



SINGER LEWAK GREENBAUM & GOLDSTEIN LLP
Certified Public Accountants & Management Consultants

2006 Year-End Tax Planning

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As year-end rapidly approaches (and before the inevitable holiday chaos begins), it makes sense to set aside a few moments and assess your income tax situation. The time you spend (and the actions you take) may affect your 2006 tax bill. SLGG can offer you some tips here.

Year-end tax planning often appears overwhelming and fraught with complicated details. However, at its core is the goal of managing cash flow first and balancing long-term and short-term benefits. And it's all too easy to let potential tax savings get in the way of that primary goal (e.g., by focusing on tax deductions rather than their after-tax benefits).

In that context, tax planning is often a matter of *timing*. In the case of individuals (and frequently businesses as well), tax planning often involves accelerating (or deferring, as appropriate) certain deductions, items of income, and gain or loss, while making sure to balance the potential tax savings against the Alternative Minimum Tax (AMT) impact. Making annual gifts to loved ones (and especially to yourself via retirement plan contributions) play an important role as well.

Some frequently used strategies include:

- Postponing certain *earning* activities to just after year-end (e.g., if acceptable to a client, performing a final project step, and getting paid, in early January instead of late December). Note, this does not mean that you can defer income simply by asking to be paid a few days later.
- Prepaying expenses (e.g., state income taxes) that are otherwise due shortly after year-end. However, depending on your specific tax situation, the AMT may eliminate any potential benefit. But it's generally best to avoid prepaying items too early (or incurring unnecessary expenses), because a tax deduction is always worth less than the cash used to pay it.
- Matching long and short term capital gains with losses to lower overall capital gains tax and make the best use of the \$3,000 of capital losses that can offset other income.
- Bunching deductible expenses into one or the other year depending upon whether the standard deduction may be taken in one of the years, or whether the adjusted gross income limits for medical (7.5%) or miscellaneous itemized deductions (2%) are more easily met.
- Acquiring and putting certain business assets into service before year-end and taking advantage of the "section 179" writeoff deduction (up to \$108,000 for 2006 and \$112,000 for 2007).

- Making the maximum allowable contributions to your retirement plan accounts.
- Donating household items to a worthwhile charity.
- If you have an interest in an S corporation or partnership, making sure that your basis is sufficient to allow any available loss deductions, if applicable.

New tax laws impact you

In 2006, President Bush signed into law the *Tax Increase Prevention and Reconciliation Act* (TIPRA) in May and the *Pension Protection Act* (PPA) in August. Once again, the new laws create many tax planning opportunities.

TIPRA and the PPA, like most tax bills, contain both good and bad news, depending on your situation. Fortunately, for many taxpayers the news is good. However, there are traps for those who are not in the know, especially when it comes to the effective dates of many tax breaks.

Some of the highlights of the new tax laws that could impact your year-end tax planning are:

- Permanent retirement savings tax incentives, such as higher IRA and 401(k) contribution limits, taxpayer-friendly rollovers and many other pro-taxpayer changes.
- Extended lower capital gains and dividend tax rates through 2010 (which were set to expire in 2008).
- Expanded “kiddie tax” under which a child’s income is taxed at a parent’s tax rate, under age 18 (up from age 14 and applied retroactively from January 1, 2006). This applies to a child’s unearned income (e.g., dividends, interest) in excess of \$1,700.
- Direct, tax-free charitable contributions from IRAs for individuals age 70½ and older (for 2006 and 2007 only).
- More stringent substantiation rules for gifts of cash to charity and reform of the rules for donations of clothing and household items (some changes effective immediately; others in future years).

Besides the tax incentives in these new laws, there are many existing, yet still relatively new tax breaks that could be valuable when planning your year-end tax strategy. These include:

- AMT “patches,” temporary relief that could help lower your AMT liability.
- Hybrid vehicle credit available to purchasers, along with its reduction once a manufacturer sells more than 60,000 units (which is already the case for Toyota hybrids starting October 1, 2006).
- Residential energy credits of \$500 for residential energy improvements, \$2,000 for solar equipment and \$500 for fuel cells per half kilowatt capacity (restricted to 2006 and 2007 only).

- Educational tax incentives, such as the HOPE and Lifetime Learning tax credits.

Caveat: Despite the temporary AMT relief available, it nevertheless poses hazards when engaging in tax planning. Some of the items to consider regarding AMT are:

- State and local taxes;
- Home equity loans and other mortgage interest not incurred in buying, building or improving your principal residence;
- Incentive stock options – these have AMT implications that often give recipients an unwelcome surprise when exercised. Specifically, even though the “spread” between the option price paid and the underlying stock’s value at exercise is not taxable for regular tax purposes, for AMT purposes it is. Moreover, if the shares are later sold at a loss, that loss may be limited to that year’s net capital gains (or the \$3,000 annual limitation);
- Private activity bonds; and
- Certain other itemized deductions – it may make sense to itemize even if the standard deduction is higher, but medical expenses have a higher minimum requirement for itemization under AMT and others are disallowed. On the other hand, an itemized deduction limitation is being phased out over the next few years, which may be incentive to push them back.

Caveat: The rules for charitable donations have been tightened. Some of the new restrictions include:

- Donations of clothing and household items must be in “good” condition to be deducted.
- Starting in 2007, cash donations in any amount must be substantiated by a bank record or a written communication from the charity indicating the amount and date of the contribution and the name of the organization.

Pending Legislation

On December 9th, the Tax Relief and Health Care Act of 2006 was passed by Congress and the President is expected to sign it into law when it reaches his desk. Some of the provisions included in this highly anticipated “extenders” package include:

- Retroactive extension back to January 1, 2006 of the state and local sales tax itemized deduction option;
- Retroactive extension back to January 1, 2006 of the above-the-line higher education tuition deduction and the teacher’s classroom expense deduction;
- Enhancements to the Health Savings Account rules beginning after 2006,
- Extension and/or modification of a host of tax breaks for business, including the Work Opportunity and Welfare-to-Work tax credits, Archer Medical Savings Accounts, energy

tax incentives, the new markets tax credit and the research tax credit.

Year-End Tax Planning for Businesses

As with year-end tax planning for your personal matters, year-end business planning often represents a last chance to take certain action to reduce what the tax bill will be when you file the business return next year. A good portion of the tax law is based on the tax year, with benefits that are available in any particular year ending with that year. Missed opportunities usually cannot be taken later.

Timing is key

Year-end focus on the timing of income and deductions is as applicable to your business as it is to your personal tax situation. In dealing with a business, however, the opportunities are even more varied, and often more complex.

- First, timing considerations are more complicated because many businesses account for income and expenses on the accrual basis, as opposed to the cash method. The difference is significant because it introduces a whole new set of rules and because it must be coordinated with a business's tax year, which may not be the calendar year on which its owner must figure his or her taxes.
- Next, many more provisions address business income and expenses than personal tax issues. Let's face it, business is complicated. Businesses operate in many different forms and are involved in a variety of industries and professions. The tax law must reflect those differences. In turn, businesses must address the complexities of the tax law if maximum tax savings are to be realized.
- Finally, timing of a business' tax consequences should be coordinated with the financial and tax needs of its owners. Year-end planning that produces flow-through losses, qualified dividends distributions and other tax wizardry will not mean much if the business owners can not take advantage of them.

Year-end tax planning for any business is highly depending on each business' facts and circumstances. General rules on what to do go only so far in uncovering the opportunities and pitfalls. Nevertheless, there are some considerations that should be on everyone's checklist as the year end approaches.

Here is our short list:

“Section 179 expensing” – Internal Revenue Code Section 179 allows your business to purchase up to \$430,000 of qualifying property and deduct up to \$108,000 of depreciation as an *immediate* expense. Normally, the business would have to spread the cost of the asset over its useful life and deduct only a percentage of the total cost each year (i.e., via depreciation). By claiming the section 179 deduction, the business may be able to deduct the full \$108,000 section 179 deduction even if the qualifying property was placed into service on the last day of the tax year.

While you might maximize your section 179 deduction by accelerating 2007 purchases

into 2006, you should watch the \$430,000 limit, after which you start to lose part of this deduction.

Manufacturing deduction – The manufacturing deduction (which, despite its nickname, is also available to many service businesses) cap rises from 3% to 6% of qualified production activities income starting in 2007. While moving more qualifying income into 2007 to gain another three percentage points in the deduction may make sense, another wrinkle was just added by the recently enacted TIPRA. A new W-2 wage limit on the deduction may in fact encourage many businesses to *accelerate* the deduction. Starting in 2007, the overall deduction is limited to 50% of W-2 wages incurred by the business within the manufacturing process only. In 2006, the cap is applicable to all W-2 wages, whether or not related.

Nonqualified deferred compensation – The section 409A nonqualified deferred compensation rules are giving many businesses major compliance headaches. The deadline for getting a business' deferred pay plans and policies into line with this new law has been moved once before, from year-end 2005 to year-end 2006. Whether it will be moved again is presently open to speculation. In any event, a business must prepare now “just in case.”

Basis in S corporation and partnership interests – If you are an S corporation shareholder or partnership/LLC member, now is the time to make certain that your stock basis is sufficient to entitle you to any available loss deductions that your passthrough entity is likely to realize.

Net operating losses – Net operating losses (NOLs) incurred in the course of business may be carried forward for 15 or 20 years (as well as carried back 2 years, or more, under certain circumstances) depending on when the loss was incurred. If the NOL is not utilized within these periods, it will expire without providing any benefit. Rather than let this asset expire without being utilized, there are some basic tax planning strategies that will generate offsetting taxable income for which you will be spared tax liability in the future.

Personal holding company tax – If a business is taxed as a regular C corporation, personal holding company tax may be a danger if ownership of more than 50 percent of the corporation is held by a small group. A check before year-end on whether personal holding company income (generally, passive investment income) is within the danger zone and then deferring that income or accelerating offsetting active business income becomes an important step for many businesses.

Reserve account write offs – As year-end approaches, you should review your reserve accounts for potential deductions, such as bad debt or inventory write-offs. As you are probably aware, a deduction for bad debts is only permitted in the year the receivable becomes partially or completely worthless so annual reviews are necessary to avoid amended returns or missed deductions. Similarly, a write down for any excess inventory is only allowed in the year the inventory is actually sold or scrapped. Thus, effective tax planning for inventory write-downs requires action before your tax year ends.

Final Thoughts

As is probably clear from the above, there are many opportunities for year-end planning, but they ultimately depend on each person's (or business') particular circumstances. At SLGG, we encourage you to call us to assist you in making the best of yours – 877.754.4557. We welcome any questions or feedback you may have.



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www.slgg.com

Los Angeles
310-477-3924

Orange County
714-953-9734

Inland Empire
909-941-9245

Woodland Hills
818-999-3924
