



Winter 2007

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TAX DEVELOPMENTS

Tax Credit for Residential Energy Items

Effective with the 2006 Form 1040, there is a new tax credit for energy-saving items installed in your principal residence. As we approach the first application of this credit, it is important to understand which items qualify and the recordkeeping that is required.

The Basics

The residential energy credit has a \$500 lifetime maximum and only applies to energy-saving items installed in your principal residence. As a tax credit, the \$500 amount is a direct offset to federal tax, and it will also offset the dreaded Alternative Minimum Tax or AMT. There is no high income phase-out, so all taxpayers have access to this credit. The credit has two components to its calculation: "building envelope" items receive a credit equal to 10% of their cost, while a second element provides a flat credit for specified items.

The 10% Building Envelope Credit

The first component is calculated as 10% of the cost of "building envelope" items. These include an insulation material or system, including a vapor retarder or seal, exterior windows, skylights or doors, storm windows, a storm door, or a metal roof that has pigmented coatings designed to reduce the heat gain of the dwelling. However, in calculating the credit for windows, only \$2,000 of cost (i.e., \$200 of the \$500 lifetime credit) can relate to window improvements. For the 10% credit component, only the cost of materials (not labor or installation) can be considered.

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Fixed Credit Items

The second component of the \$500 lifetime energy credit relates to specific expenditures for which a stated credit is allowed, assuming the homeowner spends at least that amount on the improvement:

- A \$300 credit for various heat pumps, central air conditioners, natural gas, propane or oil water heaters,
- A \$150 credit for natural gas, propane, or oil furnaces or hot water boilers, and
- A \$50 credit for an advanced main air circulating fan used in a natural gas, propane, or oil furnace.

Energy Certification

In all cases, the residential energy item must meet a qualified energy efficiency standard. With respect to exterior windows or skylights bearing the Energy Star label, no further evidence is required. However, for all other items, a manufacturer's certification that the component is eligible for the \$500 maximum credit is required. That manufacturer's certification can be included with the product's packaging, or it can be made available in printable form on the manufacturer's website.

It seems that most manufacturers are addressing this responsibility by providing the energy credit certification on their website. Thus, it becomes necessary to locate the specific model number or other appropriate identifier of your energy improvement item, and then link that to the detail on the manufacturer's website to determine if the item has been certified as available for the energy credit.

The manufacturer's certification is not required to be attached to your tax return. Rather, it should be retained with your tax records in the event of later IRS examination. We expect that many of our clients have acquired items, such as residential doors, windows, or perhaps replacement furnaces or air conditioners, and it would be important now to begin getting your paperwork in order for the 2006 tax credit.

In addition, there is a separate new credit that also becomes available in 2006 for home energy expenditures. However, it is only applicable to more costly and technical expenditures. It is calculated as 30% of the cost of:

- Qualified solar electric property (using solar energy to generate electricity), subject to a credit cap of \$2,000 per year,
- Qualified solar water heating property (again subject to a \$2,000 credit cap per year), and

- Qualified fuel cell property (subject to a \$500 credit for each half kilowatt of electricity-generating capacity).

If any of these credits are a possibility, please contact us, and we can assist with determining eligibility.

Other Key Tax Changes

A brief reminder of several other important changes that have recently been added to the tax law:

IRA-to-Charity Transfers

As we summarized in an earlier newsletter, the tax law now allows those over age 70½ to make a direct transfer from their Individual Retirement Accounts (IRAs) to charity without reporting any taxable income on the IRA withdrawal. Further, these withdrawals count toward the required minimum distribution that those over age 70½ must take from their retirement accounts. There are a number of tax advantages that can accrue to an individual by bypassing the 1040 through a direct charitable contribution from an IRA. This law change took effect in 2006 and remains available through 2007.

Telephone Excise Tax Refunds

Most 2006 tax returns, whether filed by an individual or business, will receive a one-time refund of federal excise tax related to long distance telephone charges. During 2006, the IRS conceded that a federal excise tax levied on interstate long-distance charges was invalid, and taxpayers were owed refunds for prior years. Carriers were instructed to no longer levy this excise tax as of August 1, 2006. But refunds are allowed by the IRS for the period from March 1, 2003, through July 31, 2006.

For most individual taxpayers, safe harbor amounts announced by the IRS will be the only practical way to address these refunds. The safe harbor amounts range from \$30 to \$60, based on family size, and no special calculations are needed to secure the rebate. It will simply be claimed within the 2006 Form 1040.

Business entities, on the other hand, will generally claim their refund based on a formula approach recently announced by the IRS. Businesses are to compare their April telephone excise tax ratio, a period when the full 3% excise tax levy was incurred, to their September telephone excise tax, a period when the levy no longer applied. The decrease in the ratio of excise tax from April to September is applied to all telephone costs during the 41-month refund period to establish the amount of refund. However, limits apply to the refund ratio, based on the size of the business (based on whether the business has under or over 250 employees).

If your Form 1040 reports a business activity with over \$25,000 of gross receipts, or if you have a business entity such as a corporation or partnership that incurs telephone charges, we will want to consider this business formula for calculation of a federal excise tax refund within the 2006 tax return. For fiscal entities, the refund claim is placed in the tax year that includes December 31, 2006.

Cash Contributions

Beginning with the 2007 Form 1040, an individual must have either a canceled check, credit card charge or a receipt from the charity to support a cash contribution. Estimates and notations are no longer sufficient to support deductibility of cash contributions. To obtain tax deductibility, individuals should use checks or credit cards for donations; donations using greenbacks are no longer allowable unless the taxpayer obtains a receipt from the charity.

2007 Mileage Rates

The business mileage rate for 2007 has increased to 48.5 cents per mile, up from 44.5 cents in 2006. The allowance for mileage for medical or moving expenses has increased to 20 cents per mile (formerly 18 cents), whereas the rate for charitable driving remains at 14 cents per mile.

BUSINESS DEVELOPMENTS

Reconsidering the Retirement Plan

Most businesses today offer employees some form of qualified retirement plan. The most common version is the elective deferral plan, in which each eligible employee has the ability to carve off in a pre-tax manner some portion of compensation for investment into a retirement plan. But the rules regarding these 401(k) or other salary-reduction plans are constantly changing, and this year is no exception. Business owners who offer these retirement plans will want to consider the following developments:

New Vesting Rules

Vesting refers to the rules under which an employee has full or partial rights to the plan account if they depart from employment. Previously, the vesting rules differed between employer funding accomplished as a match to employee contributions versus employer funding done as a general contribution. Matching funding has been required to vest under one of two schedules (either 100% after three years of participation or on a graded schedule ranging from year two through year six). On the other hand, employer general funding vested slower, either at 100% after five years or on a graded schedule running from the third to the seventh year of participation.

But for retirement plan years beginning after 2006, all employer funding, whether matching or general funding, must use one of the more rapid schedules that applied previously to matching funds only.

This should cause a reconsideration of the vesting designation in the business retirement plan. Essentially, there are now only two choices: 100% vesting after three years of participation or 20% per year graded vesting ranging from the second to sixth years. Some businesses that previously used the cliff approach of 100% vesting after five years may be better served by converting to the graded schedule.

Roth 401(k) Feature

Another plan amendment, in this case optional, that can be made to a salary-reduction 401(k) plan is to add a Roth feature. If an employer amends the 401(k) plan to allow Roth contributions, each participant has the flexibility of electing either tax-deductible salary reductions as in the past or alternatively treating the salary-reduction funding as a non-deductible Roth account. The attraction of the Roth account is that those non-deductible investments not only build in a tax-free manner but remain tax-free when withdrawn during retirement years.

Unlike Roth IRA funding, there are no restrictions preventing upper income filers from funding a Roth 401(k). And the dollar amounts are based on the full 401(k) maximum (\$15,500 for any participant in the 401(k) plan and a \$20,500 limit for those who have attained age 50 by year-end for the year 2007).

In the recent Pension Act, Congress made this Roth feature a permanent part of the tax law.

Any amounts that an employee designates as Roth funding must be maintained separately in the plan records, so that at retirement the employee's pre-tax traditional funds and post-tax Roth funds are separately identifiable. Any employer matching on a Roth 401(k) contribution continues to be treated as a pre-tax contribution.

While there is somewhat more administration with the Roth option added to a 401(k) plan, the evidence suggests an increasing number of employers are adopting this feature. The primary interest in using the Roth choice seems to be coming from younger workers in lower tax brackets. These employees are not as incented by the tax deductibility of a traditional 401(k) and also have a longer period of time for the compounding of a Roth account to produce greater tax-free amounts. If you wish to explore the Roth feature for your business, we can provide further information.

401(k) Automatic Enrollment

Most 401(k) plans, as elective deferral arrangements, allow employees to sign up and decide how much, if any, of their compensation they wish to salary-reduce as their investment into the retirement plan. But of course many employees never quite get around to starting those

salary deferrals, sometimes due to uncertainty about the investment decision or how much they can afford to save, or perhaps the obstacle of the enrollment paperwork.

To overcome these obstacles, Congress is providing an incentive to employers to adopt the “automatic enrollment” approach to employee participation. The 401(k) plan is amended to provide that each new participant automatically has a specified percentage of compensation set aside into the retirement plan, with the funds invested in a diversified mix of funds. The employee has the opportunity to electively decline participation or adjust the funding percentage, but the objective is to automatically get the ball rolling and overcome the investment inertia.

To encourage this, employers who adopt an automatic enrollment feature will be relieved of the various discriminatory tests (ADP and ACP testing), and are also not subject to the top-heavy contribution rules. To receive these advantages, however, the automatic enrollment feature must meet specified minimums (3% of participant compensation during the first year, 4% during the second, 5% during the third, and finally 6% of compensation during all subsequent years).

In addition, there is an employer match requirement, which must be at least 100% of the first 1% of employee deferrals, plus 50% of remaining employee elective deferrals from 1% to 6% of an individual’s compensation. Alternatively, an employer can do an across-the-board 3%-of-compensation contribution, which must cover all employees, even those declining to continue elective deferrals. Vesting is shortened from the normal 100% at three years to a 100% at two year rule for employer contributions. Finally, each participant must be given a written notice at the beginning of each plan year, informing them of their rights to decline the automatic elective feature.

For employers interested in this approach, implementation becomes available for tax years beginning after 2007.

New Research Credit Opportunity

For many years, businesses that incur research and development expenditures (R&D) have been able to claim a tax credit if their research expenses exceeded certain thresholds. The basic research credit is calculated at a lucrative 20% rate. But it only applies to the extent the business R&D for the current year exceeds a base amount computed by reference to that company’s R&D expenditures in the mid-1980s.

In lieu of that complicated computation, businesses have been allowed to elect an alternative research credit that used a 3-tiered comparison of current R&D in excess of a percentage of gross receipts. As R&D expenditures for the current year exceeded a tiered computation of 1% to 1.5% to 2% of gross receipts, a more modest research credit ranging from 2.65% to 3.75% was allowed.

New Law in 2007

Effective as of January 1, 2007, the alternative research credit has been enhanced. The three credit rates that formerly ranged from 2.65% to 3.75% have been increased to 3%, 4%, and 5%, respectively. Thus, as current R&D exceeds 1% of gross receipts, a 3% credit applies, as R&D moves above 1.5% of gross receipts, the 4% rate applies, and finally the 5% rate applies to the portion of current R&D expenses over 2% of gross receipts.

More importantly, a new alternative simplified credit has been added to the law for 2007. This new choice provides a 12% credit rate for R&D that exceeds 50% of the average R&D of the taxpayer for the three preceding tax years. If the business has no qualified R&D in any of those preceding years, the alternative simplified credit rate is 6% of the R&D for the current year.

For fiscal year taxpayers, the tax law allows a transition where the old lower alternative rate may be used until December 31, 2006, with the business then switching to the more generous 6% or 12% simplified credit computation for the months after 2006.

If any of your labor or contractual expenditures relate to research and experimentation, please contact us, as it may be possible to claim a tax credit for these expenditures.