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Year-end Individual Income tax Strategies

In our last month's Newsletter we discussed some new tax legislations giving short-term relief on simmering issues like, Alternative Minimum Tax, a two-year extension to 2010 on the 15% top tax rate on capital gains and qualified dividend income, Kiddies tax, hybrid Vehicle credit, Roth Conversions, Charitable Donations and Charitable Gifts from IRAs and the related year-end tax planning tools. In this newsletter we will discuss some proven strategies that may help you reduce your taxes once again this year.

The most basic form of year-end planning involves pushing tax bills into the future by deferring income into the next year, accelerating deductions into the current year and shifting Income. The steps that individuals take now can reduce their 2006 federal tax bills and put them in better position to pay less in 2007 and beyond.
Let us look at some common individual situations and relevant tax strategies.

1) Cash Method of Accounting: Opportunities to manage taxes are greater for taxpayers on a cash basis of accounting. If you are self-employed and use the cash method of accounting for income-tax purposes, time late 2006 customer billings so that payment won't be received until 2007.

2) Bonuses: You can delay receipt of anticipated bonuses or incentive compensation coming to you to defer taxation until a future year so that these amounts will not be taxed on your return in 2006. Ask your employer to defer paying your 2006 year-end bonus until early 2007. (The employer may still be able to claim a deduction on its 2006 tax return.)

3) Capital Gains and losses: You can use capital gains or losses within your accounts to offset each other so you don't have to pay tax on realized gains in the current year. So, if you have a few loser stocks that you wouldn't mind unloading, now is the time. You can sell them to wipe out all your realized capital gains for the year, plus another $3,000 ($1,500 for married filing separately) in regular income. The balance of any loss will carry over to next year. Be careful to avoid a wash sale — i.e. buying the same security within 30 days before or after you dump shares. Tax rules disallow the loss if such practice is adopted.

You also need to be mindful of the length of time that you have held the investment – favorable long-term capital gain rates are applicable when you have held the property for more than one year. Don't spoil the favorable long-term capital gain rate with a short-term capital loss.

4) Convert non-deductible interest to Deductible interest: Interest expense on personal auto loans, credit cards, and most student loans offers no tax deduction. However, interest on home equity loans and investment loans is tax deductible within certain limits. For example, if you have $35000 ready in the bank and you are planning to buy a car and some stock, make sure you use the money to buy the car and get a loan to buy the stock. This will maximize your interest expense deduction and avoid the borrowings on which interest is not tax deductible.

5) Deductible Interest & Real state Taxes: Consider making your January 2007 mortgage payment (which includes December's interest) in late December 2006, so that the mortgage interest will be deductible on your 2006 return (applicable only if you itemize deductions on your income-tax return). You can prepay in December real estate taxes due in January or February.

6) Medical and Miscellaneous Itemized Deductions: Your deductions are limited to the amounts that exceed 7.5% of adjusted gross income for medical expenses and 2% of adjusted gross income for miscellaneous expenses. Bunching two years of your or your family's unreimbursed medical or miscellaneous itemized expenses (such as certain job-related expenses and investment expenses) into one year may allow you to surpass the deduction floors and help you gain an itemized deduction for part of your expenses.

7) Retirement Contributions: Maximize 2006 contributions to any tax-deferred retirement savings plan in which you participate, such as a 401(k) plan or a 403(b) tax-sheltered annuity. If you are age 50 or older, you may be able to make additional "catch up" contributions to your plan.

8) Charitable Contributions*:* If you are planning to make a charitable donation in early 2007, consider a 2006 year-end donation instead. Contributions charged on your credit card in 2006 count as 2006 deductions, even if you don't receive or pay the credit card bill until 2007.

A popular retirement savings alternative for individuals who are self-employed is SEP IRA. Contributions to the plan are tax deductible within certain limits, it is relatively easy to establish, and there are no annual compliance burdens to maintain. Therefore, self-employed individuals who do not already have a tax-deferred retirement plan should consider starting one before year-end.

9) Passive Activity: Dispose of a passive activity with suspended losses. When a passive activity has suspended losses, those losses become deductible in the year the activity is sold.

10) Installment Sales: Consider an installment sale of property rather than collecting all proceeds this year.

11) Tax Liability: Finally as it comes upon year-end, be sure you have had enough withholdings, or paid in enough estimated tax. You don’t want to be in a position where you will be penalized for underpaying taxes, nor do you want to give the government an interest-free loan.

Income deferral and expense acceleration strategies are especially effective if you expect to be in the same or a lower tax bracket in the year in which you will be reporting the income on your tax return. However, if you are a high earner facing a limitation on your itemized deductions or if you expect to be in a much higher tax bracket in 2007, deferring income and accelerating payments into 2006 may not be your best course of action. In addition, if you claim high deductions in 2006, you may be subject to the alternative minimum tax.

Two important factors should be kept in mind for application of above-mentioned planning tools: -

• Most strategies must be completed before Dec. 31 to affect 2006 tax levels.

• Only a number of tax-saving opportunities are highlighted here. There are many other tax planning strategies to consider with the assistance of a tax adviser taking into account your individual tax situations.

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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