

“Get ready for your year-end tax planning, 2006-style”

Year-end tax planning opportunities abound this year. They do so not only because it has been a particularly active year for tax legislation, but also because of other significant tax developments taking place in 2006, as well as changes from pre-2006 tax legislation that have a particular impact this year and next.

Traditional year-end tax strategies should not be abandoned. Income should either be accelerated or postponed between 2006 and 2007, depending upon the anticipated tax brackets for each client. Similarly, deductions and credits should be manipulated to lower income either in the more favorable year or, in some cases, in both years, before midnight, Dec. 31, 2006, has come and gone.

Within the framework of traditional strategies, however, is a list of 2006-based developments that either should be combined with tried-and-true traditional year-end techniques or should be added as new strategies. Here's our list.

Manufacturing deduction

❖ **Percentage rises.** The manufacturing deduction cap rises from 3 percent to 6 percent of qualified production activities income starting in 2007. Taxpayers should follow their method of accounting to determine when to take deductions. If domestic production gross receipts and the corresponding expenses are recognized in different tax years, taxpayers must take receipts and expenses in the year they are recognized.

❖ **W-2 cap drops.** Moving more qualifying income into 2007 to gain another three percentage points in the deduction generally makes sense. However, a new W-2 wage limit to the deduction may in fact encourage taxpayers to accelerate the deduction. Under this year's Tax Increase Protection and Reconciliation Act, the 50-

percent-of-W-2-wages limit on the amount of the deduction taken each year has been reduced significantly for many businesses.

Effective for tax years beginning after May 17, 2006 (that is, 2007 for calendar year businesses), TIPRA limits the W-2 wage amount to wages paid in the manufacturing process, rather than to all employees a significant difference. Accelerating manufacturing gross receipts into 2006, therefore, may provide the larger deduction as between 2006 and 2007 for some businesses.

More TIPRA changes

❖ **Higher Kiddie Tax age coverage.** Those parents who before TIPRA, had been planning to sell much of their child's portfolio when she turns 14 in 2007 need to be advised now of the new rules. The magic age for not being subject to the Kiddie Tax has been raised to 18. The new cutoff age is effective retroactively to Jan. 1, 2006. Therefore, clients need to worry immediately about timing the sale of investments for minors between 14 and 18 both this year and in 2007.

❖ **Roth conversions.** 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.

❖ **Working abroad.** The new computation of the foreign housing allowance under TIPRA will significantly increase the cost for foreign employees (and indirectly for employers that subsidize them), especially in areas with high housing costs and low tax rates. Retroactive to Jan. 1, 2006, the maximum anticipated 2006 housing-allowance

exclusion will be \$11,536. Year-end planning might include preparing either the employee of the employer to pay this new cost of working abroad.

Pension Protection Act

❖ **Cash donations.** Starting in 2007, the PPA requires cash donations of any size to be backed up by paperwork that includes either a cancelled check or a written note from the charity indicating the amount, the date and the name of the charity. Prior to 2007, there was a question as to the amount of proof required for small contributions of less than \$250 that would justify taking a charitable deduction.

❖ **Clothing and household items.** With the cash donation rule starting in 2007, taxpayers may assume a similar start date for the PPA rule on donating old clothing or household goods not at least of “good condition.” They should be apprised of the Aug. 17, 2006, trigger date for that provision.

❖ **Special IRA contributions rule.** For each of 2006 and 2007 only, the PPA 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. For those who 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.

❖ **Food and book donations.** The PPA extended the liberalized deduction for food and book inventory available to all businesses for two years, through 2007.

❖ **And more.** Also temporary for 2006 and 2007 only under the PPA is the higher contribution base allowed for donations of real property for conservation purposes, as well as a special stock-basis adjustment for S corporation donations.

Energy Tax Act

❖ **Hybrid vehicle credit.** A full alternative motor vehicle credit must begin to be phased out pursuant to the Energy Tax Act for vehicles manufacturer during the second quarter following the quarter in which hybrid vehicles sales by that manufacturer exceed 60,000 units.

Since Toyota Motor Co. exceeded the 60,000 level at the end of the second quarter, purchasers of all Toyota hybrid vehicles (which includes the Lexus brand) during the Oct. 1, 2006, to March 31, 2007, period are entitled to only a 50 percent credit. For the moment, however, other manufacturers do not appear in danger of surpassing the 60,000 mark anytime soon.

❖ **Residential energy credit.** The Energy Tax Incentives Act of 2005 created several new credits that apply to property placed in service after Dec. 31, 2005, but before Jan 1, 2008. A limited-time credit of up to \$500 is available for the installation of non-business energy property such as central air conditioning, heat pumps, water heaters, furnaces, insulation, and residential exterior doors and windows. Homeowners can also receive a limited-time credit for installing solar water heaters (except for hot tubs and swimming pools), solar electricity equipment and fuel cell plants.

The \$500 credit is a total amount available for 2006 and 2007 combined, while those who install solar equipment at least hypothetically may receive a credit of \$2,000 per type of equipment for each year, and fuel cell plants entitle taxpayers to \$500 for each half-kilowatt of capacity installed per tax year.

Guidance and case law

❖ **Nonqualified deferred compensation.** The Code Section 409A nonqualified deferred compensation rules have given many businesses major compliance headaches. New regulations had insisted that the effective date be a firm Jan.1 2007, for complete compliance. Now, there are signs that the IRS will extend this date. However, at press time that action had not yet been taken.

In Notice 2006-33, the IRS provided another grace period for nonqualified deferred comp plans to comply with Code Sec. 409A(b). Deferred comp plans using offshore “rabbi” trusts or financial health triggers now have until Jan. 1, 2008, to conform to the new rules.

❖ **Bonus depreciation.** Announcement 2006-29 extended for one year the deadline for certain hurricane-affected taxpayers to place property in service to claim first-year bonus depreciation. Taxpayers impacted by Hurricane Katrina, Rita or Wilma now have until Dec. 31, 2006, to place property in service so that they can claim 50 percent bonus depreciation under Code Sec. 168(k)(4).

❖ **Simple IRA plans.** In early 2006, the IRS extended the time for employers to amend their Simple IRA plans to be in compliance with the Economic Growth and Tax Relief Reconciliation Act of 2001. Employers now have until Dec. 31, 2006 to amend their plans. The likelihood of another extension is not great. Noncompliant plans run the risk of losing the tax benefits associates with these plans.

❖ **Advanced trade discounts.** In *Westpac Pacific Food* (CA-9, June 21, 2006), the Ninth Circuit Court of Appeals, reversing the Tax Court, held that cash paid in advance by a wholesaler to an accrual-method retailer, in exchange for a volume commitment, was not gross income at the time received. Since the retailer had to pay

back the cash if it did not follow through on its purchase commitments, the appellate court reasoned that the cash should be treated as a security deposit and not taxed until the purchases were completed.

Unfortunately, this decision sets up a split in opinion on how to treat cash that is paid as “advance trade discounts.” The Tax Court held that it was income because it had “unfettered control” of the cash. The Ninth Circuit focused on the fact that the taxpayer had to pay back the cash advance if subsequent purchases were not made. The issue has not been addressed yet by other circuit courts of appeal.

❖ **ISOs.** In *Montgomery* (127 TC No. 3), the Tax Court has rejected a taxpayer’s end-run argument around the \$100,000 annual limit on options that qualify as incentive stock options. There, the taxpayer unsuccessfully claimed that the \$100,000 limitation is only applied to shares that are not subject to a subsequent disqualifying disposition during the same tax year in which the share are acquired.

❖ **Co-op arrangements.** Deferring “value-added” payments to a farmer-taxpayer from a cooperative’s sale of corn didn’t work in *Sherbart* (CA-8, July 13, 2006). The court found that there was no sale, since the taxpayer was a member of the co-op and, therefore, no installment sale was possible.

Furthermore, the deferred payment was a self-imposed limitation which would not defer tax.

❖ **AMT computation.** The Tax Court in *Merlo* (126 T.C. No. 10) refused to allow taxpayers with useless incentive stock options a way out from having to pay the full alternative minimum tax on gains they never enjoyed. The court held that an individual computing AMT income cannot carry back stock losses to reduce AMTI. The

same rules that restrict carryback losses to an individual's regular tax also apply to the determination of AMTI.

❖ **Tax-sheltered annuities.** The effective date of 403(b) regulations on tax-sheltered annuities recently was extended one more year, to Jan. 1, 2008. This avoids a year-end rush in 2006 to amend retirement annuity contracts available to employees of public schools and 501(c) (3) organizations.

Pending legislation

At press time, some year-end tax planning must remain up in the air, with taxpayers remaining flexible enough to react appropriately when the time comes.

Many popular but temporary tax breaks expired after Dec. 31, 2005. H.R. 5970, the "extenders" bill before Congress as of December 1, 2006 would extend most through Dec. 31, 2007. Incentives that would be retroactive to Dec. 31, 2005, include:

- ❖ State and local sales tax deduction;
- ❖ Above-the-line higher education tuition deduction;
- ❖ Archer Medical Savings Accounts;
- ❖ Teacher's classroom expense deduction;
- ❖ Work Opportunity and Wel-fare-to-Work tax credits (combined for 2007);
- ❖ The Indian employment tax credit and other Native American incentives;
- ❖ Percentage depletion for oil and natural gas produced from marginal properties; and,
- ❖ Special tax incentives for the District of Columbia.

Provisions set to be modified and extended through Dec. 31, 2007, are:

- ❖ Brownfields remediation expensing;

- ❖ Deduction for corporate donations of scientific property and computer technology;
- ❖ New markets tax credit;
- ❖ Research tax credit (with enhancements for 2007); and,
- ❖ Zone academy bonds.

The extenders bill would also permit manufacturers in Puerto Rico to take the Code Section 199 deduction, grant a deduction for premiums for mortgage insurance and create a deduction for qualified timber gain.

The Congressional Research Service this past April issued another report encouraging lawmakers to re-examine what it calls “the sport utility vehicle loophole.” It observed that the American Jobs Creation Act of 2004 simply limited the cost of and SUV that may be expensed under Code Sec. 179 to \$25,000, rather than \$100,000 (\$108,000 inflation-adjusted).

Since congressional action to curtail the deduction may take place in 2007, purchasing the SUV in 2006 may make sense from that perspective.