



tax & financial

U P D A T E



Volume 12, Number 3 Year-End 2005

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Year-End Planning Strategies to Lower Your Taxes

The following is a checklist that might help you save taxes if you act before the year's end. Not all strategies will apply to everyone, but many clients will benefit from more than one item. Not all available strategies are listed either.

- If you are over 70¹/₂ years of age and have retirement plans, make sure you take the required minimum distribution before the end of the year. If you turned 70¹/₂ in 2005, you can wait until next year to take your distribution, provided you take it before April 3, 2006. You will still need to take another distribution for 2006, so if you delay the 2005 distribution until 2006, you will essentially be doubling your distributions for that year. The penalty for failing to make the proper distribution is an additional tax equal to 50% of the amount of the underdistribution.

- If you anticipate having a tax liability for 2005, you can increase your withholding for the balance of the year and eliminate or reduce underpayment penalties.

- If you have stocks that have declined in value, you may wish to sell them before the end of the year and use the loss to offset other gains for the year or to produce a deductible loss. The net capital loss on a tax return is limited to \$3,000 for the year, but any excess loss carries over to future years.

- If a job-related bonus is expected to be paid around the end of the year, you might be able to defer that income into the following year if that is appropriate in your situation. See if your employer is willing to put off payment until just after the first of the year.

- If itemizing deductions, a taxpayer can increase those deductions for the year by prepaying certain taxes. Consider one or more of the following:

- Prepaying the next installment of your property taxes, or

- Pay your 4th quarter state tax estimate in December.

- If your sales tax deduction is greater than your state income tax deduction, or if you live in a state with no state income tax and you are planning a large purchase (such as a car) in the future, it might be appropriate to make that purchase in 2005. This is because 2005 is the last year for the sales tax deduction under the current law.

Caution: This strategy will not work if you are subject to the AMT, since taxes are not deductible for AMT purposes.

- Reduce your gift and estate taxes by making gifts before the year's end. For 2005, the amount you may give without creating a gift tax filing requirement is \$11,000 per person. You can make gifts each year to an unlimited number of individuals, but you can't carry over unused annual gift tax exclusions from one year to the next. For 2006, the annual gift exclusion is expected to rise to \$12,000.

- If you own an interest in a partnership or S corporation, you may need to increase your basis in the entity so you can deduct a loss from it for this year.

- Consider using a credit card to prepay expenses that can generate deductions for this year.

- Business clients also should consider making expenditures that qualify for the \$105,000 business property expensing (Sec 179) election.

- If taxed by the AMT, you might consider deferring payments that would qualify as a "miscellaneous" itemized deduction, since you will receive no benefit for those expenses. On the other hand, if you are not taxed by the AMT, consider accelerating those expenses.

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Year-End Planning Strategies to Lower Your Taxes (Cont'd)

- If you're thinking of making non-cash charitable donations, do so before the end of the year to maximize your charitable deduction. And remember that if you write a check to make a charitable donation, it must be mailed by December 31 to count as a current year deduction.

These are some year-end strategies to help minimize your tax liability. You may wish to contact this office for a year-end planning session, so we can tailor a plan that best serves your needs.

Stealth Tax in Your Future?

There are two ways to determine your tax, the regular way that most everyone understands and the alternative method (AMT). Your tax for the year is the higher of the two. Barring any last minute Congressional changes, beginning in 2006, the AMT is going to affect a much larger number of taxpayers because a temporary increase of the AMT exemptions will expire at the end of 2005 and a number of tax credits will no longer offset the AMT. The changes may push you into the AMT, and if you are already taxed by the AMT, you can most likely expect an increase in tax for 2006. Here are the changes that will take effect in 2006:

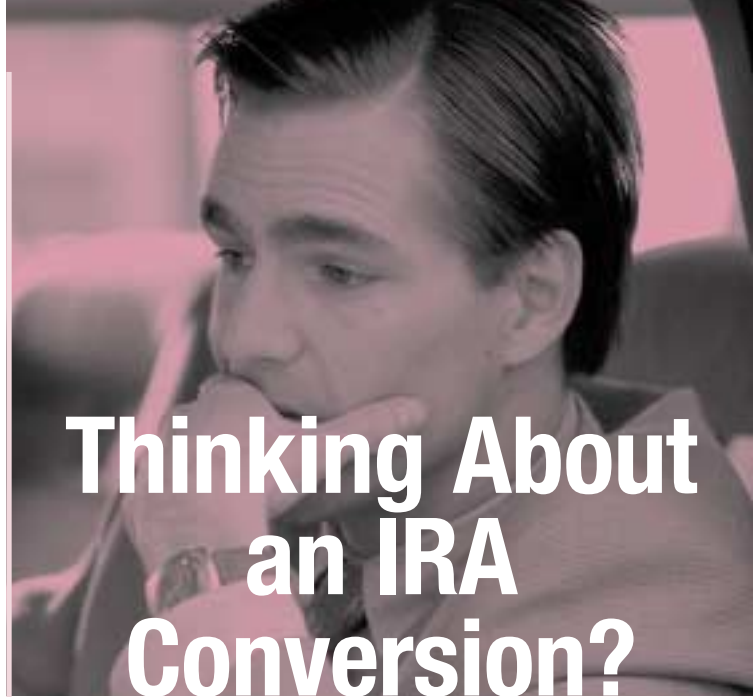
1. Reduced Exemptions – The tax code exempts a fixed amount of income from being taxed under the AMT method. Beginning in 2006, this AMT exemption amount will decrease by \$13,000 for joint and qualified surviving spouse (SS) filers and by \$6,500 for all others. This reduction in exemptions can result in tax increases of \$3,380 for joint and SS filers and \$1,690 for others who are taxed by the AMT and in the lowest AMT tax bracket.

2. Nonrefundable Credits – Beginning in 2006, certain nonrefundable credits that currently offset both the regular tax and the AMT will no longer offset the AMT. Thus, if you are taxed by the AMT, you will receive no (or a reduced) benefit from these credits. The following is a summary of the nonrefundable credits that will no longer offset the AMT beginning in 2006.

- Education credits (Hope and Lifetime)
- Child and Dependent care expense credit
- Mortgage interest credit
- Electric vehicle credit
- Elderly and disabled credit
- DC homebuyer credit (Sunsets after 2005)

In addition, the new energy credits for home and fuel-efficient vehicles that will become available in 2006 do not offset the AMT.

Find out in advance whether you are in the AMT before making any financial decisions based on any of the credits mentioned above. Please call this office for assistance.



Thinking About an IRA Conversion?

The big benefit to Roth IRA contributions is that the distributions from the Roth IRA when you retire are tax-free, but the drawback is that the contributions are not deductible. If you made a Roth IRA contribution during 2005 and discover later in the year that you would be better off with a deduction, you might consider “recharacterizing” the Roth IRA into a deductible traditional IRA. But keep in mind that traditional IRA contributions are only deductible if:

- (1) Neither you nor your spouse is covered by an employer-provided retirement plan, **or**
- (2) Either you, your spouse, or both are active participants in an employer’s retirement plan and your adjusted gross income (AGI) is under the phase-out limits. For 2005, phase-out of the deduction begins at an AGI of \$70,000 (\$50,000 for unmarried taxpayers) and no contributions are deductible if the AGI exceeds \$80,000 (\$60,000 for unmarried taxpayers).
- (3) You are not covered by a pension plan but your spouse is, then the AGI phase-out for your deductible traditional IRA starts at \$150,000, and the deduction is completely phased-out when the AGI reaches \$160,000.

You can also “change your mind” if you converted a traditional IRA into a Roth IRA during the year. Frequently, the income from the rollover will propel you into a higher tax bracket or will rob you of tax breaks that phase out at higher levels of AGI. You might not have even been aware of the tax liability. You can reverse your decision by recharacterizing the rollover back to a traditional IRA. Other times, taxpayers make a traditional to Roth IRA conversion without considering that they cannot do so if their AGI without the conversion exceeds \$100,000.

Unless there is some other compelling reason, contributions or conversions should not be made until there is a clear picture of your income for the year and after you have considered all options.

Don't Pay the Price For Your Bank's Error

Are you considering rolling over your IRA to another account? Keep in mind that from the time you receive the distribution you have only 60 days to complete the rollover. If the 60-day period is exceeded, taxes and penalties will apply. There is an exception to that rule, however.

The IRS provides an automatic waiver for failure to meet the 60-day rollover caused by a financial institution error. They will automatically waive the 60-day rule for qualified plan and IRA rollovers if a financial institution error caused the rollover to be untimely and the following conditions are met:

- The financial institution received the funds on behalf of the taxpayer before the 60-day rollover period expired;
- The taxpayer followed all of the financial institution's procedures for depositing the funds into an eligible retirement plan within the 60-day period (including giving instructions to deposit the funds into an eligible retirement plan);
- Solely due to the financial institution's error, the funds are not deposited into an eligible retirement plan within the 60-day rollover period;
- There would have been a valid rollover if the financial institution had deposited the funds as instructed; and
- The funds are actually deposited into an eligible retirement plan within one year from the beginning of the 60-day rollover period.

If these conditions are not met, taxpayers must apply for a private letter ruling to obtain a hardship waiver.

How Katrina Tax Incentives Can Benefit You

Late in September, Congress passed the Katrina Emergency Act. This Act provides a vast number of tax benefits to individuals who were residents of the disaster area. In addition, it includes provisions that apply to all taxpayers whether or not they resided within the disaster area. The following is a brief summary of those provisions:

Increased charitable contributions – Generally, most charitable contributions are limited to 50% of a taxpayer's adjusted gross income (AGI). To provide an incentive for larger charitable contributions, that 50% limit has been increased to 100% for cash contributions made between August 28 and December 31, 2005, with a five-year carryover provision subject to the 50% limit for contributions in excess of the 100% of the AGI limitation for 2005. There may be other complications so consult our office if you anticipate making a substantial contribution. In addition, the contributions made during August 28 through December 31 of 2005 are not subject to the overall itemized deductions phase-out that applies to high-income taxpayers.

Additional exemption for housing Katrina-displaced individuals – Taxpayers who provide free housing in 2005 or 2006 for at least 60 days to qualified Katrina-displaced individuals will be entitled to an additional exemption of \$500 for each individual but it is not to exceed \$2,000 for the year. For higher-income taxpayers, these additional exemptions do not phase out like the regular taxpayer, spouse, and dependent exemptions. The deduction can be claimed in either 2005 or 2006, but not both years, by the taxpayer for the same individual.

Recontribution of home purchase withdrawals – Certain retirement plans or IRA withdrawals made after February 28, 2005 and before August 29, 2005 for home purchases in the Katrina disaster area that were cancelled due to Hurricane Katrina, can be returned to a qualified plan or IRA tax-free and without penalty. Under normal tax law provisions, these types of distributions cannot be recontributed and if they are not used towards purchasing a home, they are subject to the 10% early withdrawal penalty. Any amount of the withdrawn funds (not to exceed the total amount withdrawn) can be recontributed at any time during the period beginning on August 25, 2005 and ending on February 28, 2006.

Work Opportunity Credit for Katrina-displaced individuals – Employers may claim the work opportunity tax credit if they hire individuals who:

- On August 28, 2005, had a principal place of abode in the Katrina core disaster area, and who are hired during the two-year period beginning on August 28, 2005 for positions where the principal place of employment is located in the core disaster area, or
- On August 28, 2005 had a principal place of abode in the core disaster area, who are displaced from those abodes because of Hurricane Katrina, and who are hired during the period beginning on August 28, 2005 and ending on December 31, 2005.





QUESTION: I am retired and age 74. I began taking my minimum IRA distributions since I turned 70½. I almost forgot to take my distribution last year, and I am concerned about the ramifications should I miss taking a distribution in some future year?

ANSWER: The penalty for not taking a distribution in a tax year is an additional tax of 50% of the amount that should have been taken that year based upon the Required Minimum Distribution (RMD) rules. Your RMD is determined by taking the IRA balance on December 31 of the prior year and dividing that total by your remaining life expectancy from the IRS table. If you have more than one IRA, figure the RMD for each one and then combine them to get the total required distribution for the year. The penalty is 50% of the RMD and can be severe if the IRA balances are large. The good news is that the IRS will generally, upon request, abate and refund the penalty, provided you show that you have made a corrective distribution in the subsequent year. However, you must first pay the penalty and request the abatement.

QUESTION: My wife and I are getting a divorce. As part of the property settlement, she will keep the home. What are the possible tax consequences that may arise?

ANSWER: When property is divided up in a divorce, there are no immediate tax consequences. Therefore, the transfer of your interest in the home to your spouse will not result in a taxable gain or loss to you or her. However, let's say she assumes the home at the community basis. Generally, community basis is what you jointly paid for the home plus the cost of improvements you've made. Thus, she would be responsible for reporting any gain in excess of the community basis when and if she sells the home. If she qualifies, she can exclude the first \$250,000 of gain; any part of the gain in excess of the exclusion will be taxable to her. As part of your divorce tax strategy, and assuming you qualify for the home gain exclusion, you might want to consider selling the home jointly. This will convert the asset to cash, which can then be divided up as part of the settlement. By doing so, you will have a combined \$500,000 home gain exclusion and will only be taxed on the amount, if any, in excess of this larger exclusion amount.



taxcalendar November 2005 – April 2006

November-December 2005:

Time for 2005 Year-End and 2006 Tax Planning. This is especially true if you have substantial increases in income or fewer deductions. Tax planning provides an opportunity to make adjustments before year's end that can improve your tax situation and minimize potential penalties. Please call for an appointment.

December 31, 2005:

- Last day to pay deductible expenses for 2005 return (this doesn't apply to IRA, SEP or Keogh contributions, all of which can be made after December 31, 2005).
- Last day to make minimum required withdrawal of funds from a Traditional IRA Account and avoid a penalty if you turned age 70½ before 2005.
- Last day to set up a Keogh Retirement Account if you plan to make a 2005 Contribution.

January 16, 2006:

Fourth-Quarter 2005 Federal Estimated Tax Payment due unless 2005 return is filed by January 31, 2006. **Caution:** Some states may have different filing dates.

January 31, 2006:

Deadline for providing 1099s and W-2s to those people you paid during 2005. If you're a business owner or rental property owner, and you paid \$600 or more for the services of

individuals (other than employees) during the year, you need to provide 1099s for those workers by January 31, 2006. "Services" can mean everything from labor and professional fees to rents on property. In addition, in order to avoid a penalty, copies of 1099s need to be sent to the IRS by February 28, 2006. If you would like this firm to prepare these documents for you, please give us a call.

February 28, 2006:

Deadline for filing (sending) 1099s and W-2s to the government.

April 3, 2006:

Last day to withdraw funds from your Traditional IRA if you turned age 70½ in 2005 and you haven't taken your 2005 Distribution yet. In addition, this is the last day to withdraw funds from your SEP or Keogh plan if you're retired and turned age 70½ in 2005. Failure to take the required distributions can result in substantial penalties.

April 17, 2006:

- Deadline for individuals to file a 2005 Federal Return or request an extension of time to file.
- First Installment of 2006 Federal Estimated Tax Payment due.
- First Installment of 2006 Defined Benefit Pension Plan Contributions due.