



TAX ALERT

DECEMBER 22, 2005

RESEARCH AND DEVELOPMENT TAX CREDIT

U.S. high-tech companies, manufacturers and pharmaceutical companies have been trying to get Congress to expand the Research and Development (R&D) tax credit. Lobbyists for the expanded credit argue that most industrialized countries have more generous tax breaks for investing in new technologies and manufacturing techniques than the U.S. The Senate has passed a bill and the House Ways and Means Committee has approved an expansion of the credit. This legislation may be approved in a broader tax bill expected to be enacted into law later this month. The problem is that the one year cost of the expanded credit is estimated at \$9.9 billion. If this proves to be too expensive, the current R&D credit would be extended for one year at a cost of \$7 billion.

We at Shepard Schwartz & Harris are in process of contacting our clients that are likely to benefit from the R&D credit legislation. We are working with engineers to maximize the R&D credits available to our clients.

THE CHANGING STANDARD MILEAGE RATE

This year, because of the increase in the price of gasoline which took place this summer, the automobile allowance rate increased during the year. Since the price of gasoline has dropped, the new auto rate for 2006 has decreased as shown below:

Type of Mileage	1/1 – 8/31/05	9/1 – 12/31/05	2006
Business	40.5¢ per mile	48.5¢ per mile	44.5¢ per mile
Medical and Moving	15¢ per mile	22¢ per mile	18¢ per mile
Charitable	14¢ per mile	14¢ per mile	14¢ per mile

INTERNET SCAM

An Internet scam in which individuals receive an e-mail purportedly from the IRS informing them about a tax refund was the subject of a warning that the IRS issued earlier this month.

The e-mail, which states that it comes from “tax-refunds”, tells the recipient that he or she is eligible to receive a tax refund for a given amount. It then directs the individual to a bogus link which asks for personal information which is subsequently used to steal the individual’s identity and financial assets. Information on schemes to defraud the public and the federal government can be found on the criminal enforcement page at <http://www.irs.gov>.

IRS OUTSOURCING OF COLLECTIONS BEGINS NEXT SUMMER

In February 2006, the IRS expects to award the first three contracts for private collection agencies to pursue delinquent taxpayers. Private collections will begin in June 2006. By January 2008, the IRS expects to have 10 to 12 private collection agencies doing its collection work. The IRS is trying to anticipate problems before they occur. The private debt collectors are being trained so that taxpayer rights will be protected. The IRS intends to send taxpayers a notice their account is being turned over to a private collection agency so that taxpayers will know that the contacts they receive are legitimate.

CHARITABLE GIVING

The number of private charitable foundations has increased 60% from 1999 to approximately 33,645. The allure of a private foundation begins with the fact that you can name it after yourself or members of your family and make gifts in your name to causes that you believe in. The foundation survives your death.

The main tax requirements of a foundation are:

1. it must distribute at least 5% of its assets each year to charity, and
2. it must pay an excise tax each year equal to 2% of its investment income – it doesn't pay income tax.

Before establishing your own foundation, make sure that the contributions that you plan to make will be substantial to justify the costs of establishing and operating a foundation.

An easier way to proceed is to use a donor-advised fund. There are over 800 donor-advised funds. They are being run by community trusts, religious charities, money managers, and others. All that you need to do is to contribute to a donor-advised fund. You get an immediate tax deduction. The fund then invests your contribution and usually contributes it to charities that you recommend over several years. Your recommendations for contributions to specific charities are not binding. The funds technically have the final say but they usually go along with your recommendations. You don't incur any professional fees or organization expenses.

IRS PLANS TO INCREASE AUDITS NEXT YEAR

A recent IRS study concluded that tax evasion and noncompliance, in general, costs the government more than \$250 billion in lost revenue each year. The IRS plans to get some of that lost revenue back by attacking tax shelters. Additional revenue is lost by using foreign entities including offshore trusts. Another target is self-employed individuals earning more than \$100,000 per year who fail to report all of their income.

While the percentage of audits of tax returns reflecting income of over \$100,000 has increased in fiscal 2005 and will increase again in fiscal 2006, it is still below the percentage audited 10 years ago. The IRS argues that its audits today are more efficient because more audits which don't require face to face examinations are done by mail.

The IRS is concluding a study to help it determine which returns should be audited. In other words, which returns have the greatest potential of resulting in large tax deficiencies.

The IRS has asked Congress for legislation which would give it additional weapons. For example, one provision doubles penalties, interest, and fines for concealing income by means of offshore accounts. Another provision imposes tougher penalties on tax shelter promoters and those who knowingly aid or abet tax liability understatement.

U.S. PRODUCTION ACTIVITIES DEDUCTION

Beginning this year, businesses are permitted to deduct a percentage of the income that they earn from production activities in the U.S. The activities include manufacturing, food production, software development and film and music production. The percentage in 2005 and 2006 is 3%. In subsequent years, it increases in stages to 6% and then to 9%.

The IRS has issued two sets of rules and proposed regulations intended to clarify ambiguities in the law. Unfortunately, ambiguities remain. Nevertheless, we have concluded that this is very favorable legislation which will prove helpful to many of our clients.

PRIOR TO YEAR END

Consider Making Gifts to Family Members. The first \$11,000 (\$22,000 for married couples electing to split their gifts) given to each recipient is not subject to gift tax. Additionally, these gifts do not reduce your lifetime \$1,500,000 estate tax exemption.

The \$11,000 exemption (\$22,000 for married couples electing to split their gifts) increases next year to \$12,000 and \$24,000, respectively.

These annual limits are not reduced by any payments made during the year for medical expenses and tuition.

Consider Maximizing Your 401(k) Contributions. For 2005 you can contribute up to \$14,000 (\$18,000 if you are age 50 or older).

In 2006, these limits increase to \$15,000 and \$20,000, respectively.

Consider Increasing Your Charitable Contributions. Charitable contributions within the limits of the law will decrease your income tax. The amount of the decrease depends on whether you are subject to the alternative minimum tax (AMT). Contact us and we will let you know the tax effect of any contemplated additional contribution.

IRS Circular 230 Notice: Any tax advice contained herein is not intended to be used and cannot be used by the recipient for the purpose of avoiding penalties that may be imposed by law.