



## CLIENT ALERT BULLETIN

### 2006 Year End Tax Planning Ideas for Individuals

December 2006

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As 2006 draws to a close, there is still time to reduce your 2006 tax bill and plan ahead for 2007. This letter highlights several potential tax-saving opportunities for you to consider. We would be happy to meet with you to discuss specific strategies.

#### **Basic Numbers You Need To Know**

Because many tax benefits are tied to or limited by adjusted gross income (AGI)—IRA deductions, for example—a key aspect of tax planning is to estimate both your 2006 and 2007 AGI. Also, when considering whether to accelerate or defer income or deductions, you should be aware of the impact this action may have on your AGI and your ability to maximize itemized deductions that are tied to AGI. Your 2005 tax return and your 2006 pay stubs and other income- and deduction-related materials are a good starting point for estimating your AGI.

Another important number is your "tax bracket," i.e., the rate at which your last dollar of income is taxed. The tax rates for 2006 are 10%, 15%, 25%, 28%, 33%, and 35%. Although tax brackets are indexed for inflation, if your income increases faster than the inflation adjustment, you may be pushed into a higher bracket. If so, your potential benefit from any tax-saving opportunity is increased (as is the cost of overlooking that opportunity).

#### **IRA, Retirement Savings Rules for 2006**

More tax-saving opportunities continue for retirement planning in 2006 than in previous years due to the availability of Roth IRAs, changes that make regular IRAs more attractive, and other retirement savings incentives. As discussed herein, even more changes will begin in 2007.

*Traditional IRAs:* Individuals who are not active participants in an employer pension plan may make deductible contributions to an IRA. The annual deductible contribution limit for an IRA for 2006 is \$4,000. Individuals who are active participants in a plan may also make deductible contributions to an IRA, but limited in amount depending on their AGI. For 2006, the AGI phase-out range for deductibility of IRA contributions is between \$50,000 and \$60,000 of modified AGI for single persons (including heads of households), and between \$75,000 and \$85,000 of modified AGI for married filing jointly. Above these ranges, no deduction is allowed.

For 2006, a \$1,000 "catch-up" contribution deduction is allowed for taxpayers age 50 or older by the close of the taxable year who meet the other qualifications for IRA deductions. Thus, the total deductible limit for these individuals may be as high as \$5,000.

In addition, an individual will not be considered an "active participant" in an employer plan simply because the individual's spouse is an active participant for part of a plan year. Thus, you may be able to take the full deduction for an IRA contribution regardless of whether your spouse is covered by a

plan at work, subject to a phase-out if your joint modified AGI is \$150,000 to \$160,000. Above this range, no deduction is allowed.

*Roth IRA:* This type of IRA permits nondeductible contributions of up to \$4,000 a year. Earnings grow tax-free, and distributions are tax-free provided no distributions are made until more than five years after the first contribution and the individual has reached age 59 1/2. Distributions may be made earlier on account of the individual's disability or death. The maximum contribution is phased out for persons with AGI above certain amounts: \$150,000 to \$160,000 for joint filers, and \$95,000 to \$110,000 for single filers (including heads of households). For 2006, a \$1,000 "catch-up" contribution is allowed for taxpayers age 50 or older by the close of the taxable year, making the total limit \$5,000 for these individuals.

*Roth IRA Conversion Rule:* Funds in a traditional IRA may be rolled over into a Roth IRA. Such a rollover, however, is treated as a taxable event, and you will pay tax on the amount converted. No penalties will apply if all the requirements for such a transfer are satisfied.

A taxpayer's AGI (whether married filing jointly or single) is limited to \$100,000 to make such a conversion and the taxpayer must not be a married individual filing a separate return.

*401(k) Contribution:* The 401(k) elective deferral limit is \$15,000 for 2006, up from \$14,000 in 2005. If your 401(k) plan has been amended to allow for catch-up contributions for 2006 and you will be 50 years old by December 31, 2006, you may contribute an additional \$5,000 to your 401(k) account, for a total maximum contribution of \$20,000 (\$15,000 in regular contributions plus \$5,000 in catch-up contributions).

*SIMPLE Plan Contribution:* The SIMPLE plan deferral limit is \$10,000 for 2006, the same as in 2005. If your SIMPLE plan has been amended to allow for catch-up contributions for 2006 and you will be 50 years old by December 31, 2006, you may contribute an additional \$2,500.

*Catch-Up Contributions for Other Plans:* If you will be 50 years old by December 31, 2006, you may also contribute an additional \$5,000 to your 403(b) plan or SEP.

*Saver's Credit:* A nonrefundable tax credit is available based on the qualified retirement savings contributions to an employer plan made by an eligible individual. Only taxpayers filing joint returns with AGI of \$50,000 or less, head of household returns with AGI of \$37,500 or less, or single returns (or separate returns filed by married taxpayers) with AGI of \$25,000 or less, are eligible for the credit. The amount of the credit is equal to the applicable percentage (10% to 50% based on filing status and AGI) of qualified retirement savings contributions up to \$2,000.

*Maximize Retirement Savings:* In many cases, employers will require you to set your 2007 retirement contribution levels before January 2007. You may want to increase your contribution to lower your AGI in order to take advantage of some of the tax breaks described above. In addition, maximizing your contribution is generally a good tax-saving move.

*Hurricane Relief:* The 10% penalty on early distributions from qualified retirement plans does not apply to qualified hurricane distributions of up to \$100,000 from a qualified retirement plan, a §403(b) annuity, or an IRA. A qualified hurricane distribution covers distributions taken after Hurricanes Katrina, Rita and Wilma. A qualified Hurricane Katrina distribution is any distribution from an eligible retirement plan made on or after August 25, 2005, and before January 1, 2007, to an individual whose principal place of abode on August 28, 2005, is located in the Hurricane Katrina disaster area and who has sustained an economic loss by reason of Hurricane Katrina. A qualified Hurricane Rita distribution is any distribution from an eligible retirement plan made on or after September 23, 2005, and before

January 1, 2007, to an individual whose principal place of abode on September 23, 2005, is located in the Hurricane Rita disaster area and who has sustained an economic loss by reason of Hurricane Rita. A qualified Hurricane Wilma distribution is any distribution from an eligible retirement plan made on or after October 23, 2005, and before January 1, 2007, to an individual whose principal place of abode on October 23, 2005, is located in the Hurricane Wilma disaster area and who has sustained an economic loss by reason of Hurricane Wilma. Distributions from someone affected by multiple hurricanes cannot overlap. Withdrawals are ratably included in income over a three-year period, unless the taxpayer elects to include the amount in the current year. Withdrawals can be recontributed to a qualified plan during such three-year period to avoid the withdrawal being included in income. Any tax paid prior to the recontribution can be recovered through refund procedures.

*Pension Act Relief:* Effective for distributions made after 2006, nonspouse beneficiaries may roll over to an IRA or other plan structured for that purpose amounts inherited as a designated beneficiary. The inherited amounts are subject to the annual minimum distribution rules requiring distributions over the person's life expectancy (recalculated annually). Also, for taxable years beginning after 2006, the IRS must make available a form for a taxpayer to file with the IRS directing the IRS to send a refund directly to the taxpayer's IRA. In addition, indexing the adjusted gross income levels for the saver's credit (also made permanent) and IRAs will begin in taxable years after 2006. Effective for distributions made after September 11, 2001, a reservist (called up between September 11, 2001, and before December 31, 2007, for more than 179 days) is excepted from the 10% premature distribution tax for distributions before age 59 1/2 to a reservist, and allows the money to be repaid within two years after the end of active service. Effective for distributions made after August 17, 2006, public safety officers can avoid the early 10% distribution penalty for distributions based on separation from service if the officer is at least 50. Individuals who worked for a bankrupt employer whose officers were indicted and whose employer had at least a 50% match in the form of employer stock in its §401(k) plan can make an additional IRA catch-up contribution (three times the otherwise applicable catch-up amount). The contributions can be made for 2007, 2008, and 2009. For tax years beginning after 2006, after-tax contributions from qualified plans may be rolled over into defined benefit plans and §403(b) tax-sheltered annuities. Prior to the 2006 Pension Act, after-tax contributions only could be rolled over into defined contribution plans and IRAs.

### **Deferring Income to 2007**

If you expect your AGI to be higher in 2006 than in 2007, or if you anticipate being in the same or a higher tax bracket in 2006, you may benefit by deferring income into 2007. Deferring income will be advantageous so long as the deferral does not bump your income to the next bracket. Some ways to defer income include:

*Delay Billing:* If you are self-employed, delay year-end billing to clients so that payments will not be received until 2007.

*Interest and Dividends:* Interest income earned on Treasury securities and bank certificates of deposit with maturities of one year or less is not includible in income until received. To defer interest income, consider buying short-term bonds or certificates that will not mature until next year. If you have control as to when dividends are paid, arrange to have them paid to you after the end of the year.

### **Accelerating Income Into 2006**

In limited circumstances, you may benefit by accelerating income into 2006. For example, you may anticipate being in a higher tax bracket in 2007, or perhaps you will need additional income in order to take advantage of an offsetting deduction or credit that will not be available to you in future tax years. Note however that accelerating income into 2006 will be disadvantageous if you expect to be in

the same or lower tax bracket for 2007. In any event, before you decide to implement this strategy, we should "crunch the numbers."

If accelerating income will be beneficial, here are some ways to accomplish this:

*Accelerate Collection of Accounts Receivable:* If you are self-employed and report income and expenses on a cash basis, issue bills and attempt collection before the end of 2006. Also see if some of your clients or customers might be willing to pay for January 2007 goods or services in advance. Any income received using these steps will shift income from 2007 to 2006.

*Year-End Bonuses:* If your employer generally pays year-end bonuses after the end of the current year, ask to have your bonus paid to you before the beginning of 2007.

*Retirement Plan Distributions:* If you are over age 59 1/2 and you participate in an employer retirement plan or have an IRA, consider making any taxable withdrawals before 2007.

You may also want to consider making a Roth IRA rollover distribution, as discussed above.

Special rules for taxpayers affected by the late 2005 hurricanes have special distribution rules, even into 2006, discussed above.

### **Deduction Planning**

Deduction timing is also an important element of year-end tax planning. Deduction planning is complex, however, due to factors such as AGI levels and filing status. If you are a cash-method taxpayer, remember to keep the following in mind:

*Deduction In Year Paid:* An expense is only deductible in the year in which it is actually paid.

*Payment By Check:* Date checks before the end of the year and mail them before January 1, 2007.

*Promise To Pay:* A promise to pay or providing a note does not permit you to deduct the expense. But you can take a deduction if you pay with money borrowed from a third party. Hence, if you pay by credit card in 2006, you can take the deduction even though you won't pay your credit card bill until 2007.

*AGI Limits:* The AGI limits on itemized deductions affect deduction planning. Normally, overall itemized deductions are reduced by 3% of the AGI exceeding \$150,500 (\$75,250 if married filing separately). However, for 2006, the reduction is itself reduced to two-thirds of what it otherwise would be. Similarly, certain deductions may be claimed only if they exceed a percentage of AGI: 7.5% for medical expenses, 2% for miscellaneous itemized deductions, and 10% for casualty losses.

*Standard Deduction Planning:* Deduction planning is also affected by the standard deduction. For 2006 returns, the standard deduction is \$10,300 for married taxpayers filing jointly, \$5,150 for single taxpayers, \$7,550 for heads of households, and \$5,150 for married taxpayers filing separately. If your itemized deductions are relatively constant and are close to the standard deduction amount, you will obtain little or no benefit from itemizing your deductions each year. But simply taking the standard deduction each year means you lose the benefit of your itemized deductions. To maximize the benefits of both the standard deduction and itemized deductions, consider adjusting the timing of your deductible expenses so that they are higher in one year and lower in the following year.

*Medical Expenses:* Medical expenses, including amounts paid as health insurance premiums, are deductible only to the extent that they exceed 7.5% of AGI. Consider bunching medical expenses into years when your AGI is lower.

*State Taxes:* If you anticipate a state income tax liability for 2006 and plan to make an estimated payment, consider making the payment before the end of 2006.

*Charitable Contributions:* Consider making your charitable contributions at the end of the year. This will give you use of the money during the year and simultaneously permit you to claim a deduction for that year. You can use a credit card to charge donations in 2006 even though you will not pay the bill until 2007. A mere pledge to make a donation is not deductible, however, unless it is paid by the end of the year. Note, however, for claimed donations of cars, boats and airplanes of more than \$500, the amount available as a deduction will significantly depend on what the charity does with the donated property, not just the fair market value of the donated property. If the organization sells the property without any significant intervening use or material improvement to the property, the amount of the charitable contribution deduction cannot exceed the gross proceeds received from the sale.

To avoid capital gains, you may want to consider giving appreciated property to charity.

*Hurricane Relief:* Individual taxpayers may claim a \$500 deduction against taxable income for each "Hurricane Katrina displaced individual" that the taxpayer houses for free in the taxpayer's principal residence for a period of at least 60 days that ends in the taxable year. The deduction is available in 2006. The aggregate total (including any amount claimed in 2005) cannot exceed \$2,000.

*Pension Act Relief:* Individuals can exclude from gross income qualified charitable distributions of up to \$100,000 from a traditional individual retirement account (IRA) or a Roth IRA, made to a tax-exempt organization to which deductible contributions can be made. A qualified charitable distribution is any distribution from an IRA that is made in a taxable year beginning after December 31, 2005, and before January 1, 2008, directly by the IRA trustee to an organization described in §170(c). Direct distributions are eligible for the exclusion only if made on or after the date the IRA owner attains age 70 1/2. A distribution is treated as a qualified charitable distribution only to the extent that the distribution is includible in gross income. The exclusion does not apply to direct distributions only if a charitable contribution deduction for the entire distribution otherwise is allowable under §170. Effective for contributions made after August 17, 2006, the following special rules are in effect: (1) no deduction is allowed for charitable contributions of clothing and household items if such items are not in good used condition or better; (2) the IRS may deny a deduction for any item with minimal monetary value; (3) these restrictions do not apply to the contribution of any single clothing or household item for which a deduction of \$500 or more is claimed if the taxpayer includes a qualified appraisal with his or her return; (4) in the case of a charitable contribution of money, regardless of the amount, a deduction is denied, unless the donor maintained a cancelled check, bank record, or receipt from the donee organization showing the name of the donee organization, the date of the contribution, and the amount of the contribution.

### ***Business Deductions***

*Self-Employed Health Insurance Premiums:* Self-employed individuals are allowed to claim 100% of the amount paid during the taxable year for insurance that constitutes medical care for themselves, their spouses and dependents as an above-the-line deduction, without regard to the 7.5% of AGI floor.

**Equipment Purchases:** If you are in business and purchase equipment, you may make a "Section 179 Election," which allows you to expense (i.e., currently deduct) otherwise depreciable business property. In general, you may elect to expense up to \$108,000 of equipment costs (with a phase-out for purchases in excess of \$430,000) if the asset was placed in service during 2006. In addition, careful timing of equipment purchases can result in favorable depreciation deductions in 2006. In general, under the "half-year convention," you may deduct six months worth of depreciation for equipment that is placed in service on or before the last day of the tax year. (If more than 40% of the cost of all personal property placed in service occurs during the last quarter of the year, however, a "mid-quarter convention" applies, which lowers your depreciation deduction.) A popular strategy in recent years is to purchase a vehicle (usually an SUV) for business purposes that exceeds the depreciation limits set by statute (i.e., a vehicle rated over 6,000 pounds). Doing so would not subject the purchase to the statutory dollar limit, \$2,960 for 2006; \$3,260 in the case of vans and trucks. Therefore, the vehicle would qualify for the full equipment expensing dollar amount. However, for SUVs (rated between 6,000 and 14,000 pounds gross vehicle weight) placed in service in 2006, the expensing amount is limited to \$25,000.

**Hurricane Relief:** Taxpayers can deduct the lesser of \$100,000 or the cost of qualified Gulf Opportunity Zone property, in addition to the existing \$108,000 amount for 2006. In general, the property must be originally used by the taxpayer on or after August 28, 2005, and placed in service before January 1, 2007 (January 1, 2008, for nonresidential real property and residential rental property). The phase-out amount is also increased by the lesser of \$600,000 or the costs of qualified Gulf Opportunity Zone property placed in service during the year.

**NOL Carryback Period:** If your business suffers net operating losses in 2006, you may apply those losses against taxable income going back two tax years. Thus, for example, the loss could be used to reduce taxable income—and thus generate tax refunds—for tax years as far back as 2004.

**Hurricane Relief:** The NOL carryback period is five years for any qualified Gulf Opportunity Zone loss.

**Bonus Depreciation:** Taxpayers meeting certain criteria can claim a 50% bonus depreciation allowance for Gulf Opportunity Zone business property that is placed in service before 2008 (before 2009, for nonresidential real and residential rental property) and exempts such depreciation allowances from the alternative minimum tax. The original use of the property in the GO Zone must begin with the taxpayer on or after August 28, 2005.

## **Education and Child Tax Benefits**

**Child Tax Credit:** A tax credit of \$1,000 per qualifying child under the age of 17 is available on this year's return. The credit is phased out at a rate of \$50 for each \$1,000 (or fraction of \$1,000) of modified AGI exceeding the following amounts: \$110,000 for married filing jointly; \$55,000 for married filing separately; and \$75,000 for all other taxpayers. A portion of the credit may be refundable.

**Credit for Adoption Expenses:** For 2006, the adoption credit limitation is \$10,960 of aggregate expenditures for each child, except that the credit for an adoption of a child with special needs is deemed to be \$10,960 regardless of the amount of expenses. The credit ratably phases out for taxpayers whose income is between \$164,410 and \$204,410.

**HOPE Credit and Lifetime Learning Credit:** The maximum HOPE credit is \$1,650 (100% on the first \$1,100, plus 50% of the next \$1,100) for qualified tuition and fees paid on behalf of a student (i.e., the taxpayer, the taxpayer's spouse, or a dependent) who is enrolled on at least a half-time basis. The credit is available for only the first two years of the student's post-secondary education.

**Hurricane Relief:** For individuals attending qualified education institutions in the Gulf Opportunity Zone in a taxable year beginning in 2006, the eligible expenditures qualifying is expanded to include books, supplies and equipment. In addition, the \$1,100 amounts for 2006 are doubled.

The Lifetime Learning credit maximum in 2006 is \$2,000 (20% of qualified tuition and fees up to \$10,000). A student need not be enrolled on at least a half-time basis so long as he or she is taking post-secondary classes to acquire or improve job skills. As with the HOPE credit, eligible students include the taxpayer, the taxpayer's spouse, or a dependent. *Hurricane Relief:* The Lifetime Learning credit percentage is increased to 40% for individuals attending qualified education institutions in the Gulf Opportunity Zone in a taxable year beginning in 2006.

For 2006, both the HOPE credit and the Lifetime Learning credit are phased out at modified AGI levels between \$90,000 and \$110,000 for joint filers, and between \$45,000 and \$55,000 for single taxpayers.

*Coverdell Education Savings Account:* Beginning in 2006, the aggregate annual contribution limit to a Coverdell education savings account is \$2,000 per designated beneficiary of the account. This limit is phased out for individual contributors with modified AGI between \$95,000 and \$110,000 and joint filers with modified AGI between \$190,000 and \$220,000. The contributions to the account are nondeductible but the earnings grow tax-free.

*Student Loan Interest:* You may be eligible for an above-the-line deduction for student loan interest paid on any "qualified education loan." The maximum deduction is \$2,500. The deduction for 2006 is phased out at a modified AGI level between \$105,000 and \$135,000 for joint filers, and between \$50,000 and \$65,000 for individual taxpayers.

Rules are in effect to coordinate education provisions, such as the qualified higher education expense deduction, the Hope and Lifetime Learning credits, Coverdell education savings accounts, and qualified tuition plans, to prevent double benefits.

## **Energy Incentives**

*Alternative Motor Vehicle Credit:* Available for the first time in 2006, a credit is available for purchases of motor vehicles powered by certain alternative fuels. A credit, the dollar amount depending on fuel savings and weight of the vehicle, is available for vehicles placed in service on or after January 1, 2006. The most popular vehicles subject to the credit are hybrids. However, when a particular manufacturer sells in the United States its 60,000th of the particular hybrid, a phaseout period kicks in. The phaseout will reduce the credit from fully available to nothing being available. The phaseout begins in the second calendar quarter following the calendar quarter where the manufacturer sold its 60,000th hybrid vehicle following December 31, 2005. Credits are also available for lean-burn technology vehicles (subject to the same phaseout), qualified fuel cell motor vehicles, and qualified alternative fuel motor vehicles.

*Residential Energy Efficient Property Credit:* Tax incentives are available to taxpayers who install certain energy efficient property, such as photovoltaic, solar water heating or fuel cell property. In 2006, a credit is available for the expenditures incurred for such property up to a specific dollar limitation. The property purchased cannot be used to heat swimming pools or hot tubs. The credit is set to expire for property placed in service after 2007.

*Nonbusiness Energy Property Credit:* Tax incentives are available to taxpayers who remodel their home and/or incorporate specific energy efficient property. Beginning in 2006, a credit is allowed for the purchase of qualified energy efficiency improvements. Such property includes advanced main air circulating fans, natural gas, propane, oil furnace or hot water boiler, windows, insulation material, exterior doors, etc. that meet certain energy efficiency standards. The credit is capped in dollar amounts per item of property. The credit is set to expire for property placed in service after 2007.

## Business Credits

*Small Employer Pension Plan Startup Cost Credit:* For 2006, certain small business employers that did not have a pension plan for the preceding three years may claim a nonrefundable income tax credit for expenses of establishing and administering a new retirement plan for employees. The credit applies to 50% of the first \$1,000 in qualified administrative and retirement-education expenses for each of the first three plan years.

*Employer-Provided Child Care Credit:* For 2006, employers may claim a credit of up to \$150,000 for supporting employee childcare or childcare resource and referral services. The credit is allowed for a percentage of "qualified child care expenditures" including for property to be used as part of a qualified child care facility, for operating costs of a qualified child care facility and for resource and referral expenditures.

## Investment Planning

The following rules apply for most capital assets in 2006:

- Capital gains on property held one year or less are taxed at an individual's ordinary income tax rate.
- Capital gains on property held for more than one year are taxed at a maximum rate of 15% (5% if an individual is in the 10% or 15% marginal tax bracket).

*Timing of Sales:* You may want to time the sale of assets so as to have offsetting capital losses and gains. Capital losses may be fully deducted against capital gains and also may offset up to \$3,000 of ordinary income (\$1,500 for married filing separately). In general, when you take losses, you must first match your long-term losses against your long-term gains, and short-term losses against short-term gains. If there are any remaining losses, you may use them to offset any remaining long-term or short-term gains, or up to \$3,000 (or \$1,500) of ordinary income. When and whether to recognize such losses should be analyzed in light of the changes in the capital gains rates applicable to your specific investments.

*Dividends:* Qualifying dividends received in 2006 are subject to rates similar to the capital gains rates. Therefore, qualifying dividends are taxed at a maximum rate of 15%. Qualifying dividends includes dividends received from domestic and certain foreign corporations.

## Social Security

Depending on the recipient's modified AGI and the amount of Social Security benefits, a percentage—up to 85%—of Social Security benefits may be taxed. To reduce that percentage, it may be beneficial to defer receipt of other retirement income. One way to do so is to elect to receive a lump sum distribution from a retirement plan and to rollover that distribution into an IRA. Alternatively, it may be beneficial to accelerate income so as to reduce the percentage of your Social Security taxed in 2007 and later years.

## Other Tax Planning Opportunities

We also can discuss the potential benefits to you or your family members of other planning options available for 2006, including §529 qualified tuition programs, which were made permanent by legislation enacted in 2006.

## Alternative Minimum Tax



In 2006, the alternative minimum tax exemption amounts are: (1) \$62,550 for married individuals filing jointly and for surviving spouses; (2) \$42,500 for unmarried individuals other than surviving spouses; and (3) \$31,275 for married individuals filing a separate return. Also, nonrefundable personal credits can offset an individual's regular and alternative minimum tax.

Some of the standard year-end planning ideas will not reduce tax liability if you are subject to the alternative minimum tax (AMT) because different rules apply. Because of the complexity of the AMT, it would be wise for us to analyze your AMT exposure.

If you have any questions, please do not hesitate to call. We would be happy to meet with you at your convenience to discuss the strategies outlined above. There is still time to implement these strategies to minimize your 2006 tax liability.

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