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Dear Clients and Friends:

Year-end planning also may turn out to be more of a “last minute” challenge this year than most because many deductions that expired at the end of 2005 may be retroactively extended by Congress in time for you to capitalize on them before year-end. These expired tax breaks include the above-the-line deductions for educators, the above-the-line deductions for higher education expenses, and the election to deduct state and local general sales taxes instead of state and local income taxes.

**RECENT CHANGES FOR 2006**

**NEW DEDUCTION – DOMESTIC PRODUCTION DEDUCTION** – Do you have any of the following activities: manufacturing (including computer software, music recording and film production), farming, construction, renovation of real property, engineering or architectural services? You may qualify for a NEW deduction if you also have taxable income and pay W-2 wages. The deduction is basically 3% of the net income from the activity for 2006 and 6% for 2007. The calculation is complex.

**A CHOICE!?! – FOR 2006 DEDUCT EITHER SALES OR INCOME TAX** – You now have the choice of deducting either sales tax or state income tax as an itemized deduction on your tax return. In determining the amount of sales taxes you deduct, you can either use tables provided by IRS (plus tax amounts on purchases of large items, i.e. car, boat) or you can collect receipts on all of the purchases you make during year

**SPORTS UTILITY VEHICLES USED FOR BUSINESS BOUGHT AFTER 10/22/04 NO LONGER QUALIFY FOR 100% WRITE-OFF!!! (Post 10/22/04)** – However, the business deduction can still be large. Example, you buy a new \$65,000 SUV with gross vehicle weight over 6,000 pounds:

		<u>2006</u>	
Cost	\$ 65,000	\$ 25,000	179 Depreciation
Remaining cost	40,000	<u>8,000</u>	Normal Depreciation
		<u>\$ 33,000</u>	Total 1 <sup>st</sup> year Depr

If this were an expensive car, the limit on depreciation would be only \$2,960. But is the loophole really closed? **PLEASE NOTE** – If this were an over 6,000 pounds GVW truck

(pickup with a cargo area of at least 6 feet in length that is separate from the passenger compartment) the deduction could still be \$65,000.

**New Depreciation Breaks Are Still Excellent**

In 2006 the one time, first year, write off (Sec. 179) of personal business property is \$108,000.

Example: Cost – New

Equipment (5 years)	\$208,000	\$(108,000)	Section 179 Depr
Remaining Cost	100,000	<u>(20,000)</u>	Normal depreciation
		<u>\$128,000</u>	Total depreciation, 1 <sup>st</sup> year

Thus, the total depreciation for 2006 is \$128,000, or over 60% of the cost.

Please note that 179 deduction is subject to limits in net income. Also any unused 179 deduction can be carried over. If you buy over \$430,000 of business equipment in any one year the amount eligible for 179 is reduced.

**NEW TAX CREDITS FOR 2006 - ENERGY-SAVING HOME IMPROVEMENTS** – Energy-saving home improvements in 2006 will also cut you tax bill. You can claim a tax credit for 10% of the cost of skylights, outside doors, windows and pigmented roofs, as well as for high-efficiency furnaces, water heaters and central air conditioners. The maximum credit is \$500, and no more than \$200 can be attributable to windows. These items must be installed in your primary home to qualify. For 2006, homeowners can also claim a 30% tax credit for the cost of solar energy systems used to heat air or water. Solar heaters for pools or hot tubs will not qualify. The credit is capped at \$2,000 apiece for home furnaces and water heaters. Arizona also offers a tax credit and APS and SRP offer rebates.

**CHANGES TO KIDDIE TAX** – beginning in 2006 unearned income over \$1,700 of children under age 18 (was 14) is now taxed at the parents highest marginal tax rate.

**OTHER TAX POINTS TO NOTE:**

- ✓ Self-employed health insurance deduction remains at 100%.
- ✓ Child tax credit is \$1,000.
- ✓ Dividend tax bracket remains at 15%.
- ✓ Standard mileage rates for vehicles in 2006 is 44.5 cents per mile for business usage. Mileage for charity, medical and moving were also adjusted.
- ✓ Social security wage base jumps from \$90,000 for 2005 to \$94,200 for 2006. This means for 2006 the non-Medicare portion of Social Security tax jumps to \$11,680 (\$5,840 employer, \$5,840 employee).

- ✓ There are credits that apply to cars with good fuel economy. Although the credit phases out after the manufacturer sells its 60,000<sup>th</sup> hybrid, the squeeze won't affect buyers until 2007.

- ✓ Standard mileage rates for vehicles:

	<u>2006</u>	<u>2007</u> (cents per mile)
✓ Business usage	44.5	48.5
✓ Medical and moving	18.0	20.0
✓ Charity	14.0	14.0

A taxpayer may not use the business standard mileage rate for a vehicle after using any depreciation method under the modified accelerated cost recovery system, after claiming a Section 179 deduction for that vehicle, for any vehicle used for hire, or for more than four vehicles used simultaneously.

### **GENERAL RULE OF PLANNING**

The general year-end tax planning rule of thumb is to defer income into the next year and accelerate deductions into the current year. If you expect a substantial drop in income next year, then this strategy is not for you.

#### **POSTPONE INCOME UNTIL NEXT YEAR:**

- Income from employment may not be easily switched from year to year, but there could be some flexibility for bonuses and commissions. If your company has a 401(k) or a Simple plan, consider investing your year-end bonus in the plan if you have not reached the maximum amount.
- Business owners have flexibility in deferring income. Sales and billing can be deferred until the following year.
- Social security recipients need to be aware that their Social Security can become taxable as it exceeds modified income of \$32,000 married, \$25,000 single. A sudden increase in other income may make Social Security as much as 85% taxable.
- Also, increases in income reduce amounts available for medical deductions and miscellaneous deductions, not to mention the general itemized deduction phase out for adjusted gross income over \$145,950 for joint filers.

## **TAKE DEDUCTIONS NOW:**

- **PAY STATE INCOME TAXES** – If you will owe state income taxes, pay them by year-end. Either have more state taxes withheld or make the state fourth quarter estimated tax payment in December rather than by January 15.
- **MEDICAL** – Remember **ALL** medical is fully deductible in Arizona. Schedule and pay for medical deductions by year-end (eyeglasses, dental, surgery, etc.). Remember, medical is subject to federal limitations (7.5% of adjusted gross income), so it may pay to “bunch” them into one year instead of over two years.
- **BUSINESS DEDUCTIONS** – Prepay business expenses (some limits). Write off obsolete inventory at year-end. Write off bad accounts receivable and look for additional accounts payable at year-end (if on accrual basis). Look for business deductions that were paid personally but are really business related – for example business travel and entertainment, dues, subscriptions, etc. Autos and light trucks also benefit if they are used for business. Maximum first-year write off for vehicles has decreased to \$2,960.
- **DEDUCT POINTS PAID ON A HOME PURCHASE** – Mortgage points can be deducted in full by the buyer in year of home purchase. Same is true of points paid on home improvement loans. Points being amortized on an old loan may be fully deducted in the year of refinance.
- **MORTGAGE INTEREST** – You may deduct mortgage interest on two residences. The limits on the deduction are \$1,000,000 combined total mortgage on the two homes. You can also deduct the interest on an additional \$100,000 of home equity loans. Boats and motor homes qualify as residences if they have a stove, bed and toilet.
- **DONATE PROPERTY TO CHARITY BY YEAR-END (Used Car Rules Changed in '05!)** – Donated appreciated stocks and bonds generally get full fair market value deduction. For used clothing and household goods, make list (possibly take photos) and get receipt from charitable organization. Charities that sell auto must inform both donor and IRS of proceeds and that amount becomes deductible amount. The proceeds acknowledgement must be attached to the donor’s tax return.
- **CAPITAL LOSSES** – Please consider selling stocks and bonds that have a built in capital loss by year-end. You can deduct the losses fully up the amount of your capital gains (including capital gain distributions from mutual funds). In addition, if your losses exceed your capital gains you can deduct up to \$3,000 against ordinary income, such as wages. Any losses greater than the \$3,000 carries forward to future years.

- **REGULAR IRA ACCOUNTS**

- ✓ You can put \$4,000 to IRA for 2006 (Plus \$1000 additional catch up if you are over 50).
- ✓ Contributions to regular IRA accounts must be made by 4/16/06 to qualify for the deduction this year.
- ✓ You can contribute \$4,000 for a NON-WORKING SPOUSE.
- ✓ If you are covered by an employer retirement plan, you can still deduct an IRA contribution for yourself, but this deduction phases out when modified adjusted gross income for 2006 reaches between \$50,000 to \$60,000 for singles, and \$75,000 to \$85,000 for married filing joint.
- ✓ However, if you are covered by an employer retirement plan and your spouse is not, your spouse may make an IRA contribution if modified adjusted gross income is less than \$160,000.

- **ROTH IRA'S ARE GENERALLY TAX FREE FOREVER!!**

- ✓ If age 59 ½ and held 5 years, no tax on interest, dividends or appreciation.
- ✓ If age 59 ½ but not held 5 years, taxed but not penalties.
- ✓ If you are under 59 ½ and not held 5 years, both tax and penalties apply upon distribution.
- ✓ Nondeductible contributions of \$4,000 may be limited based on modified adjusted gross income.
- ✓ Can make contributions after age 70 ½ (unlike current IRAs).
- ✓ No required minimum distribution at age 70 ½.
- ✓ You may still be in employer retirement plan and have a ROTH IRA.

- **OTHER RETIREMENT PLANS** – Think about contributing more to your 401(k) or 403(b) plan at work. If self-employed, set up a Keogh plan by year-end. A SEP Plan may be set-up and funded as late as the extended due date of your 2006 tax return. A 401(k) for sole proprietors combines the deferrals of a 401(k) with the flexibility of a profit sharing plan. This also must be set up prior to year-end.

**AREAS OF SPECIAL INTEREST**

- **SALE OF PERSONAL RESIDENCE – NO TAX EVER ON \$500,000 GAIN!!** – Remember – homeowners can now exclude \$250,000 for single filers/\$500,000 for married filing joint filers of capital gain on the sale of a personal residence which you have owned and lived in for at least two years out of the last five years. THIS MEANS THAT MOST PEOPLE CAN EXCLUDE FOREVER MOST OF THE GAIN IF THEY LIVE IN AND OWN THE HOUSE 2 YEARS OR MORE. The home sale rules and regulations are very lenient. If you move because of change in employment, health, or

“special circumstances”, you can prorate the exclusion based on the amount of time in the home!

- **OFFICE IN HOME** – Beginning in 1999 the rules for home offices were somewhat relaxed. If the home office is used to conduct administrative or management functions of a business **and** there is no other fixed location where the taxpayer conducts substantial management functions, the deduction is available. The home office must still be exclusively used for business purposes.
- **SIX MONTH AUTOMATIC EXTENSION** – Individuals can receive a full six-month automatic extension in April, 2007 using Form 4868.
- **COLLEGE TAX CREDITS** – The Hope Credit, available in the first two years of post-secondary education, is 100% of the first \$1,000 of qualified expenses plus 50% of the next \$1,000 (maximum credit \$1,500). The Lifetime Learning Credit is equal to 20% of expenses up to \$10,000 (maximum credit \$2,000). Those credits are phased out based on income, the phase out begins at \$87,000 on a joint return. (Note: you cannot claim both credits for the same student). Nondeductible Coverdale Education Savings Accounts are \$2,000 per student.
- **STUDENT LOAN INTEREST** – You can deduct up to \$2,500 of interest paid on an education loan in 2005, but the deduction begins to phase out as your income exceeds \$50,000 for singles and \$105,000 for married filing joint.
- **TWO ARIZONA SCHOOL TAX CREDITS (UP TO \$1,400 FOR MARRIEDS)**
  - ✓ \$200 for single, \$400 for married for payment of fees to an Arizona public school for support of extracurricular activities.
  - ✓ \$500 for single, \$1,000 for married credit for a cash contribution to a school tuition organization that provides scholarships or grants to qualified schools.
  - ✓ In addition to credit, you get federal tax deduction!!

Thus, you may contribute to your child’s specific school activity and get a direct 100% credit on your Arizona income tax return. These are nonrefundable credits, but any unused credit will carry forward to next year.

- **OTHER ARIZONA CREDITS TO NOTE** – Cash contributions to charities that provide assistance to the working poor (such as Salvation Army, Food Banks and United Way etc) - \$200 single, \$400 married credit. There is a prior year itemized deduction test. Nonrefundable credit, unused credit carries forward to next year.

- **ESTATE AND GIFT TAXES – A CHANGING ENVIRONMENT** – The amounts you can pass on tax free to your beneficiaries is changing as follows:

2006 thru 2008	\$2,000,000
2009	\$3,500,000
2010	UNLIMITED!!!
2011	\$1,000,000

This is an area where the uncertainty needs to be eliminated by the government. It will be interesting to see if this happens with a Republican President and a Democratic Congress.

- **\$12,000 GIFTED PER YEAR REDUCES FUTURE ESTATE TAX** – You can gift to each donee per year without using your combined gift and estate tax credit (\$24,000 per donee if married). A donee is usually a child, grandchild or relative but can be anyone. Annual gifting can lower your taxable estate at your death. It does **not**, however, reduce your current year **income tax**.
- **GIFTING** – You may gift more than the \$12,000 annual amount, if you give tuition directly to an educational institution (for the benefit of your donee). Also you may gift over \$12,000 by gifting directly to a medical provider for the benefit of the donee.
- **FUND A QUALIFIED TUITION PROGRAM** – make gifts to a Section 529 Qualified Tuition Program (QTP) to fund future education for children or grandchildren. These gifts are removed from your estate and future distributions for education are not income to the beneficiary. One may normally gift up to \$12,000 per year per beneficiary.
- **SOCIAL SECURITY PAYBACK** – If an individual over 62 to age 65 is receiving Social Security and earning wages or self employment income, THEY MAY HAVE TO **PAY BACK** PART OF THE SOCIAL SECURITY RECEIVED! THE GOOD NEWS IS THAT NOW IF YOU ARE OVER 65 YOU DO NOT HAVE TO PAY BACK SOCIAL SECURITY RECEIVED NO MATTER WHAT YOUR EARNINGS ARE.

**CAPITAL GAINS AND DIVIDENDS STILL AT 15%** - Long-term capital gains are still at 15% (initially put in by the 2003 tax act). As long as you hold a capital asset (stock, bond, land, business goodwill, client list, trade name) one year and a day, you can benefit by the 15% tax rate. This is the lowest capital gains rate in years!!!!!! Arizona however has no beneficial capital gains rates and the gains are taxed at regular tax rates. Also, capital gains taxed in a regular corporation are taxed at the highest rates.

Dividends are still at the low 15% rate, this too is the lowest rate in years. (However, this seems to be fair since dividends are already taxed once at the corporate level.)

### **Tax Rate Schedules**

There are currently 6 major tax rates for individuals:

Single Individual 2006			Married – Joint 2006		
Taxable Income			Taxable Income		
Over	But Not Over	Tax Rate %	Over	But Not Over	Tax Rate %
\$0	\$7,550	10	\$0	\$15,100	10
7,550	30,650	15	15,100	61,300	15
30,650	74,200	25	61,300	123,750	25
74,200	154,800	28	123,750	188,450	28
154,800	336,550	33	188,450	336,550	33
336,550.....		35	336,550.....		35

Head of Household 2006			Married Filing Separate 2006		
Taxable Income			Taxable Income		
Over	But Not Over	Tax Rate %	Over	But Not Over	Tax Rate %
\$0	\$10,750	10	\$0	\$7,550	10
10,750	41,050	15	7,550	30,650	15
41,050	106,000	25	30,650	61,850	25
106,000	171,650	28	61,850	94,225	28
171,650	336,550	33	94,225	168,275	33
336,550.....		35	168,275.....		35

- Personal exemptions are \$3,300 per person for 2006
- Long term capital gains rates:
  - 5% if regular tax bracket < 25%
  - 15% NORMAL
  - 25% Depreciation Recapture on Real Estate
  - 28% Collectables (*i.e.* 1957 Chevy)

**A POTENTIAL NIGHTMARE FOR BUSINESS OWNERS – ARIZONA UNCLAIMED  
PROPERTY REPORTS!!!**

**Businesses Beware:** Have you written any payroll checks or other checks that remain uncashed? For several years the state of Arizona and many other states have had a law on the books that if any businesses have unclaimed property in their possession, they must remit that property to the state of Arizona.

The dollar amount of any uncashed checks should be sent to the state of Arizona. If no one claims the property, it becomes the property of the state. Needless to say, the uncashed checks plus interest over a ten-year period can accrue to a substantial amount.

The business owner's nightmare begins when the state audits for unclaimed property. Typically the auditor will search for uncashed payroll checks or checks to vendors. **THE AUDIT PERIOD CAN BE A TEN-YEAR PERIOD!!**

Please call us with any questions or if you wish our help on year-end planning.

Sincerely,

Morton CPAs, P.C.  
Certified Public Accountants