck period and in 2007 – 2008 as the newly elected democrats take office.

Working for U.S. Senator Max Baucus, Ranking Member of the U.S. Finance Committee, Mr. Sullivan stated that the following issues were areas that are likely to be addressed in the near future:

- **Alternative Minimum Tax**
There is an understanding that there needs to be relief for individuals affected by AMT. He thinks that relief will be enacted in the near future.
- **The Tax Gap**
With any new legislation there is a need to offset tax cuts with additional revenue or spending reductions. The democrats do not see any areas where spending could be cut at this time. Therefore, their focus would be on raising the tax compliance rate. Recently, the percentage of taxpayers filing and paying their taxes has dropped from 86% to 83%. To increase compliance, there would be additional third party reporting requirements. Also, there would be mandatory income tax withholding on

certain payments, such as those received on all government contracts.

In addition to the goal of increasing the number of tax returns filed, there would be an initiative to deter under-reporting income and over-reporting deductions. This includes the mortgage interest rules and, in particular, the excess interest expense deductions currently being taken for home-equity loans. The legislators encourage enforcement of interest deduction limitations on \$100,000 of home equity debt. Mr. Sullivan also stated that the IRS needs to use available technology to target taxpayers that are falling behind in payments.

- **Education**
There is a desire to reduce interest rates on student loans and increase tax incentives. The Section 529 College Saving Plans have already been enacted permanently. The focus now will be on the Hope Credit and Lifetime Learning Credit.
- **Energy**
There is an interest in extending energy tax incentives. There may be an increase in tax on multi-national oil companies.
- **Estate Tax**
As the estate tax currently stands, in 2009 the maximum tax rate decreases to 45% and the lifetime equivalent exemption amount increases to \$3.5 million. In 2010 the estate tax is repealed for one year. In 2011 the rules go back to the 2001 rules. There probably will not be a full repeal of the

estate tax. The likely structure of an estate tax compromise probably will include an increase of the lifetime equivalent exemption to \$5 million (indexed for inflation), re-unifying the gift and estate tax systems and “portability” (where the excess lifetime exemption amount from the first spouse to die can be used by the second spouse).

Because of the loss in estate tax revenue from these changes, Mr. Sullivan states that a revenue raiser would include disallowing valuation discounts in certain situations. These situations include liquid or fairly-liquid assets where the economic reality is that no discount should be taken. He was referring to discounts for gifts of interests in family limited partnerships where the underlying assets are publicly traded stocks. Mr. Sullivan predicted that the Senate will make progress with estate tax reform but he is less sure of the House. He hopes to reach agreement during the current lame-duck session. Otherwise it may be more difficult to reach a consensus during 2007 or 2008.

- **Capital Gains Tax**

Mr. Sullivan feels that Congress will retain the current law, where long term capital gains are taxed at 15%, and that there will be no change in this area until the 2008 election.

- **Reduced Tax Rate for Qualified Dividends**

Although the 15% tax rate will probably remain over the next two years, it is in greater jeopardy than the 15% capital gains rate.

Mr. Sullivan’s comments were interesting and thought-provoking. We will keep you updated on the various tax issues and legislation as it arises. As always, if you have any tax issues that you would like to discuss, please contact us.

REPORTING GAMBLING WINNINGS AND LOSSES

The following discussion relates to taxpayers who aren’t professional gamblers. Winnings must be reported as “other income” on your tax return. Losses cannot be netted against winnings. Losses must be aggregated and deducted separately as itemized deductions. They are deductible only if you itemize your deductions. Therefore, if you take the standard deduction, you cannot deduct gambling losses. Another important limitation is that gambling losses are only deductible to the extent of your gambling winnings. Therefore, losses enable you to reduce your gambling winnings income but you can never report a net gambling tax loss. Finally, since Federal itemized deductions are not deductible in computing your Illinois income tax, you are required to pay Illinois income tax on your gambling winnings but you are unable to deduct your gambling losses.

It’s important to keep good records to substantiate your gambling losses. Keep a diary in which you indicate the date, place, amount and type of loss as well as the people who were with you when the loss occurred. Save all documentation such as losing tickets, checks, and credit slips which substantiate the amount of the loss. If the loss occurred in another city, save airline tickets, hotel receipts and other documentation substantiating that you were there.

Losses on slot machines and video poker machines can be substantiated by a print-out which the casino will give you if you request it. Losses on table games such as blackjack, craps, poker, etc. can be substantiated by getting the table number where the loss occurred and substantiation of any credit advanced by the casino.

Casinos and racetracks are required to issue information return Form W-2G if your winnings equal or exceed the following amounts:

- Keno \$1,500
- Slot Machines \$1,200
- Table games \$600 or at least 300 times the amount of the wager.
- Bingo \$1,200
- Racing - \$600 or at least 300 times the amount of the wager
- Lotteries - \$600 or at least 300 times the amount of the wager.

YEAR-END TAX PLANNING

Capital Gains and Losses

Stock values have recorded large gains this year. You may have already realized some of those gains and other gains will be realized by the end of the year from mutual funds. The anticipated large year-end distributions by mutual funds is the result of the recent profitability of the stock market and the fact that mutual funds have exhausted the large losses that were incurred during the dot com crash. Estimated total distributions from mutual funds for the last three years are as follows:

<u>Year</u>	<u>Capital Gains (Millions)</u>
2003	\$ 15,200
2004	62,000
2005	144,800

Capital gain distributions this year promise to be much larger. This often unanticipated source of capital gains – mostly long-term but some short-term – must be planned for. If you are considering investing in a mutual fund in the near future, check to see if it is planning to make a year-end distribution and, if so, how much and when. If the payout will be large, consider waiting to invest until after the record

date of the distribution. Unfortunately, if you buy a mutual fund a day before the record date of the distribution, you can be taxed on gains which were realized all year long.

Now is a good time to consider selling your loss stock. If the price of stocks that you purchased during the dot com era hasn't come back by now, this may be the time to bite the bullet and move on. Capital losses can be used to offset capital gains. Excess capital losses can be used to offset ordinary income to the extent of \$3,000 per year. Any excess capital losses beyond that can be carried forward and deducted in future years.

In determining the tax that you pay on capital gains, combine and net your long-term gains and losses and your short-term gains and losses. A net long-term capital gain is taxed at a maximum rate of 15% under the current law. A net short-term capital gain is taxed at a maximum rate of 35%. Therefore, it is especially important to avoid ending the year with net short-term capital gains.

Caveat – The alternative minimum tax may increase the effective tax rate on long-term capital gains by several percentage points.

When considering sales of loss securities, watch out for the wash-sale rule. A wash-sale occurs when you sell a stock or security at a loss and buy the same security or one that is “substantially identical” within thirty days either before or after the sale. If you violate this rule, the loss that results from the sale will not be deductible. Instead, the basis of the new stock which you purchase will be increased thereby deferring the loss. Remember the wash sale rule only applies to losses – it does not apply to gains.

The term “substantially identical” is vague enough to have been argued many times in court. This issue seems to arise more frequently when selling bonds as opposed to stock. One

way of solving this problem is to purchase a similar stock in the same industry.

Example –

If you sell \$100,000 of Merck, you might decide to purchase \$100,000 of Pfizer.

If you need help with this substantially identical question, please call us — we will be happy to help you navigate through these waters.

Worthless Securities

Securities that are worthless can be written off. The problem is satisfying the definition of worthless. By worthless, the IRS means absolutely worthless. A stock that is worth a penny a share is not worthless even though the proceeds may not even be enough to cover the cost of selling it. In order to protect your loss deduction, we suggest that you sell the security even if you only get a dollar. You can sell it to an unrelated individual if the paperwork is done properly and there isn't any agreement to repurchase the stock any time in the future. Again, we will be happy to advise you.

Social Security Wage Rises to \$97,500 in 2007

The Social Security Administration recently announced that the wage base for computing social security and Medicare tax in 2007 rises to \$97,500 from \$94,200 in 2006. The maximum tax for an employee or self-employed individual earning \$97,500 in 2007 will be \$12,090. The Medicare tax continues at the rate of 2.90% on income earned in 2007 over \$97,500.

Year-End Charitable Contributions

If you are planning to make substantial year-end charitable contributions, consider using appreciated securities instead of cash.

Do not give depreciated securities to charities. You would be better off selling stocks that are worth less than your cost, realizing the loss, and then giving the cash to charity. In order to make sure that the shares are transferred to the charity prior to December 31st, it is important to start the process at least a couple of weeks before year-end. Also, we will be happy to prepare a projection prior to the contribution to tell you the amount of your projected tax savings.

As we mentioned in our September 22, 2006 Tax Alert, the Pension Protection Act of 2006 signed into law earlier this year permits individuals over age 70-1/2 to withdraw up to \$100,000 per year during the remainder of 2006 and 2007 and contribute to charity without having to pay tax on the distributions.

Caveat – the withdrawal must go directly to the charity – it can't go to the taxpayer and then be distributed by the taxpayer to the charity.

The charitable contribution from the IRA must go to a public charity. Although a charitable contribution deduction is not allowed, the income exclusion is preferable. Finally, the distribution and contribution to charity satisfies the annual minimum distribution requirements.

Estate Tax Planning

As another year draws to an end, at a minimum, consider gifting at least \$12,000 (\$24,000 by a married couple) to each of your children, grandchildren, etc. to make use of the increased annual exclusion. Failure to use the entire \$12,000 annual exclusion results in its loss - the unused portion cannot be carried forward.

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