

2005 Year-End Tax Planning for Individuals
BNA Client Letter

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Dear Client:

As 2005 draws to a close, there is still time to reduce your 2005 tax bill and plan ahead for 2006. This letter highlights several potential tax-saving opportunities for you to consider. I 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 2005 and 2006 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 2004 tax return and your 2005 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 2005 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 2005

More tax-saving opportunities continue for retirement planning in 2005 than in previous years due to the availability of Roth IRAs, changes that make regular IRAs more attractive, and other retirement savings incentives.

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 2005 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 2005, 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 \$70,000 and \$80,000 of modified AGI for married filing jointly. Above these ranges, no deduction is allowed.

For 2005, a \$500 "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 \$4,500.

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 59½. 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

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heads of households). For 2005, a \$500 "catch-up" contribution is allowed for taxpayers age 50 or older by the close of the taxable year, making the total limit \$4,500 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 \$14,000 for 2005, up from \$13,000 in 2004. If your 401(k) plan has been amended to allow for catch-up contributions for 2005 and you will be 50 years old by December 31, 2005, you may contribute an additional \$4,000 to your 401(k) account, for a total maximum contribution of \$18,000 (\$14,000 in regular contributions plus \$4,000 in catch-up contributions).

SIMPLE Plan Contribution: The SIMPLE plan deferral limit is \$10,000 for 2005, up from \$9,000 in 2004. If your SIMPLE plan has been amended to allow for catch-up contributions for 2005 and you will be 50 years old by December 31, 2005, you may contribute an additional \$2,000.

Catch-Up Contributions for Other Plans: If you will be 50 years old by December 31, 2005, you may also contribute an additional \$4,000 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. Note that this credit terminates at the end of 2006.

Maximize Retirement Savings: In many cases, employers will require you to set your 2006 retirement contribution levels before January 2006. 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 Katrina Relief: The 10% penalty on early distributions from qualified retirement plans does not apply to qualified Hurricane Katrina distributions of up to \$100,000 from a qualified retirement plan, a §403(b) annuity, or an IRA. 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. Withdrawals are ratably included in income over a three-year period, unless the taxpayer elects to include the amount in the current year. This income averaging offsets the increased taxable income that would otherwise result in 2005. 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.

Deferring Income to 2006

If you expect your AGI to be higher in 2005 than in 2006, or if you anticipate being in the same or a higher tax bracket in 2005, you may benefit by deferring income into 2006. 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:

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Delay Billing: If you are self-employed, delay year-end billing to clients so that payments will not be received until 2006.

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 2005

In limited circumstances, you may benefit by accelerating income into 2005. For example, you may anticipate being in a higher tax bracket in 2006, 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 2005 will be disadvantageous if you expect to be in the same or lower tax bracket for 2006. 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 2005. Also see if some of your clients or customers might be willing to pay for January 2006 goods or services in advance. Any income received using these steps will shift income from 2006 to 2005.

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 2006.

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 2006.

You may also want to consider making a Roth IRA rollover distribution, as 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, 2006.

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 2005, you can take the deduction even though you won't pay your credit card bill until 2006.

AGI Limits: The AGI limits on itemized deductions affect deduction planning. For 2005 returns, overall itemized deductions are reduced by 3% of the AGI exceeding \$145,950 (\$72,975 if married filing separately). 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. Hurricane Katrina Relief: Qualified charitable contributions are not subject to the overall itemized deduction limitations.

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Standard Deduction Planning: Deduction planning is also affected by the standard deduction. For 2005 returns, the standard deduction is \$10,000 for married taxpayers filing jointly, \$5,000 for single taxpayers, \$7,300 for heads of households, and \$5,000 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 2005 and plan to make an estimated payment, consider making the payment before the end of 2005. Note that in 2005, you can choose to deduct as an itemized deduction state and local sales taxes instead of state and local income taxes. This choice expires at the end of 2005, so if there is a plan to purchase a big ticket item, like a car or boat, which the sales tax paid can lead to a higher deduction, it would make sense to purchase it before year end.

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 2005 even though you will not pay the bill until 2006. 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 Katrina Relief: For qualified charitable contributions made by individuals between August 28, 2005, and December 31, 2005, for Katrina relief efforts, the percentage limitations under §170(b) and the carryover provisions of §170(d) are suspended. Although enacted under the guise of Hurricane Katrina relief, this provision applies to qualified contributions made for any purpose, not just those for relief efforts related to Katrina, but the recipient organizations are limited to those described in §170(b)(1)(A) (other than a §509(a)(3) supporting organization). Also, 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 only in 2005 and 2006. The aggregate total for both years cannot exceed \$2,000.

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 \$105,000 of equipment costs (with a phase-out for purchases in excess of \$420,000) if the asset was placed in service during 2005. In addition, careful timing of equipment purchases can result in favorable depreciation deductions in 2005. 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

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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 2005; \$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 2005, the expensing amount is limited to \$25,000.

NOL Carryback Period: If your business suffers net operating losses in 2005, 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 2003.

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. Hurricane Katrina Relief: For the refundable portion of the child tax credit, an affected taxpayer can elect to use earned income from either a year that includes August 25, 2005 (i.e., 2005), or the preceding year (i.e., 2004), in determining the child tax credit for 2005.

Credit for Adoption Expenses: For 2005, the adoption credit limitation is \$10,630 of aggregate expenditures for each child, except that the credit for an adoption of a child with special needs is deemed to be \$10,630 regardless of the amount of expenses. The credit ratably phases out for taxpayers whose income is between \$159,450 and \$199,450.

HOPE Credit and Lifetime Learning Credit: The maximum HOPE credit is \$1,500 (100% on the first \$1,000, plus 50% of the next \$1,000) 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.

The Lifetime Learning credit maximum in 2005 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.

For 2005, both the HOPE credit and the Lifetime Learning credit are phased out at modified AGI levels between \$87,000 and \$107,000 for joint filers, and between \$43,000 and \$53,000 for single taxpayers.

Coverdell Education Savings Account: Beginning in 2005, 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 2005 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.

Qualified Higher Education Expenses: For 2005, you also may be eligible to deduct qualified tuition and related expenses as an above-the-line deduction. In 2005, a taxpayer with modified AGI of not more than

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\$65,000 (\$130,000 for a married couple filing jointly) who is not claimed as a dependent on another person's return is entitled to a maximum deduction of \$4,000. For taxpayers with modified AGI of \$65,000 or more but not more than \$80,000 (\$130,000/\$160,000 for a married couple filing jointly), the maximum deduction is \$2,000. Note that, unless extended, 2005 is the last year for this deduction.

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: Although not available until tax year 2006, if you are planning to purchase a motor vehicle powered by certain alternative fuels, you may need to act in a hurry. A credit, dollar amount depending on fuel savings and weight of the vehicle, is available for vehicles placed in service after December 31, 2005. 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: If you plan on installing certain energy efficient property, such as photovoltaic, solar water heating or fuel cell property, it will be worthwhile to wait until 2006. Beginning 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: If you plan on remodeling your home and you plan on incorporating specific energy efficient property, it will be worthwhile to wait until 2006. 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 2005, 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 2005, 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 and Gift Planning

The following rules apply for most capital assets in 2005:

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- 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 2005 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.

Gifts: To avoid capital gains, you may want to consider giving appreciated property to children or grandchildren if they are in a lower tax bracket than your own. For 2005, each person is entitled each year to give gifts of \$11,000 to an unlimited number of donees without incurring any gift tax. For example, you can annually give \$11,000 to each of your children, their spouses, and your grandchildren without utilizing any of your applicable credit amount. Your spouse can agree to "gift-split" thus doubling the amount of these gifts. (The applicable credit available against the gift tax is \$1 million in 2005.)

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 2006 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 2005, including §529 qualified tuition programs, the above-the-line deduction for teachers for classroom-related expenses, and the deductions for qualified electric vehicles and clean-fuel vehicle property (which terminates for property placed in service after December 31, 2005, but replaced with a credit, discussed above).

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. I 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 2005 tax liability.