

2006 TAX PLANNING FOR INDIVIDUALS

Dear Clients and Friends:

The following is a summary of the most important tax developments that have occurred during 2006 that may affect you, your family, your investments, and your livelihood. Please call us for more information about any of these developments and what steps you should implement to take advantage of favorable developments and to minimize the impact of those that are unfavorable.

Pension Protection Act makes many changes for individuals. The key changes affecting individuals include:

- Increases the maximum IRA and Roth IRA contributions to \$4,000, makes permanent the ability to make “catch-up” contributions to IRAs (\$1,000) and 401(k)s (\$5,000) after reaching age 50, and widened rollover choices.
- A new opportunity in 2006 and 2007 for an individual age 70 1/2 or older to exclude up to \$100,000 a year of distributions from IRAs (including Roth IRAs) that are paid directly by the IRA or Roth IRA trustee to a qualifying charity. If the exclusion is chosen, the donated amount can't be deducted as a charitable contribution.
- For distributions after 2006, non-spouse beneficiaries of retirement plan accounts will be able to make rollovers to inherited-IRA accounts. Currently, only spouse-beneficiaries of retirement plan accounts can make rollovers to IRAs. The change gives much-needed flexibility to those who inherit retirement plan accounts from a non-spouse.
- More rollover options for after-tax contributions to retirement plans. After 2006, such contributions may be rolled over to another retirement plan or to a tax-sheltered annuity, if the transfer is made via direct rollover and the receiving plan or annuity separately accounts for the after-tax contributions.
- After 2007, distributions from retirement plans, tax-sheltered annuities, and governmental Code Sec. 457 plans can be rolled over directly into a Roth IRA, subject to the usual rules that apply to rollovers from a traditional IRA into a Roth IRA. For example, under these rules, a rollover to a Roth IRA generally is taxable, and, until 2010, can't be made if adjusted gross income is \$100,000 or more (but the \$100,000 rule won't apply after 2009).
- Toughened rules for certain contributions. For example, contributions of clothing and household items that is not in good used condition or better can't be deducted. In addition, the IRS may deny a deduction for any contribution of clothing or a household item with minimal monetary value, such as used socks or undergarments. A deduction may be approved for clothing or a household item not in good used condition or better that has a more than \$500 claimed value and is backed up by a qualified appraisal.
- New substantiation requirements. A taxpayer won't be able to deduct a post-2006 contribution of cash, check, or other monetary gift unless he maintains as a record of the contribution a bank record or a written communication from the charity showing its name, the date of the contribution, and the amount of the contribution.

The “Tax Increase Prevention and Reconciliation Act” (TIPRA). The most talked about provisions in this law were the short-term alternative minimum tax relief for 2006 and the



extension of the current low-taxed capital gains and dividends rate that was due to expire after 2008. However, it also carried a number of other changes affecting individuals. Some of these are:

- Kiddie tax age limit raised from under 14 to under 18 for tax years beginning in 2006.
- Income limit on Roth IRA conversions eliminated for tax years beginning in 2010.
- Increased Sec. 179 expensing for new equipment and furniture acquired in 2006 (\$108,000) for a small business with investment based phase-out beginning at \$430,000.
- Information reporting required for tax-exempt interest after Dec. 31, 2005.
- Changes (some not favorable to taxpayers) to the foreign earned income exclusion and housing allowance for U.S. citizens working abroad for tax years beginning in 2006.

Tax planning works best when it begins before the end of the year. The following strategies and new opportunities offer immense benefits for your 2006 tax return, if you act now:

- **Apply a Bunching Strategy.** Are your itemized deductions sometimes less than the standard deduction? If so, consider a bunching strategy, where you apply the standard deduction one year and itemize deductions the following year. In the itemized deduction year, consider paying two years worth of property taxes and making multi-year payments for other expenses. Consider, too, paying for business items and professional development expenses during an itemized year to reduce lost itemized deductions based on adjusted gross income. Remember though, that paying additional property tax and taking more miscellaneous deductions in one year could subject you to the Alternative Minimum Tax.
- **Hybrid Car.** Buyers qualify for tax credits ranging from \$400 to \$3,400 for new hybrid vehicles purchased after January 1, 2006. Tax credit considerations include vehicle weight, fuel economy, and lifetime fuel savings.
- **Phase-outs of 2006 itemized deductions and personal exemptions.** There is now a smaller phase out of a higher-income taxpayer's itemized deductions and personal exemptions. For 2006, a taxpayer loses only 2/3 max of the amount he would otherwise lose under the reduction computation (was 80% in 2005).
- **Energy-efficient Home Improvements Tax Credit.** The IRS has issued guidance on the up-to-\$500 tax credit available to homeowners for eligible energy-efficient home improvements placed in service after 2005 and before 2008. A 10% credit is allowed for the cost of certain improvements, e.g., insulation, exterior windows, skylights, exterior doors, and pigmented coated metal roofs; and a specified amount is allowed for other items—e.g., advanced main air circulating fans (\$50), natural gas, propane, or oil furnaces or hot water boilers (\$150), and heat pumps, water heaters, and central air conditioners (\$300). Manufacturers of these energy-efficient items must provide consumers with a certification that they can rely on in claiming the credit.
- **Donations of Vehicles.** The IRS has revised the form which a charity must use for 2006 to report qualified vehicles donated to it, Form 1098-C, Contributions of Motor Vehicles,



Boats, and Airplanes. Under stringent new rules, a taxpayer's charitable deduction for these vehicles with a claimed value in excess of \$500 can't, with a few narrow exceptions, exceed the charity's gross proceeds from its sale of the property.

- **Fund IRA/401(k) Plans.** Everyone should set aside as much as possible for retirement funding. For a 401(k) plan, contribute enough to fully benefit from an employer's matching funds, and try to make the maximum \$15,000 contribution. Individuals 50 years old or older can add "catch up" contributions up to \$5,000. Self-employed individuals can get a maximum \$44,000 deduction if they establish a self-employed retirement plans. The new Roth 401(k) plans give younger employees in lower tax brackets a great way to get long-term, tax-free appreciation. High school or college-age children with part-time job income can also contribute up to \$4,000, or the amount they earned, to a Roth IRA.
- **Consider Gifts to Individuals.** The annual gift tax exclusion for 2006 was raised to \$12,000 per individual. Gifting enables you to transfer investments to a child or someone else who is in a lower tax bracket. A child younger than 18 years old can have an unearned (investment) income of \$1,700 for 2006, before subjecting parents to the "kiddie tax" rules. The first \$3,850 is tax free, with the next \$850 subject to a 10 percent tax bracket.
- **Be Tax-Wise in Charitable Giving.** Giving appreciated stock enables you to make a valuable charitable contribution without paying capital gains tax on that stock. When donating a used car, inquire whether the charity will sell the car, or use it for charitable activities. The latter may yield a bigger deduction. For a sale, the price the charity gets is the donated value. Bank-issued credit cards can also be used to make charitable contributions, even if the card balance isn't paid until 2007.
- **Coordinate Capital Gains/Losses.** You are limited to \$3,000 in annual net losses. Try to offset short-term gains against short-term losses so that when you sell stocks with long-term capital gains, they are taxed at the 15 percent maximum tax.
- **Avoid Penalties for Underpaying Estimates.** If you can be penalized for underpaying estimated taxes, increase your withholding tax or estimated tax payments.
- **Invest in a 529 College Savings Plan.** If you are saving for a child's or grandchild's college education, contribute to a 529 college savings plan. Every person can make annual gifts, up to \$12,000 per beneficiary. If you exceed that annual amount, you can elect on a gift tax return to take the contributions into account ratably over five years, as long as the five-year total per beneficiary does not exceed \$60,000. Earnings are tax free when used for qualifying educational expenses.

The above items may whet your appetite for some year-end planning. If so, please give us a call.

Very Truly Yours,

Joe, David & Harold

BENJAMIN & BIRKENSTEIN, P.C.