CURRENT INTEREST

MARTIN WERBELOW LLP

Winter 2005

New Partners Named —

Two Accountants Continue Traditions of Firm

Martin Werbelow LLP proudly announces the addition of two partners who were admitted to the firm on June 1, 2005. Each of the new partners combines a wealth of technical expertise with a caring, personal approach that is responsive to the needs of our clients.

Donald R. Westenhaver, Jr.
Partner

With more than 17 years in public practice, Don has developed a broad range of experience in all areas of corporate, partnership, trust and individual income taxation, including domestic and international matters.

He also has extensive experience in representing clients before the Internal Revenue Service, Franchise Tax Board and other taxing agencies. Don provides services with tailored strategies and solutions for clients based on their individual needs.

Donald R. Westenhaver, Jr.

Don's professional memberships include the American Institute of Certified Public Accountants and the California Society of Certified Public Accountants.

Don earned his Bachelor of Science degree in business administration from the California State Polytechnic University at Pomona and his Master of Business Taxation at the University of Southern California.

Don joined Martin Werbelow LLP in 2004. Previously he worked as a manager for a regional public accounting firm.

He resides in Pasadena with his wife, Sandra, and two children, Meaghan and Matthew, and is involved in local school and youth sports activities.

Noriko Nakanishi
Partner

With more than 17 years in public practice, Noriko has developed a broad range of experience in all areas of corporate, partnership and individual income taxation. She also has extensive experience in international and multi-state matters.

Noriko specializes in developing and implementing effective tax strategies and advising business owners, helping them to attain their financial and business goals.

Noriko Nakanishi

Noriko's professional memberships include the American Institute of Certified Public Accountants and the California Society of Certified Public Accountants.

Noriko earned her Bachelor of Science degree in business administration from the California State University at Northridge and her Master of Business Taxation at the University of Southern California.

Noriko was born in Kyoto, Japan and moved to the United States in 1982. She joined Martin Werbelow LLP in 1995 after having worked at a Big Four public accounting firm.

She resides in Altadena with her three dogs, Oso, Coco and Lucy, and is an avid hiker.

Year-End Planning —

Tax-Saving Strategies Help Respond to Changes

With 2005 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 2005 there are new planning strategies resulting from the three tax acts Congress has passed so far this year, as well as the phase-in 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.

Assess 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.

Although AMT was designed originally to apply only to taxpayers who took too much advantage of certain tax breaks, the current rules affect many unsuspecting taxpayers. Being in the world of AMT puts a whole new spin on tax planning, because many great planning strategies that make sense in a regular tax situation completely backfire in an AMT scenario.

Given certain levels of recurring income and deductions, AMT may not be avoidable on a year-to-year basis.

Certain actions can increase your risk of AMT. These include exercising incentive stock options, recognizing substantial long-term capital gains and deducting a significant amount of state and local taxes or miscellaneous itemized deductions (such as un-reimbursed employee business expenses).

But no one is safe from AMT any longer, and planning is tricky when AMT applies 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.

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 for these actions is that it's better to pay taxes later rather than sooner, due to the time value of money.

So how do you shift income and deductions between tax years? The most common techniques involve using income or deductions that you can control easily.

For example, if you're due a year-end bonus and you can get your employer to agree, receive the bonus in January 2006 rather than before the end of 2005.

Move charitable donations you normally would make in early 2006 to the end of 2005. Do the same with the payment of real estate taxes or state income taxes.

If you own a cash-basis business, delay billings so payments are not received until 2006 or accelerate payment of certain expenses, such as office supplies and repairs and maintenance, to 2005. Of course, before deferring income, you must assess the risk of doing so.

Defer energy efficient purchases

The Energy Tax Incentives Act of 2005 provides two new credits for energy efficient improvements made to personal residences, but only if the improvements are made after 2005. So if you are planning on making any such improvements in the near future, you will want to put them off until 2006. Otherwise the credit won't be available.

Improvements eligible for credits in 2006 include those that follow.

• Qualified home improvements on your principal residence (no vacation homes), such as metal roofs coated with heat-reduction pigments; exterior windows, including those in skylights; exterior doors; insulation materials or systems designed to reduce heat loss or gain: energy efficient electric heat pumps, electric heat pump hot water heaters, geothermal heat pumps, and central air conditioners, qualified natural gas, propane and oil furnaces and qualified hot water boilers; and advanced main air circulating fans.

The available credit for such expenditures is generally limited to a lifetime amount of $500, although other limits may also apply. And to reiterate, it applies only to items put to use

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Employee Tax Deductions —
Some Gifts Qualify as Income Exclusions

by Houry Guluzian
Staff Accountant

Rather than a gift, call it a prize or award. There is a definite tax advantage to giving employees noncash prizes and awards rather than cash gifts. This advantage benefits both parties.

Employers can deduct the total cost of the gift from their taxes, while employees do not have to include the value of the gift as part of their taxable income. It is a great way around the well-known $25 gift limit imbedded in the IRS code for the last 40 years.

A noncash prize or award of tangible personal property can be excluded from income if:

• The gift is part of an employee achievement award, or

• The gift qualifies as a *de minimis* fringe benefit. A *de minimis* gift is a gift of minimal value, which cannot be converted readily to cash. Examples include holiday baskets, company pens, T-shirts, mugs and so on.

To qualify as an employee achievement award, a gift should be awarded by the employer pursuant to a permanent, written, qualified plan or program. The gift should be awarded as a part of a meaningful presentation, honoring the employee's length of service or safety achievement.

Houry Guluzian

The cost of the qualified-plan award is deductible to the extent of $1,600 per employee for the tax year. In the absence of a defined qualified award plan or program, the employer's deduction for an employee gift is limited to $400 per employee.

Certain restrictions for noncash gifts/awards apply. Items such as vacations, meals, lodging, theater and sports tickets, gift certificates and company stock are not considered to be tangible personal property. These items can be converted easily to cash and therefore would be taxed as income or compensation to the employee.

Whether transfer of an item from an employer to an employee constitutes a gift depends on the employer's intent.

For example, a gold watch awarded to an existing employee in consideration of length of service is treated as an award and thus excluded from income tax. However, a dinner for two awarded to an employee upon his retirement is considered as compensation for past performance and would be considered a taxable employee benefit.

In summary, a gift from an employer may or may not be subject to income tax, depending on the circumstance in which the item was awarded, as well as the type of item that was awarded. Therefore it is wise for employers to implement qualified award plans in order to maximize their tax deductions.

Please contact our office if you would like a sample plan.

Tax-Saving Strategies *— from page 2*

after December 31, 2005.

• Qualified solar water heating equipment, electricity generating solar photovoltaic property and fuel cell property put to use after 2005 in your personal residence. However, equipment used to heat swimming pools or hot tubs does not qualify.

The credit generally will equal 30 percent of the item's cost, limited to $2,000 per type of item or, in the case of fuel cell property, $500 for each .5 kilowatt of capacity.

Another energy efficient purchase to consider is a hybrid vehicle. The Energy Tax Incentives Act of 2005 replaced the $2,000 deduction available for hybrid vehicle purchases made before 2006 with a credit of up to $3,400 for hybrid vehicles purchased after 2005.

At first blush, delaying hybrid vehicle purchases until 2006 to take the credit seems to be the best deal. However, that is not necessarily so. You might actually be better off making the purchase before the end of this year and cashing in on the existing $2,000 deduction.

If you are considering a hybrid vehicle purchase in the near future, please give us a call. We can put all the pieces together to ensure that you make the optimal tax-saving decision.

Increase charitable giving

Ordinarily the amount of cash donations to IRS-approved public charities that an individual can deduct in any year is limited to 50 percent of adjusted gross income (AGI). Any charitable contribution deduction is also potentially subject to phaseout if your AGI exceeds $145,950 in 2005.

Given the horrendous tragedies that occurred in 2005, Congress has bent these rules for most cash contributions made between August 28, 2005 and December 31, 2005. Such contributions are deductible — with-

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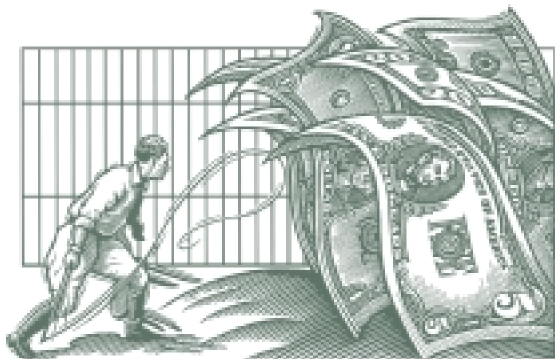
out any reduction under the phase-out rule — up to 100 percent of your AGI when combined with donations made earlier in the year.

Caution: The donations need to be in cash, not in appreciated securities, and cannot be made to a donor-advised fund.

This makes 2005 a particularly good year to make charitable contributions if you are so inclined. And if you charge the contribution to a credit card, it is deductible in the year charged, not when payment is made on the card.



Thus charging donations to your credit card before year-end enables you to increase your 2005 charitable donations deduction, even if you're temporarily short on cash or simply want to defer payment until next year. Note, however, that any interest paid with respect to the charge is not deductible.

Deduct state and local sales taxes

If you itemize deductions, you can deduct either state and local sales taxes or state and local income taxes.

While this option clearly benefits individuals who live outside California in states that don't impose a significant income tax, even California residents may find that the sales tax deduction exceeds their state income tax deduction. This is especially true if you make significant purchases this year, have a low AGI or receive significant tax-exempt income.

If it turns out that the sales tax deduction is more beneficial than deducting state income taxes, you can choose between claiming the actual sales taxes you paid during the year or an amount from IRS-published tables.

The table amount is based on your income level and the size of your family. Saving your receipts to document the sales tax you actually paid (especially if you made or are planning to make significant purchases) may yield a larger deduction than using the IRS tables.

But even if you use the IRS tables, the sales tax on certain big-ticket items can be added to the sales tax amount from the tables. Namely, the sales tax on motor vehicles, whether purchased or leased, aircraft, boats, homes (including mobile and prefabricated) and home building materials (if the tax rate was the same as the general sales tax rate) can be added to the table amount.

A motor vehicle includes a car, motorcycle, motor home, recreational vehicle, SUV, truck, van and off-road vehicle. So even if you plan to simplify your life and use the IRS tables to figure your 2005 sales tax deduction, be aware of these items and be sure to keep documentation of sales tax paid on them so the tax can be added to the table amount.

Year-end planning for your business

Expense cost of business property

The section 179 deduction allows business owners to deduct up to $105,000 of the cost of qualifying depreciable property placed in service in 2005. 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' net income.

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 2005 deductions.

Maximize new deduction for U.S. production activities

For 2005, businesses (incorporated or not) can deduct (for both regular and alternative minimum tax) up to 3 percent of their qualified domestic production activities income. "Qualified domestic production activities income" is the net income from certain business activities if substantially all the activity takes place in the U.S. (or its possessions).

"Production" is somewhat of a misnomer. In addition to traditional manufacturing, the deduction is available for income from selling personal property that the business manufactures, grows, produces or extracts; construction; producing software, film or videotape; farming; and processing agricultural products and food.

If your business is engaged in one of these qualified activities, the new deduction can be significant. But there is one catch — the deduction cannot exceed 50 percent of the wages paid to employees (W-2 wages) for the year. This could be a problem for businesses that pay little or no wages.

Many sole proprietorships do not pay the owner a salary. Likewise, S-corporations often pay owners relatively small salaries to minimize their payroll taxes. This means that after applying the W-2 wages limit, their deduction for U.S. production activities could be significantly reduced.

Business owners who are eligible for the U.S. production activities deduction should look at their compensation policies and consider increasing owner salaries to ensure that their deduction is not scaled back.

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Also, because the deduction is based on net income from qualifying activities, it would be a good idea to take a look at your accounting system to be sure it will allow you to determine the income from qualifying activities, as well as expenses directly related to or allocable to that activity. If not, some tweaking of the accounting system may be in order.

Pay dividends in lieu of owner salaries

If for 2005 you expect to personally be in the 28 percent or higher tax bracket and you own a corporation that you expect to be in the 15 percent 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 so because dividend income is subject to a maximum 15 percent tax rate, while your salary is subject to your 28 percent 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 percent or 15 percent tax bracket (which many children are) will pay only 5 percent on this dividend income.

Strategies that never go out of style

Lower tax rates on capital gains

Long-term capital gains and qualifying dividend income are subject to a tax rate of only 15 percent for taxpayers in a regular tax bracket of 25 percent or higher and 5 percent for taxpayers in the lower regular tax brackets. Given tax rates as high as 35 percent for other types of income, this is quite a break.

To be eligible for the lower 15 percent (or 5 percent) 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 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.

Harvest 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.

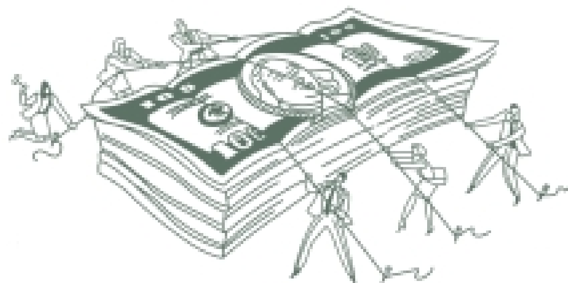
But don't forget the wash-sale rule. This rule defers your loss if you purchase a substantially identical security within the period beginning 30 days before and ending 30 days after the date of sale.

Caution: Mutual funds are expected to make their largest year-end capital gains distributions since 2000 this year. That means you need to determine the extent of these distributions and factor them into your capital gain and loss calculations.

The major fund companies, such as Fidelity, Vanguard and T. Rowe Price, all anticipate larger than normal distributions, and you should contact the fund or go to their Web site to determine the amount.

Take retirement plan distributions

If you are 70 1/2 years of age or older, you're normally subject to the minimum distribution rules with regard to your retirement plans. Under these rules, you must receive at least a certain amount each year from your retirement accounts.



You can always take out more than the required amount, but if you take out less than that amount a 50 percent penalty is due on the shortfall amount. Thus if you haven't taken your required distribution for 2005, do so before year-end to avoid a hefty penalty.

If you turned age 70 1/2 in 2005, you can delay your 2005 required distribution until April 1, 2006 if you choose. But waiting until 2006 will result in two distributions in 2006 — the amount required for 2005 plus the amount required for 2006.

While deferring income normally is a sound tax strategy, here it results in bunching income into 2006, which may push you into a higher tax bracket or have a detrimental impact on other tax deductions you normally claim.

Conclusion

Taking the time now to review your 2005 tax situation gives you a chance to take advantage of many year-end tax saving opportunities. This article 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 2005 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.

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"The difference between golf and government is that in golf you can't improve your lie."
— George Deukmejian

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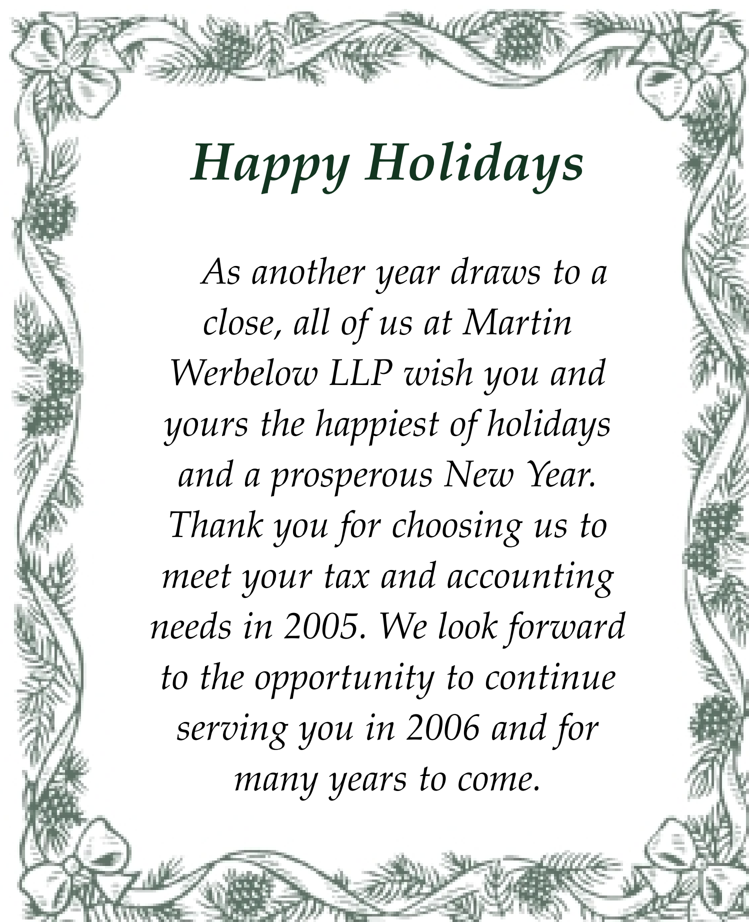

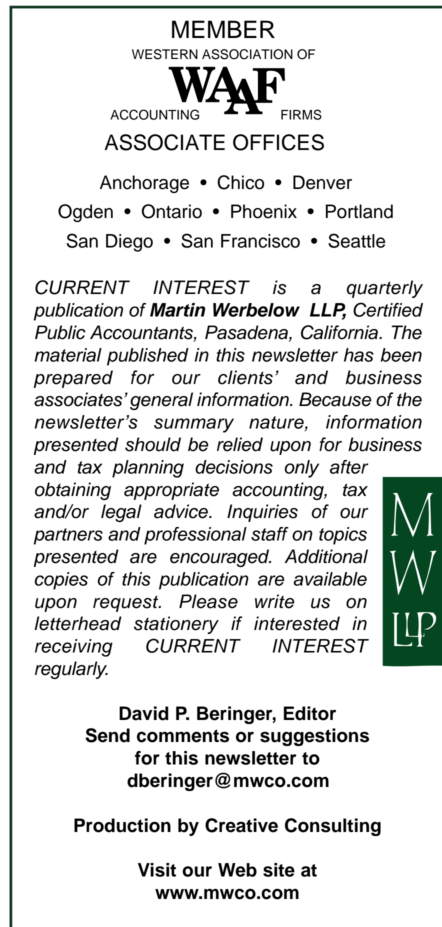
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