

Year End Tax Planning: Strategies for Businesses and Individuals

By Jim Bailey

It's just around the corner. The end of the calendar year signals the annual planning process for tax season, and with a couple fairly new tax laws on the books and another couple set to expire, right now is the time to make sure you are familiar with and taking optimal advantage of all benefits coming your way.

Business owners should keep abreast of several tax issues, including the following:

New U.S. Production Activities Deduction: For business owners, tax-year 2005 introduces a new deduction for U.S. production activities, whereby businesses, incorporated or not, can deduct up to 3% of the net income from certain business activities. In addition to traditional manufacturing, this deduction is available for income from selling personal property that the business manufactures, grows, produces or extracts and can be applied to the construction, software production, film, videotape or farming industries. This new deduction can be significant, but take notice – the deduction can't exceed 50% of the wages paid to employees for the year.

S Status Election: Electing S status often saves a fair amount of tax since it avoids the double taxation experienced by many C corporations, however S status is only available if the corporation meets several requirements, including a limit on the number of shareholders. This year, new changes to S status requirements increases the maximum number of eligible shareholders from 75 to 100, thereby opening up the availability of this entity to larger corporations. Moreover, family members can elect to be treated as one shareholder, making the number of shareholders limitation more palatable.

Expiring Tax Breaks: Several credits and deductions are slated for reduction or expiration following 2005, (although it is certainly possible that Congress will extend them) so if you are considering either hiring individuals whose wages qualify for “work opportunity” or “welfare to work” credits or purchasing qualified electric or clean fuel vehicles it makes sense to do so before year-end.

Maximize Deductions: Deductions are certainly the name of the game during year-end planning, so be sure to take advantage of all legitimate deductions. For example, business owners can expense up to \$105,000 of the cost of qualifying depreciable property placed into service in 2005. Eligible property for this immediate tax write-off includes “off-the-shelf” computer software, office furniture, equipment, vehicles or other tangible business property.

Work Opportunity Tax Credit: Employers can claim the work opportunity tax credit (WOTC) if they hire individuals from designated target groups. “Hurricane Katrina employees” are now included on that target group list. The credit generally equals 40% of the first \$6,000 of wages paid to the employee in the first year.

The Dividend Option: Business owners can get a break by paying dividends in lieu of owner salaries if their personal tax rate will be in the 28% or higher tax bracket for tax-year 2005 and if they own a corporation anticipated to be in the 15% income tax bracket. By paying themselves some dividends, a business owner could net more cash after taxes since dividend income is subject to a maximum 15% tax rate, while salaries are taxed at 28% or higher.

The business owner who is considering evaluating his or her corporate status should check with a CPA and an attorney to be certain to take advantage of maximum legal tax benefits allowed.

And, for individuals (many of whom are business owners), it makes sense to be aware of the following conventional and less publicized options:

State and Local Sales Tax Deductions: If you itemize deductions, you can deduct either state and local sales taxes or state and local income taxes, and if it turns out that the sales tax deduction is more beneficial, you can choose between claiming the actual sales taxes you paid during the year or an amount from IRS-published tables. Remember to always save your receipts to document the tax you actually paid as those year-end totals may yield a larger deduction than using the IRS tables, which are based on your income level and the size of your family.

Minimize Tax on Capital Gains: Generally, when you sell stock or mutual fund shares, the shares you purchased first are considered sold first. That translates into good news since it can be beneficial to qualify for the long-term capital gain rate by selling shares that have been held for more than one year. However, if you're selling less than your entire holding of a specific stock or mutual fund, situations can arise when you're better off selling shares other than those held the longest as newer shares may have a higher cost-basis that could result in a smaller taxable gain or even a loss.

Benefit from Your Itemized Deductions: If your itemized deductions end up being either just under or over the standard deduction, you can double up on itemized deductions every other year and claim the standard deduction in the intervening years. Let's take a closer look at this option. For 2005, the standard deduction for joint filers is \$10,000 and \$5,000 for single filers. If you file jointly and your property taxes are your only itemized deduction and run about \$9,000 a year, you will wind up claiming the standard deduction annually. But, if you pay two years worth of property taxes in 2005, you can get the benefit of an \$18,000 itemized deduction in that year. In 2006, you would have no itemized deductions and would claim the standard deduction. So, by bunching your itemized deductions into the year 2005, you will get \$28,000 of deductions over a two-year period, instead of the \$20,000 you would deduct if just claiming the standard deduction each year. Keep in mind that deductions eligible for shifting from year to year include certain property taxes, final estimated state income tax payments, your January mortgage payment and charitable donations.

Consider a Health Savings Account: Commonly referred to as an HSA, a Health Savings Account allows you to pay medical expenses on a pretax basis. If you meet certain requirements, HSA contributions in the year 2005 of up to \$5,250 for family coverage and \$2,650 for single coverage (plus an additional \$600 for those 50 years or older) can be made regardless of your income level. Moreover, these contributions are deductible above-the-line, so you can benefit even if you don't itemize or are subject to the high-income itemized deduction phase-out. By having an HSA, you can take tax-free withdrawals to pay uninsured medical expenses. If in good health, you can use an HSA to build up a substantial medical expense reserve fund for future use. And, if you reach age 65 and don't need the funds for health care costs, you can withdraw them for non-medical reasons and pay only the income tax. What a deal! In addition to paying medical expenses with pretax dollars, HSAs allow you to save on a tax-deferred basis, similar to an IRA.

These are just a few ideas and suggestions to get you started as we approach the filing season. And as always, it's wise to consult with a reputable Certified Public Accounting firm to be sure you're reaping as many benefits as possible. With a little research and planning, 2005 could be your least "taxing" year to date.

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