Year-End and New Year Tax Planning

2005-12-15

2006 Tax Adjustments

Congress took no action in 2005 regarding gift and estate tax reform and repeal. Accordingly, the current gift and estate tax regime will remain in place, and various federal tax figures are adjusted, effective January 1.

(a) Gift tax annual exclusion amount: The amount a taxpayer may gift annually to any one person without incurring gift tax will continue to be indexed for inflation in future years, but only in increments of $1,000.

(b) Gift tax annual exclusion amount for non-citizen spouses: Gifts to a non-citizen spouse are not eligible for a marital deduction, but are eligible for a special annual exclusion amount. This amount is increased to $120,000 for 2006 and will continue to be indexed for inflation in future years.

(c) Maximum tax rate: Multiple tax rates have been abolished for both gift tax and estate tax purposes. Both taxes will be assessed at a flat rate of 46% in 2006, and 45% in 2007 and subsequent years.

(d) Estate tax applicable exclusion amount: The amount that, at death, may be applied to an individual's estate to exempt assets from estate tax will remain at $2 million (minus lifetime taxable gifts) for 2006 to 2008, and will increase to $3.5 million (minus lifetime taxable gifts) for 2009. However, all commentators expect Congress to alter the current estate tax law before the estate tax would otherwise be repealed (for one year only) in 2010.

(e) Gift tax applicable exclusion amount: The amount that may be applied toward lifetime taxable gifts to exempt them from gift tax will remain unchanged at $1 million through 2009.

Location of Domicile

States continue to impose widely disparate income, gift and estate or inheritance tax burdens. Thus, taxpayers approaching their retirement years should consider the advantages of relocating their domicile to a state where such taxes are minimal or nonexistent. For example, in 2006, a Massachusetts resident decedent with an estate worth $10 million (after debts and expenses) would owe Massachusetts estate taxes of $1,067,600--although this payment would be deductible for federal estate tax purposes. By contrast, a Florida resident with an identical estate would pay no state estate tax.

The amount of state estate tax exclusion not only differs markedly from state to state, but also may differ from the federal exclusion amount. For example, the state estate tax exclusion in Massachusetts will increase in 2006 to only $1 million, with no further increases scheduled to take effect.

Timing of Annual Exclusion Gifts

Taxpayers are encouraged to make annual exclusion gifts as early in the year as possible. If a taxpayer were to die during the year without making such gifts, the opportunity to remove gifted assets from the taxpayer's estate would be foregone.

Timing of Retirement Plan Contributions

Contributions made to an IRA, Keogh plan or 401(k) plan may be deducted in 2005 even if the contribution is not made until the applicable deadline in 2006. However, the deduction is allowable in the case of the Keogh plan or a 401(k) plan only if the plan is established by December 31. By contrast, a deduction is allowable for a timely contribution to an IRA even if the account is not established until 2006.

Alternative Minimum Tax

Taxpayers who may be subject to the alternative minimum tax (AMT) for 2005, but not 2006, or vice versa, should carefully evaluate the timing of receipt of taxable income and payment of deductible expenses. In general, a taxpayer who is subject to the AMT in 2005, but not in 2006, should accelerate items of income (e.g., by exercise of stock options) and postpone deductions (such as state and local tax payments). A taxpayer who will not be subject to AMT in 2005, but will be in 2006, should take the reverse action.

For more information on this matter or for assistance with year-end and new year tax planning, contact the author listed above.