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To Our Clients and Friends,

With the current year winding down, it's time once again to consider year-end tax planning as a way to keep more of your hard-earned money. Year-end planning changes each year due to changing tax rules, as well as changes in your own personal financial and tax situations. For 2006, there are new planning strategies resulting from the two Tax Acts Congress has passed so far this year, as well as the phase-in and expiration of some provisions of prior year Tax Acts. Here are a few tax-saving ideas to get you started. As always, you can call on us to help you sort through the options and implement strategies that make sense for you.

Know Your Alternative Minimum Tax Exposure

The first step in year-end planning is to see whether you might be subject to AMT this year (or next year for that matter). Taxpayers must compute their taxes under both the regular tax and AMT rules and then pay the greater of the two. The current rules encompass many unsuspecting taxpayers. However, some AMT tax relief was granted this year in the form of higher AMT exemptions for 2006. AMT greatly complicates tax planning because many great planning strategies that work in a regular tax situation have adverse consequences for AMT.

Certain items can increase your risk of AMT, including exercising incentive stock options, recognizing substantial long-term capital gains, and deducting a significant amount of state and local taxes or miscellaneous itemized deductions (like unreimbursed employee business expenses). But no one is safe from AMT anymore, and planning when AMT applies is tricky because each situation is unique. Therefore, if you have any of the items mentioned or suspect AMT might be an issue, please contact us so we can help you review and plan for your particular situation. Now that we've addressed the AMT matter, let's move on to a variety of tax planning strategies that normally apply to the vast majority of taxpayers—that is, those in a regular tax situation.

Business Planning

Expense the Cost of up to $108,000 of Business Property - The Section 179 deduction allows business owners to deduct up to $108,000 of the cost of qualifying depreciable property placed in service in 2006. Property eligible for the immediate tax write-off can be new or used and includes "off-the-shelf" computer software. (Even property purchased on the last day of the year qualifies.) However, the allowable deduction cannot exceed your business's net income and is reduced dollar-for-dollar to the extent the amount of qualifying property placed in service during the year exceeds $430,000. If you have plans to buy a business computer, office furniture, equipment, vehicle, or other tangible business property, you might consider doing so before year-end to maximize your 2006 deductions.

Pay Dividends in Lieu of Owner Salaries - If you expect to personally be in the 28% or higher tax bracket for 2006 and you own a C corporation that you expect to be in the 15% income tax bracket (taxable income of $50,000 or less), you could net more cash after taxes by paying yourself some dividends in lieu of additional salary. This is because dividend income is subject to a maximum 15% tax rate, while your salary is subject to your 28% or higher tax rate, plus you and your corporation must pay payroll taxes on your salary.

Any dividends paid to you must be paid to other owners as well. Thus, if there are multiple shareholders, paying dividends could alter the bottom-line cash flow reaped by the various shareholders, which may make this strategy unworkable in some situations. However, in the context of family-owned C corporations, this may be a good thing—a family recipient who is in the 10% or 15% tax brackets (which many children are) will pay taxes of only 5% on this dividend income.

New Twists for Charitable Donations

Another common year-end planning strategy is to increase charitable donations. However, this year offers some new twists.

Tax-free IRA Distributions to Charity - Taxpayers who are age 70_ or older may temporarily (in 2006 and 2007) be able to claim tax-free treatment for otherwise taxable distributions from traditional IRAs, when the IRA money is paid out *directly* to a tax-exempt charity. This new "qualified charitable distribution" is subject to a $100,000 annual cap. Since the qualified charitable distribution is federal-income-tax-free, you don't get any federal income tax deduction for the contribution. However, the income exclusion is definitely better than a deduction for seniors who might not otherwise itemize deductions. It may also pay off even if you do itemize by reducing taxable Social Security and increasing itemized deductions restricted by the adjusted gross income (AGI) limitations.

Changes for Gifts of Clothing and Household Items - The Pension Protection Act of 2006 raised the bar for the quality of used clothing and household items qualifying for a charitable deduction. After 8/17/06, generally you can no longer deduct donations of used clothing and household goods unless they are in "good used" or better condition. So, no more write-offs for that "junk" piling up in your closet, attic, garage, or basement. Unfortunately, the new law doesn't define "good used" or better condition. Fortunately, donations of used clothing and household items that are in good or better condition continue to be tax deductible and still present a great tax saving opportunity for taxpayers who itemize their deductions. Eligible household items include furniture and furnishings, electronics, appliances, linens, and similar items. However, be sure to keep a list and a photo (to help establish the item's condition) of the donated items.

You can still deduct individual items that appraise for more than $500 even if they are not in "good condition." However, this will require you to get a qualified written appraisal, which must be attached to your tax return.

Reap Tax Savings with Energy Efficient Purchases

Residential Credits for Energy Efficient Improvements - For 2006 or 2007, there are two new tax credits available for energy efficient improvements made to your home:

1. **Nonbusiness Energy Property Credit.** This credit is generally limited to a lifetime amount of $500, although other limits may also apply. Basically, the credit will equal (a) 10% of what you pay for qualified energy efficiency improvements (such as, certain energy efficient insulation, windows, doors and roofs), plus (b) 100% of what you pay for qualified residential energy property (such as, certain energy efficient heat pumps, hot water heaters or boilers, and advanced main air circulating fans) on your principal residence (no vacation homes).

2. **Residential Energy Efficient Property Credit**. This credit equals 30% of expenditures for the following types of equipment: (a) qualified solar water heating equipment (limited to a maximum credit of $2,000), (b) qualified electricity generating solar photo voltaic property (maximum credit of $2,000), and (c) qualified fuel cell property (maximum credit of $500 for each .5 kilowatt of capacity). The credit only applies to equipment you place in service in your personal U.S. residence, and it cannot be claimed for equipment used to heat a swimming pool or hot tub. The credit for fuel cell property is only available for your principal residence; however, the two solar credits apply to any residence (including vacation homes).

You can rely on the manufacturer's certification that the property qualifies for the credit. If you're planning on making any of these improvements to your home in the near future, you'll want to do so before the end of the year if there's any possibility you'll be subject to AMT this year or the next. Why? These credits can be used to offset AMT in 2006, but absent Congressional action, they won't be in effect in 2007.

Hybrid Vehicle Credit or Alternative Fuel Motor Vehicle (AFMV) Credit - If you are considering a hybrid vehicle or AFMV purchase in the near future, please give us a call. The IRS is constantly updating the list of vehicles that qualify for tax credits. The hybrid credits vary in amount by vehicle with the maximum credit being $3,400. The AFMV credits can be up to $4,000 per vehicle.

The full hybrid credit is available only up until the end of the quarter in which the manufacturer records the sale of the 60,000th vehicle. For the second and third calendar quarters following the sale of the 60,000th vehicle, the credit is reduced to 50% of the full credit. For the fourth and fifth calendar quarters, taxpayers may claim only 25% of the full credit. No credit is allowed after the fifth quarter—so the early bird gets the worm.

Education Planning

529 Plan Benefits Now Permanent - The Pension Act of 2006 made permanent the current ultra-favorable federal income tax treatment of Section 529 plans used to finance college education costs. Of particular importance, qualified Section 529 plan distributions (i.e., those used for qualified higher education expenses) will continue to be federal-income-tax-free, even after 2010 when they were previously scheduled to be taxable again. This eliminates the concern that funds distributed after 2010, when many 529 plan beneficiaries would be in college and withdrawing the plan assets for educational expenses, could be taxed. If you haven't previously taken advantage of these plans, it may be time to reconsider them.

Investment Planning

Lower Tax Rates on Capital Gains - Long-term capital gains and qualifying dividend income are subject to a tax rate of only 15% for taxpayers in a regular tax bracket of 25% or higher and 5% for taxpayers in the lower regular tax brackets. Given tax rates as high as 35% for other types of income, this is quite a break. To be eligible for the lower 15% (or 5%) capital gain rate, a capital asset must be held for more than a year. So, when disposing of your appreciated stocks, bonds, investment real estate, and other capital assets, pay close attention to the holding period. If it's less than one year, consider deferring the sale so that you can meet the greater-than-one-year period. While it's generally not wise to let tax implications drive your investment decisions, you shouldn't ignore them either.

When selling stock or mutual fund shares, the general rule is that the shares you acquired first are the ones you sell first. However, if you choose, you can specifically identify the shares you're selling when you sell less than your entire holding of a stock or mutual fund. By notifying your broker of the shares you want sold at the time of the sale, your gain or loss from the sale is based on the identified shares. This sales strategy gives you better control over the amount of your gain or loss and whether it's long-term or short-term.

Harvesting Capital Losses - It's always a good idea to periodically review your investment portfolio to see if there are any losers you should sell. This is especially true as year-end approaches, since it's the last chance to offset capital gains recognized during the year or to take advantage of the $3,000 ($1,500 for married separate filers) limit on deductible net capital losses. But, don't forget the wash-sale rule. This rule defers your loss if you purchase a substantially identical security within the period beginning 30 days before and ending 30 days after the date of sale.

Retirement Planning

IRA Contributions - Don't forget to make your traditional or Roth IRA contributions before the due date (4/16/07) of your tax return. For 2006, IRA contributions generally can be made up to the lesser of (1) $4,000 ($5,000 if age 50 or older by the end of 2006) or (2) 100% of compensation. Compensation includes wages, salaries, other amounts derived from or received for personal services actually rendered including self-employment income, and alimony. For married couples, IRA contributions up to $4,000 ($5,000 if age 50 or older by the end of 2006) can be made for each spouse if the combined compensation of both spouses is at least equal to the contributed amount and they file a joint return.

The contribution limit applies to the combined contribution to all of the taxpayer's traditional and Roth IRAs. Thus, an under age 50 taxpayer who contributes $4,000 to a Roth IRA cannot also contribute to a traditional IRA, and vice versa. Allowable contributions can also be split between the two in any fashion (e.g., $4,000 contribution split so $1,500 goes into a traditional IRA and $2,500 into a Roth IRA).

Allowable contributions to traditional IRAs are fully deductible if the taxpayer (and spouse, if married) is not an active participant in an employer-maintained retirement plan. However, if the taxpayer (or his or her spouse) is an active participant in an employer plan and modified adjusted gross income (MAGI) exceeds certain limits, the taxpayer cannot deduct the full amount of the IRA contribution - deductible IRA contributions phase-out when MAGI reaches $75,000–$85,000 for a joint return and $50,000–$60,000 for single and head of household.

Strategies That Never Go out of Style

Manage Your AGI (Adjusted Gross Income) - Many tax breaks are only available to taxpayers with AGI below certain levels. Some common AGI-based tax breaks include the child tax credit (phase-out begins at $110,000 for married couples and $75,000 for heads-of-households), the $25,000 rental real estate passive loss allowance (phase-out range of $100,000–$150,000 for most taxpayers), and the exclusion of social security benefits ($32,000 threshold for married filers; $25,000 for other filers). In addition, taxpayers with 2006 AGI in excess of $150,500 begin losing part of their itemized deductions, to the extent of 3% of the excess. Accordingly, strategies that lower your income or increase certain deductions might not only reduce your taxable income, but also help increase some of your other tax deductions and credits.

Defer Income and Accelerate Deductions - The most common year-end tax planning strategies are those that defer income from the current year to later years and those that move deductions from later years into the current year. The underlying reason is that it's better to pay taxes later rather than sooner due to the time value of money.

How do you shift income and deductions between tax years? The most common techniques are using income or deductions that you can easily control. For example, cash-basis sole proprietors might delay year-end billings so that they fall in the following year. Of course, before deferring income, you must assess the risk of doing so. On the investment side, income from short-term (i.e., maturity of one year or less) obligations like Treasury Bills and short-term CDs is not recognized until maturity. Income from those straddling year-end is deferred to the following year. For sales of property, consider an installment sale that shifts part of the gain to later years when the installment payments are received.

On the deduction side, move charitable donations or medical expenses that you normally would make in early 2007 to the end of 2006. Do the same with real estate taxes or state income taxes. If you own a cash-basis business, accelerate the payment of certain expenses, such as office supplies and repairs and maintenance, to 2006.

Adjusting Federal Income Tax Withholding - If it looks like you are going to owe income taxes for 2006, consider bumping up the Federal income taxes (FIT) withheld from your paychecks now through the end of 2006 so that your total tax payments (estimated payments plus withholdings) equal at least 90% of your estimated 2006 liability or, if smaller, 100% of last year's (2005) liability (110% if your 2005 AGI exceeded $150,000). On April 16, 2007, you may still have to pay the taxes due less the amount paid in, but you won't owe an underpayment penalty.

Conclusion

Taking the time now to review your 2006 tax situation gives you a chance to take advantage of many year-end tax saving opportunities. This letter highlights selected strategies, but there are many others that might also apply to your particular situation. We are here to help. If you would like to discuss the strategies mentioned here or other ideas for reducing your 2006 tax liability, please don't hesitate to call us. We would be pleased to set up a meeting within the next few weeks while there's still time to implement tax strategies before year-end.

Best regards,

Michael D. Wittenberg, CPA, PS