T. M. BYXBEE COMPANY, P.C. SUMMER 2008

INSIGHT

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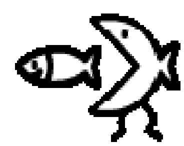
The 2008 Tax Planning Environment

Now that tax season is over we face another year of tax planning challenges. Clearly we will have important tax legislation in 2008, but tax planning this year is complicated by politics and the upcoming election.

It is likely that the upcoming November election will result in substantive changes to the tax law in 2009. We will have a new President and a new Congress taking over in January of 2009. The two major Democratic candidates, Senators Clinton and Obama, are committed to rolling back the "Bush tax cuts" and enacting higher taxes on the "wealthy." Senator McCain is committed to preserving and extending the Bush tax cuts, but if elected may have to face a Congress controlled by the Democrats. Here is what to look for over the next 12 to 18 months in terms of the major tax issues that will be coming up:

Social Security and Medicare—a Bigger Bite



For employees, the FICA tax rate, which is the combined Social Security tax rate of 6.2 percent and the Medicare tax rate of 1.45 percent, is 7.65 percent. The Medicare tax rate is not capped, but the Social Security tax is currently capped at $102,000 of earnings in 2008. The $102,000 amount is inflation adjusted every year. For a self-employed person this means a payroll tax of 15.3 percent on the first $102,000 of earned income in 2008 and 2.9 percent payroll tax on the excess over $102,000, since the self-employed person pays both the employee's portion and the employer's match.

Look for the Social Security tax to go up significantly if the Democrats win both the Presidency and the Congress in 2008. Social Security and Medicare are both headed for deficits and the government needs more money to continue running these programs. It is unlikely that the cap on Social Security will be removed entirely—although Barack Obama has hinted that he would favor such a change—but commentators suspect the tax bite here may be significantly increased for 2009 and beyond. The payroll tax is particularly hard on the self-employed and small business owners because they are paying both sides of the tax, the employee's portion and the employer's match.

Alternative Minimum Tax

The AMT was originally created to insure that the very wealthy did not use tax loopholes to avoid paying their fair share of tax. It is a parallel tax that cancels out many deductions, particularly itemized deductions for state and local income and property taxes, and therefore forces taxpayers to make two tax calculations and pay the higher amount. Nearly 40 years after it was introduced, the AMT now threatens some 20 million additional taxpayers with higher taxes in 2008. Both Republicans and Democrats indicate they want to eliminate the AMT, even though it is expected to generate $800 billion in revenue over the next decade. The problem, of course, is that the federal government's budgetary assumptions rely upon the receipt of this $800 billion in revenue, whether the AMT is repealed or not, and so a substitute revenue source for that $800 billion must be found.

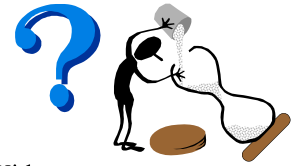
U.S. Representative Charles Rangel, Chairman of the House Ways and Means Committee, has unveiled a plan to eliminate the AMT and pay for it with a broad overhaul of the current tax system. His plan includes some tax cuts, like a larger standard deduction; expansion of the earned income and child tax credits; and a reduction in the corporate tax rate from 35 percent to 30.5 percent. But the Rangel plan, called the "mother of all tax bills" by the Republicans, also contains tax hikes that include: a surtax on married couples earning more than $200,000; higher tax rates for hedge funds and private equity firm managers; and repeal of certain tax benefits for business, including Section 199, the manufacturers' deduction for domestic production activities.

Brokers Must Report Basis in Publicly Traded Securities

In an attempt to recover some of the revenues that are believed lost to the federal government, President Bush's fiscal 2008 budget proposed requiring financial institutions to track investors' cost bases in publicly traded stocks, bonds and mutual funds. Representative Charles Rangel introduced a similar measure in late 2007. The Rangel proposal would create mandatory cost basis reporting by brokers for transactions involving publicly traded securities. Covered securities are generally stock, debt, commodities, derivatives, and other items as specified by the Secretary of the Treasury, which are acquired in the account or transferred to the account managed by the brokers.

The Rangel proposal would require the broker to report whether any gain or loss is long-term or short-term and extends to February 15, from the present-law January 31, the deadline for furnishing certain information statements to customers including statements showing gross proceeds. Representative Rangel's proposal would apply to stock acquired after January 1, 2009 and after January 1, 2011 for all other instruments.

Ordinary Income and Long-Term Capital Gains



One very controversial issue is whether the "Bush tax cuts" will be extended or allowed to expire. With respect to the highest ordinary income rate, generally the Democrats will advocate that the Bush tax cuts be allowed to expire, whereas Senator McCain would advocate that they be extended, if not enacted permanently. With respect to the long-term capital gain rate, generally the Democrats are in favor of allowing the 15 percent rate to expire, and raising the long-term capital gain rate substantially.

Planning Point

It is possible that with a change in political control resulting from the 2008 election, the year 2008 may be the last year for the 15 percent tax rate on long-term capital gains and qualifying dividends. Congress could eliminate the reduced rates for 2009 thereafter. S corporation shareholders owning an S corporation with accumulated "earnings and profits" (generally, "C" Corporation earnings which accumulated prior to making an S Corporation election) may want to consider making a dividend distribution in 2008 that would result in fully distributing the corporation's "earnings and profits." The result would be a qualifying dividend taxable at 15 percent and the elimination of the tax on excess passive investment income. This does not apply to corporations which had elected S Corporation status from their inception — these S Corporations generally do not contain "earnings and profits."

Estate Tax Revision

We are fast approaching the year 2010 and the scheduled one year elimination of the estate tax for that year. However, beginning in 2011, the estate tax is schedule to be reinstated with the exemption dropping down to the pre-tax cuts original amount of $1,000,000. No one thinks the estate tax will actually be repealed for the one year nor is it thought that the exemption will go back to only the $1 million level in the following year. Clearly something needs to be done and probably will be done—most likely in 2009. The political climate will not support elimination of the estate tax altogether. Best guess on this is the continuation of the 2009 exemption of $3.5 million, with perhaps a transition up to $5 million over a number of years. Also, the prevailing thinking that the there will be a retention of the step-up in basis at death, but Republicans and Democrats will likely fight over the rate of tax on a taxable estate.

With respect to other aspects of the estate tax, look for a constructive change—a portable exemption that could transfer to the surviving spouse, if the property of the spouse who dies first goes to the surviving spouse. For tax professionals this may result in a reduction in the complexity associated with the drafting and interpreting credit shelter trusts for many taxpayers.

INCREASED RISK OF IRS AUDIT

Based on what we have been seeing these days, the "kinder and gentler" IRS of years back has disappeared and in its place is an IRS that is more interested than ever in narrowing the "tax gap," the difference between what the IRS thinks it should be collecting from income that is actually received and reportable by taxpayers and the amount of income, deductions and tax actually reported. In 2008, high income taxpayers face a significantly increased chance of an IRS audit.

IRS audits of individual income tax returns reached a ten year high in 2007 and the IRS has indicated that it plans to increase the number of audits in 2008. The most recent data that we have from 2006 indicates the following:

Taxpayers with Income of	Increased Audit Percentage Over the Prior Year
$100,000	14%
$200,000	29%
$1,000,000	84%

The IRS audited 1,384,563 individual income tax returns in 2007. While this is only 1% of all returns filed in that year, it is a 7% increase over 2006 and as the chart below indicates, these audits focused on the highest income group.

Individual Income 2007	2007 Returns Audited	2006 Returns Audited
$100,000	293,188	257,851
$200,000	113,105	87,558
$1,000,000	32,382	17,015

The IRS has indicated that the group with the highest tax-noncompliance is self-employed workers filing Schedule C's, but S corporation shareholders, partners and limited liability company members are not far behind. As a result the IRS has increased audits of S Corporations and partnerships. Although there are many vulnerable areas on these returns, it is extremely important that the amounts what the individual is reporting on his or her Form 1040 tax return match the amounts reported to the IRS on Form K-1.

In this environment, taxpayers should consider reducing their exposure to an IRS audit by considering the following steps:

1. ***Report all information that was separately reported to the IRS.***

   Banks, brokers, pension plans and a host of other organizations report information to both the taxpayer and the IRS on forms such as 1099B, 1099MISC, 1099INT, 1099DIV and 1099R. Many times these forms are amended or changed by the company. If you do not report these amounts exactly on your tax return, your chance of audit is extremely high.

2. ***Do not invest in tax shelters.***

   The IRS has increased its efforts to weed out promoters and participants of tax shelters or abusive transactions.

3. ***Self-employed individuals must be able to substantiate both their income and expenses.***

   This group is under increased scrutiny and it is imperative that a taxpayer has all records to prove auto, travel and entertainment expenses. In most instances, it is not enough to only have an invoice or receipt, you must be able to demonstrate business purpose. The IRS will also look at bank accounts and other records to make sure all income is reported on the tax returns.

HEALTH SAVINGS ACCOUNTS

A Health Savings Account (HSA) may be particularly attractive to the owner of a small or medium size business that finds the cost of employee health insurance is becoming unaffordable or for an individual who has a hard time finding affordable health insurance coverage. Once an individual has coverage under a qualified High Deductible Health Plan, (HDHP) he or she can contribute to a HSA and the funds will accumulate tax-free. The individual can withdraw funds from the account, without paying any taxes, to apply toward the deductible or to use for other qualified medical care. If an individual chooses to pay deductible costs or other medical care from out-of-pocket funds, he or she can leave the money in the HSA account to accumulate for future use on a tax advantaged basis. For 2008, the maximum annual HSA contribution for an eligible individual with self-only coverage is $2,900. For family coverage the maximum HSA contribution is $5,800. Under recent legislation, these amounts are the maximum HSA contribution amount regardless of the amount of the HDHP deductible.

If you would like to know more about this attractive opportunity, please speak with your T. M. Byxbee Company principal.

Byxbee Company is happy to introduce you to three new employees who have recently joined our team:

Karen Davis

Karen Davis joined us in October 2007 as an addition to our tax department. She is an Enrolled Agent, eligible to practice before the IRS, and has over a decade of experience in tax planning and compliance. Karen originally hails from California and has earned a Ph.D. from the University of California system. Karen also earned an MBA from Quinnipiac University in 2005. Karen brings an inquisitive and intellectual approach to her work which serves us well on research projects and staff-training functions. Karen resides in Wallingford.

Mike Guidone

Mike Guidone came to Byxbee in August 2007 with seven years of public accounting experience. He is a CPA with a well rounded background ranging from financial statement engagements—audits, reviews and compilations—to tax preparation for businesses and individuals. Mike's experience also runs across a broad range of businesses and industries including not-for-profit organizations. He received his BS in accounting from Quinnipiac University in 2000 and never looked back. Mike resides in Hamden.

Jeff Jermine

Jeff Jermine joined the Byxbee Company as an intern in January 2005 and became a full time staff accountant in May 2007, while he was finishing his undergraduate studies. Jeff completed his BS in accounting at Quinnipiac University in May 2008. With a full tax season under his belt, Jeff has been taking on more responsibility and is an integral part of our audit and accounting team. He has been working on a wide variety of financial statement and tax engagements, where he is earning his stripes. By the way, don't let Jeff's calm, quiet and easy going manner fool you — when he is back in the office his loud, boisterous and aggressive alter ego takes over. Jeff resides in North Haven, when he is not otherwise occupied by Byxbee.

The reader may obtain more information about the material in the newsletter by contacting any of the following principals of the firm:

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