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Year-end Individual Income tax Strategies

Individuals in most income categories can manage taxes through the timing of income, deductions, credits and income shifting. When you defer income into future years, while accelerating deductions and credits into the current year, you minimize the amount of your current taxable income. Nevertheless, all planning must consider multiple years to be truly effective and therefore it is important to run your numbers under both regular tax and the Alternative Minimum Tax (AMT) for the current year as well as for future years to derive the maximum tax benefit.

This may be a good time to review some tax planning strategies that may help reduce your overall income tax burden. While there has not been any major income tax reform affecting individual taxation this year, there are a few relatively new and basic twists to include in a year-end review. Let us discuss some ***new legislations*** and the related year-end income tax strategies.

1) Alternative Minimum Tax

Tax Increase Prevention and Reconciliation Act (TIPRA) has increased and extended the AMT exemption amount to $62,550 for joint filers and $42,500 for single filers through the end of 2006. It now permits certain new credits, such as the dependent care credit, credit for the elderly and disabled, energy –saving credits, tuition credits and certain homeowner credits also for AMT purposes. Previously, credits were allowed to the extent that the taxpayer had regular income-tax liability in excess of the tentative minimum tax, disallowing them for AMT purposes but now they can be used to set off entire regular tax and AMT liability through the end of 2006.

A strategy that is beneficial for regular tax purposes can backfire for AMT purposes because of differences in how the IRS handles certain deductions and income exclusions. For example, AMT is a flat tax rate of 28%. Therefore, for most of the taxpayers in 35% tax bracket, it may be beneficial to accelerate income instead of reducing into 2006 so that it is taxed at the favorable 28% rate. Time value of money must be considered whenever you accelerate income that would not be taxed until a later time. Also, it may be wise to delay instead of accelerating deductions until a later year when you will not be in the AMT so those deductions can be used when they produce a 35% tax benefit.

If you project that you will be in AMT for 2006, but will not be in AMT for 2007, consider deferring paying real estate taxes, state taxes, year end contributions, investment fees and other miscellaneous itemized deductions until January of 2007.

2) Kiddie Tax

The tax law requires children who have more than a small amount of unearned income ($1,700 in 2006) to pay tax on that excess income at their parents' marginal tax rate. Beginning in 2006, the kiddie tax applies to children under age 18 (formerly, age 14). Due to this change, higher-income parents should consider investing any assets put aside for their under-age-18 children in investments that generate little or no current taxable income (such as U.S. savings bonds, municipal bonds, or growth stock index funds). Also, parents can explore the strategy of shifting income to children, grandchildren or other individuals over age 18 in a lower income bracket. However, such strategy must also be coordinated with a family's overall wealth transfer strategy, bearing in mind the gift tax exemptions and exclusions.

3) Reduced tax rate on capital gains and qualified dividend income

The top tax rate of 15% (or 5% for lower-income taxpayers) on capital gains and qualified dividend income was set to expire at the end of 2008. TIPRA has extended these reduced capital gain and dividend rates through 2010. In 2011, the rates will revert back to the former income tax rates. Individuals who are business owners of closely held corporations should give thought to taking advantage of the lower tax rates on dividend income.

4) Hybrid Vehicles

The tax credit for hybrid vehicles applies to those purchased on or after January 1,2006 and could be as much as $3,400 for those who purchase the most–fuel-efficient vehicles. Starting in 2006, this tax credit replaces the tax deduction of $2000, previously allowed for taxpayers who purchased a new hybrid vehicle before December 31,2005 for the clean-burning fuel deduction. The tax credit requires a different certification. Many currently available hybrid vehicles may qualify for this new tax credit, but the specific amount of the credit varies from model to model of eligible vehicle. If you purchase and take possession of a qualified hybrid motor vehicle in 2006, don't overlook the hybrid tax credit.

5) Charitable Gifts from IRAs

The Pension Protection Act of 2006 allows IRA holders who are 70-1/2 and older to make charitable contributions of up to $100,000 for 2006 and again in 2007 only from their IRAs without realizing income. So, those who are charitably inclined and wish to maximize this temporary benefit, the transfer from IRA to charity must be completed in 2006 for this year's $100,000 benefit cap to apply; the benefit is not cumulative and cannot be carried over to make $200,000 income-tax-free in 2007.

6) Roth Conversions

Earlier this year, TIPRA removed the income limit for high earners who want to convert their traditional Individual Retirement Account to a Roth IRA. While elimination of the $100,000 income limit to convert traditional IRAs to Roth IRAs under TIPRA doesn't start until 2010, maximizing that opportunity can begin in 2006 with maximizing contributions in 2006 and each year thereafter to a nondeductible IRA that can then be converted into a Roth in 2010.

7) Charitable Donations

Taxpayers wishing to deduct charitable donations of cash, clothing, household items and other items must conform to stricter rules. Charitable donations of cash, check, or other monetary gifts are allowed only if the donor can provide a bank record or written communication from the charity indicating the contribution amount, the date the contribution was made, and the name of the charity.

New rules apply to contributions of clothing and household items made after August 17, 2006. In general, the items must be in "good" condition. However, you can still deduct the value of an item that isn't in good if the value of the donation is more than $500 and you include a qualified appraisal with your tax return.

We will discuss some proven year-end tax strategies for individuals in our next issue.

Important note: Many exceptions, definitions, and special rules in the law have been paraphrased, simplified, and/or omitted. Readers should not take specific action based on this summary without first consulting the statute and regulations or seeking advice from a qualified professional.

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