

TAX RELIEF AND HEALTH CARE ACT OF 2006



a Wolters Kluwer business

December 10, 2006

Special Report

Highlights

- ✓ \$45.1 Billion Tax Relief Over 10 Years
- ✓ \$26.5 Billion Front Loaded Into 2 Years
- ✓ Over 70 Major Provisions
- ✓ Over 200 IRC Changes
- ✓ Last-Minute Energy/HSA Additions
- ✓ 130-Page Joint Committee Explanation
- ✓ Extensive "Miscellaneous" Act Sections

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Congress Approves Tax Extenders and Much More; \$45.1 Billion in Tax Breaks for Individuals and Businesses

With barely three weeks remaining to the 2006 tax year, Congress has passed a much-anticipated "extenders package." The new law retroactively restores some popular expired tax cuts to the beginning of 2006. There's much more, however. The new law also enhances some important tax incentives, bolsters Health Savings Accounts, revises deadlines for certain excise taxes, extends some expiring energy credits, makes critical "technical corrections" to existing tax laws, and includes an impressive list of "miscellaneous" tax relief.

The "Tax Relief and Health Care Act of 2006" (H.R. 6111) was approved by the House late on December 8 by a vote of 367 to 45 and several hours later on December 9 by the Senate by a 79-9 margin. President Bush is expected to sign the bill into law.

The popular extenders had been moved from one bill to another during 2006 until passed at the last possible moment by a lame-duck Congress as part of a larger health and trade bill. In addition to its \$45.1 billion in tax benefits, the new law brings with it special problems ... and opportunities ... for year-end tax planning and the upcoming 2007 tax season.

Impact *The Tax Relief and Health Care Act of 2006 adds over 200 changes to a revised Tax Code with which taxpayers and practitioners can barely keep up. The new law represents the last tax*

bill of the 109th Congress, which over the past two years has enacted major and significant tax legislation, including the Energy Tax Incentives Act of 2005, the Katrina Emergency Tax Relief Act of 2005, the Gulf Opportunity Zone Act of 2005, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, the Tax Increase Prevention and Reconciliation Act of 2005 (passed in 2006) and the Pension Protection Act of 2006.

EXTENDED/ENHANCED TAX BREAKS

The extenders portion of the new law was a "must-pass" for Congress. A simple extenders package likely would have been enacted sooner had it not been attached to more controversial pieces of legislation, such as a bill to reduce the federal estate tax. Senator Max Baucus, D-Montana, who is expected to become chairman of the powerful tax-writing Senate Finance Committee in the new 110th Congress commented, "Next year, we need to tackle expiring tax cuts earlier, so Americans won't have to wonder whether Congress will come through."

Impact *Time remains for many taxpayers to change the outcome of 2006 tax year returns by employing year-end strategies that maximize the benefits of each*

“extender.” The new law also allows fiscal-year taxpayers with tax years ending in 2006 to change elections made on already filed returns to take into account the extension of provisions that expired at the end of 2005.

Deduction for State and Local Sales Taxes

The *American Jobs Creation Act of 2004* allowed taxpayers to deduct either state and local income taxes or state and local general sales taxes as an itemized deduction. This deduction expired on December 31, 2005. However, the popularity of the deduction, especially among residents of states without an income tax, did not go unnoticed on Capitol Hill. Thus, the new law extends it through 2007.

Reminder Taxpayers can calculate their deduction either by saving receipts or using the Optional State Sales Tax Tables in IRS Publication 600. An IRS spokesperson told *CCH* that it plans to rush publication of the 2006 State Sales Tax Tables (Pub. 600).

Planning tip. *CCH has a special state and local sales calculator on its Tax Research Network that can compute allowable deductions by zip code. The 2006 CCH Federal Sales Tax Deduction Toolkit will be ready for use immediately after the IRS publishes its 2006 tables.*

Comment A taxpayer may alternate from year to year between a sales tax and a state income tax deduction. Similarly, in taking the sales tax deductions, alternating from year to year between using the IRS sales tax tables and the actual expense method is permitted.

Impact *Since Congress extended the optional sales tax deduction for 2006 and 2007, loading big-ticket sales tax purchases into 2006 may make sense for those*

taxpayers able to take advantage of the optional sales tax deduction. Those taxpayers could also defer any state income tax payments into 2007.

Higher Education Tuition Deduction

The new law extends the popular above-the-line higher education tuition deduction through 2007.

“In addition to its \$45.1 billion dollars in tax benefits, the new law brings with it special problems ...and opportunities.”

2006/2007 figures. For 2006, and again in 2007, a \$4,000 above-the-line education deduction is available each year to single taxpayers with adjusted gross incomes (AGI) of \$65,000 or less (\$130,000 for joint filers). A \$2,000 above-the-line education deduction is available to single taxpayers with adjusted gross incomes up to \$80,000 (\$160,000 for joint filers). These are the same levels set for the deduction in 2004 and 2005.

Caution *Only higher education tuition and qualifying fees are eligible for the deduction. Taxpayers cannot deduct tuition and fees paid for elementary and secondary education.*

Impact *Taxpayers taking the above-the-line higher education tuition deduction cannot also claim the HOPE or Lifetime Learning credits for the same student. In 2006, the maximum Hope credit is \$1,600 per student. The maximum lifetime learning credit is \$2,000 per return. The education deduction has a higher phase-out range (as indicated above) than the credits, however, making it the only*

education tax break available for many middle-class taxpayers. For 2006, the phase out of the education credits ranges from \$45,000 to \$55,000 AGI for single status filers and \$90,000 to \$110,000 for joint returns filers.

Comment The HOPE and Lifetime Learning credits were temporarily expanded in 2005 and 2006 for students enrolled in and paying tuition to an eligible education institution located in the Gulf Opportunity Zone. No similar enhancement has been made for the education deduction.

Impact *Taxpayers may want to estimate AGI for 2006 and, if it is within the cut off for taking the deduction, pay spring tuition in December. Generally, an education deduction or credit will be allowed for expenses paid in 2006 for enrollment during 2006 or for an academic period beginning in 2006 or in the first three months of 2007. Deferring income into 2007 to make the AGI cut-off level for a 2006 education deduction could also make sense.*

Teacher's Classroom Expense Deduction

Teachers and other education workers can deduct, above the line, up to \$250 of certain out-of-pocket classroom expenses. This deduction recognizes that many education professionals purchase classroom supplies with their own money. This popular deduction, which in 2005 was claimed by more than 3,000,000 taxpayers, expired at the end of 2005. The new law extends it through 2007.

Who is eligible? Instructors, counselors, principals, and classroom aides, as well as teachers, who work at least 900 hours during the school year are eligible to take the deduction. Qualifying taxpayers, however, must

work in a kindergarten, elementary or secondary school through Grade 12.

Impact *Qualification under the 900-hour test is measured within the academic year while the \$250 deduction is measured in terms of expenses paid for during the calendar year. Teachers who have not reached the \$250 level for 2006, either because they have not made purchases or they have not kept receipts, should make sufficient purchases now since any unused portion of the deduction cannot be carried over into 2007. Year-end purchases made while school is out for the holidays will qualify for the deduction, even if they are not used in the classroom until 2007.*

Qualifying expenditures. Classroom supplies, such as paper and pens, glue, and scissors qualify, as do purchases of books and computer equipment, including software. For courses in health and physical education, the supplies must relate to athletics.

Comment Expenses exceeding \$250 and non-classroom supplies may be deducted as an employment-related miscellaneous itemized deduction subject to the two-percent floor by eligible taxpayers who itemize.

Research Tax Credit

The new law extends the research tax credit to amounts paid or incurred in 2006 and 2007. For 2007, the new law also makes two enhancements that could make the credit more valuable for many businesses.

Impact *The research credit provisions are, by far, the largest of the big-ticket items in the entire new law, weighing in at a cost of \$16.5 billion over 10 years. Many businesses, however, remain dissatisfied over the temporary status*

of the credit because of the long-term planning research requires. Businesses likely will continue to press the next Congress to make the credit permanent.

The research credit is generally equal to 20 percent of the taxpayer's "qualified research expenses" that exceed a base amount. However, a taxpayer may elect to take the alternative incremental credit (AIC). The AIC uses a "stated percentage" of qualified expenses that exceed the taxpayer's average research expenditures over four years.

Increase in stated percentage. The new law increases the "stated percentage" beginning in 2007. The amounts are:

- 2.65 percent (increasing to 3 percent in 2007) of qualified research expenses between 1 and 1.5 of average annual gross receipts;
- 3.2 percent (increasing to 4 percent in 2007) of qualified expenses between 1.5 and 2 percent of average annual gross receipts; and
- 3.75 percent (increasing to 5 percent in 2007) of qualified expenses exceeding 2 percent.

Taxpayers on a fiscal year will take into account the percentage that applies to each calendar year.

Alternative Simplified Credit. The new law also creates an Alternative Simplified Credit for 2007. Under the simplified method, the credit is 12 percent of the qualified research expenses that exceed 50 percent of the average qualified research expenses for the 3

preceding tax years. If the taxpayer has no qualified expenses in any one of the preceding three years, the credit is 6 percent of the current qualified research expenses.

Caution *Taxpayers need to be aware that the IRS is watching for abuses of the credit. The agency has instructed its examiners not to rely on prepackaged submissions to substantiate the credit. The IRS has found that prepackaged submissions, while voluminous and well-organized, usually lack information relevant to the audit. Examiners have also been instructed to request research credit computation work papers.*

Work Opportunity and Welfare-to-Work Tax Credits

Congress created the Work Opportunity and Welfare-to-Work tax credits to give employers tax incentives to hire economically disadvantaged individuals. The new law retroactively renews the two popular credits for 2006 and for 2007, combines them, with enhancement, into one credit.

Impact *The combination of the two credits into one is expected to simplify the computation of the credit and, therefore, enhance its use, especially by small businesses. The consolidation is effective in connection with individuals who begin work for*

Forms Alert

The extenders provisions were passed after the IRS's deadline for printing 2006 tax year materials. An IRS spokesperson told CCH that the agency will issue a special publication on all of the extenders shortly. It also plans, in its own words, "a media blitz," to alert taxpayers that the extenders are back and should not be overlooked in preparing 2006 tax returns. Despite these plans, practitioners expect significant confusion, both by the general public and by return preparers, on exactly what to compute what line.

the employer after December 31, 2006, and before January 1, 2008, unless extended.

Targeted groups. The credits continue to target specific groups of economically challenged individuals. In connection with qualifying groups, the new law repeals the requirement that an ex-felon be from an economically disadvantaged family and raises the age ceiling for food stamp recipients from age 25 to 40. Employers also are given additional time to file certification paperwork with the government.

Comment The *Katrina Emergency Tax Relief Act of 2005 (KETRA)* added certain Hurricane Katrina victims as a targeted group for the Work Opportunity credit.

Amount of credit. The new law does not tinker with the total amount of the credit (although it makes the computation easier by coordinating the definition of “qualifying worker”). For most targeted groups, the credit is 40 percent of qualified first year wages (25 percent if employment is more than 120 but less than 400 hours). Qualified first-year wages cannot exceed \$6,000. Separate computations apply for recipients of long-term family assistance and summer youth employees.

Reminder The employer’s salary and wage deduction is reduced by the amount of the combined credit.

Leasehold and Restaurant Improvements

The new law extends the 15-year recovery period for certain leasehold and restaurant improvements through 2007. Generally, qualified leasehold improvement property is any improvement to an interior portion of a nonresidential building. Some items, such as elevators and escalators, are expressly excluded. Certain improvements to restaurants also qualify for the tax break.

Comment In the case of a restaurant, more than 50 percent of the

building’s square footage must be devoted to the preparation of, and seating for on-premises consumption of, prepared meals and the improvements must be made to a building that has been in service for at least three years.

Brownfields Remediation Costs

In 1997, Congress gave taxpayers a special incentive to promote the cleanup of brownfields (areas that are contaminated by industrial waste and toxins). Taxpayers can elect to deduct, rather than capitalize, some environmental remediation costs. This special treatment has been extended through 2007 and was expanded to cover the clean up of certain petroleum products for payments made during 2006 and 2007.

Comment The *Katrina Emergency Tax Relief Act (KETRA)* also permits taxpayers to elect to expense some environmental remediation costs, including the cost of cleaning up petroleum products, incurred in the Gulf Opportunity Zone through December 31, 2007.

Qualified Zone Academy Bonds

Congress has authorized state and local governments to issue special tax-exempt bonds, known as qualified zone academy bonds, to fund educational improvements. The new law renews the authority of state and local governments to issue these bonds for 2006 and 2007 and provides special new rules as to required expenditures, arbitrage and reporting requirements.

Corporate Donations of Computer and Scientific Equipment

The new law extends and enhances through 2007 the deduction for corporate donations of scientific property used for research, computer equipment, and technology to schools and public libraries. For contributions made after 2005, the provision expands the deduction to allow equipment “as-

sembled by” the donor to qualify for the deduction.

New Markets Tax Credit

Under the New Markets Tax Credit program, investors receive a credit against federal income taxes for making qualified equity investments in economically distressed communities. The new law extends the credit through the end of 2008 and requires that regulations be provided to ensure that non-metropolitan counties received a proportional allocation of qualified equity investments.

Earned Income Tax Credit for Combat Pay

Military personnel can elect to include tax-free combat pay in income for purposes of computing the earned income credit. This provision is available for tax years ending before January 1, 2008.

GO Zone Bonus Depreciation

The new law extends the placed-in-service deadline from December 31, 2007, to December 31, 2010, for taking the 50-percent bonus depreciation deduction for certain Gulf Opportunity (GO) Zone property.

Types of property. The extension applies to nonresidential real property and residential rental property. Only the adjusted basis of such property attributable to the manufacture, construction, or production before January 1, 2010, would qualify for bonus depreciation.

Personal property. The placed-in-service deadline is also extended for personal property used in a building within 90 days of the date the building is placed in service.

Qualified Veterans’ Mortgage Bonds

Qualified veterans’ mortgage bonds provide proceeds for mortgage loans to veterans. Five states are eligible to issue these bonds. The *Tax Increase Prevention and Reconciliation Act of 2006 (TIPRA)* revised eligibility requirements and changed the annual volume limits for bonds issued by Alaska, Oregon and Wisconsin. These changes have been made permanent.

HEALTH SAVINGS ACCOUNT ENHANCEMENTS

The new law enhances the use of health savings accounts (HSAs). Unlike the extenders, the HSA enhancements are permanent and most take effect for tax years beginning after 2006.

Impact *These provisions are contained in Title III, the Health Opportunity Patient Empowerment Act of 2006. This package, designed to improve the attractiveness of HSAs, will have a major impact on employer-sponsored health care decisions.*

FSA Rollovers

Employees with a health flexible spending account (FSA) or a health reimbursement account (HRA) will be allowed to make a one-time transfer of the balance in their FSA or HRA to an HSA. The maximum transfer amount is the lesser of the balance as of the date of transfer or September 21, 2006. The transfer must be made before January 1, 2012.

Impact *This provision applies to distributions made on or after the date of enactment.*

IRA rollovers

The new law allows employees a one-time, once-in-a-lifetime, rollover of funds from their IRAs into an HSA. The election to make the rollover is irrevocable. The change is designed to give employees quicker access to their funds for medical expenses. The provision applies to tax years beginning after December 31, 2006.

And more...

The new law also repeals the limits on deductible annual contributions, modifies cost of living adjustments, expands the contribution limit for part-year coverage, treats certain FSAs as disregarded coverage, and

favorably modifies the comparable contribution rules.

ENERGY EXTENDERS

The new law renews several temporary energy incentives. These were enacted as part of the *Energy Tax Incentives Act of 2005 (2005 Energy Act)*.

Impact *Noticeably absent from these energy extenders is an extension of the residential energy property credit, equal to \$500 overall and \$200 for thermal windows and doors. Like all the other energy provisions addressed by the new law, this provision does not expire until the end of 2007, as specified in the 2005 Energy Act. The alternative vehicle (hybrid) credit, which does not expire until 2010, also was not extended.*

Deduction for energy efficient commercial buildings

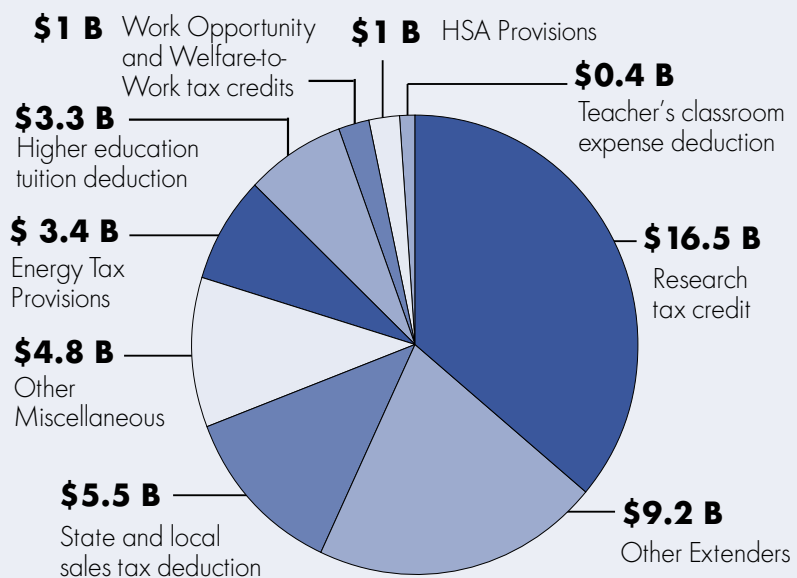
Qualifying taxpayers may deduct costs associated with energy-efficient commercial building property. The property had to be placed in service after December 31, 2005, and before January 1, 2008. The new law extends this deduction through 2008.

Business credit for energy efficient new homes

Eligible contractors may claim a tax credit for qualified new energy-efficient homes that they construct and that an individual acquires from the contractor in 2006 and 2007. The credit is generally \$2,000 for a new energy-efficient home and \$1,000 for a new energy-efficient manufactured home. The new law extends the credit through 2008.

\$45.1 Billion In Tax Relief

Although Congress frontloaded most of the tax relief in the new law into 2006 and 2007, the Joint Committee on Taxation under a standing Congressional mandate has "scored" the revenue cost of each provision over a 10-year period. Here are the results:



Credit for residential alternative energy expenditures

The *2005 Energy Act* provided a non-refundable personal tax credit of 30 percent of the cost of eligible solar water heaters, solar electricity equipment (photovoltaics), and fuel cell plants. The maximum credit is \$2,000 per tax year for each category of solar equipment and \$500 for each half kilowatt of capacity of fuel cell plants installed per tax year. The new law extends the credit through 2008.

Renewable electrical energy production credit

The *2005 Energy Act* expanded the types of qualified energy resources available for the renewable electrical energy production credit. Generally, electricity must be produced at a qualified facility, such as a wind energy facility. The new law extends the placed-in-service date for qualifying facilities for one year through 2008.

Clean renewable energy bonds

The *2005 Energy Act* authorized the issuance of up to \$800 billion in tax credit bonds, known as clean renewable energy bonds (CREBs), to finance production of electricity from clean renewable sources. Issuance of these bonds was limited to 2006 and 2007. The new law extends this authority through 2008.

Comment

The IRS recently allocated \$12 billion to more than 600 projects.

More energy incentives...

Other energy provisions impacted by the new law include:

- Modifying the advanced coal credit with respect to subbituminous coal;
- Extending the credit for business installation of qualified fuel cells, stationary microturbine power plants, and solar panels;
- Extending the reduced excise tax on methanol or ethanol fuel derived from coal;

- Providing a 25-percent exclusion for capital gains from sale of an interest in a mineral or geothermal deposit on certain federal land to tax-exempt entities; and
- Suspending the limit on percentage depletion for oil and gas produced from marginal wells for tax years beginning in 2006 and 2007.

MORE REGULAR EXTENDERS

Although addressing the high-profile expired provisions, Congress also took the opportunity to deal with other temporary provisions that either had expired or were about to expire. These provisions were initially made temporary either because Congress wanted to re-evaluate them after a test period or because the budget money was not available at the time to make them permanent.

The following additional temporary tax breaks continue without interruption through 2007:

- Availability of Archer Medical Savings Accounts (MSAs);
- Indian employment tax credit to assist economically-challenged Native Americans;
- Accelerated depreciation for certain business property on a Native American reservation;
- D.C. Enterprise Zone and first-time homebuyers tax breaks; and
- IRS' authority to impose an excise tax on a group health plan's failure to give parity to mental health benefits.

AND EVEN MORE TAX RELIEF...

The other tax provisions in the *Tax Relief and Health Care Act of 2006* are a gold mine of tax opportunities for a wide variety of taxpayers. Some of the more notable provisions include:

- A refundable credit worth up to 20 percent for the next five years, to certain taxpayers with long-term unused AMT credits who have AMT income from incentive stock options;

- An itemized mortgage insurance premium deduction available on qualified residences, with phase-out starting at \$100,000 AGI, for 2007 only;
- Giving the Tax Court jurisdiction over stand-alone nondeficiency equitable innocent spouse relief;
- Expansion of the Code Sec. 199 manufacturing deduction to U.S. businesses with manufacturing activities in Puerto Rico for 2006 and 2007;
- A 50-percent first-year expensing deduction permitted for qualified underground mine equipment that exceeds current safety requirements, for costs incurred after the date of enactment for equipment placed in service before December 31, 2008;
- A credit of up to \$10,000 for training mine rescue team members, effective for 2006 through 2008;
- Increased rewards available under the IRS whistleblower program and the creation of a whistleblower office within the IRS;
- Permanent modification to the definition of active business under Code Sec. 355;
- Permanent capital gains treatment for self-created musical works;
- Tolling the five-year period in the home sale exclusion rules for up to 10 years for employees in the intelligence community;
- Modification of the unrelated business income tax on charitable remainder trusts;
- Permanent special rule for loans to qualified continuing care facilities;
- Technical corrections to enable proper application of the look-through treatment of payments between related controlled foreign corporation under the foreign personal holding company rules; and
- Technical corrections to allow broader Treasury delegation of the authority to suspend interest where taxpayers involved in certain tax shelter activities have acted reasonably and in good faith.

IRS OPERATIONS

The new law extends the IRS' authority for undercover operations and the agency's enhanced information-sharing. Undercover operations may continue through 2007 and information sharing may continue through 2007.

Other IRS provisions include:

- Changing to the IRS' reward program for taxpayers who turn in tax cheats; and
- Boosting the penalty for frivolous returns and other submissions to \$5,000 from \$500.

Impact *The IRS has been urging Congress to curb frivolous filings. The new law gives the IRS an enhanced tool to sanction taxpayers who continuously raise bogus arguments.*

LOOKING AHEAD TO 2007

It's a whole new ballgame on Capitol Hill in January with Democrats in charge of both the House and the Senate for the first time in many years. Democrats are promising to change the direction of Congress in the "first 100 hours." They are also anticipating longer work weeks and shorter recesses.

Tax legislation is high on their agenda. Rep. Nancy Pelosi, D-Calif., the next Speaker of the House, and Sen. Harry Reid, D-Nevada, the next majority leader in the Senate, have promised to target tax relief to middle-income Americans. Although specifics are still being thrashed out, the Democratic leaders want to see movement on tax incentives for education and working families. They also are looking at scaling back some tax breaks

for big oil companies. Rep. Charles Rangel, D-N.Y., who is expected to become chair of the tax-writing House Ways and Means Committee, has indicated the Committee will tackle AMT reform. Senator Max Baucus, D-Montana, who will likely become chair of the powerful Senate Finance Committee, has also expressed his support for AMT relief.

Comment Many Democrats support "pay-as-you-go," which would require revenue increases to be offset by new spending cuts or tax increases. The Bush Administration has supported pay-as-you-go to the extent that revenue increases are paid for by spending cuts but not tax increases. An Administration official recently said that the White House will take a "wait and see" approach" if the 110th Congress embraces pays-as-you-go.

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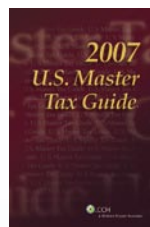
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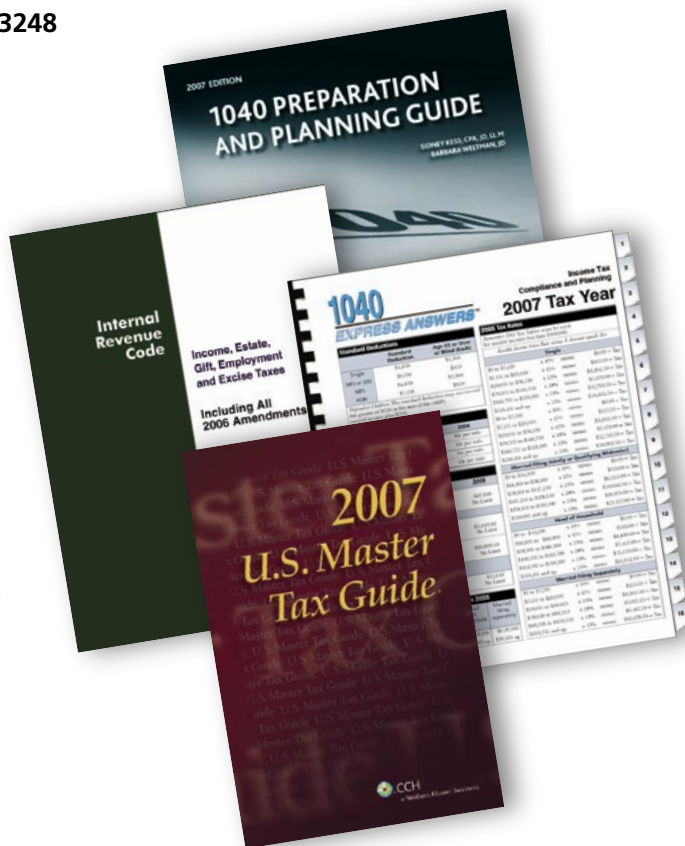


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