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Intelligent Money

Current thinking from Haven Financial Advisors

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Special Notes of Interest:

- During the 1980s, the personal saving rate averaged 9.0%. During the 1990s, the personal saving rate averaged 5.2%. Since 2000, the personal saving rate has averaged only 1.9%.
- The average retail price of a gallon of gasoline has fallen from $3.07 to $2.20 since Labor Day weekend.

Some New Tax Savings Opportunities for 2006

Congress has thus far failed to enact meaningful tax reform in 2005. President Bush's Advisory Panel on Tax Reform recently released proposals to simplify the federal tax code while making it more equitable. However, the current political situation in Washington may render these recommendations unworkable for the near future. This article will instead focus on key tax law changes already scheduled to take effect after the first of the year.

Indeed, there are some interesting tax incentives and programs scheduled to come alive after January 1st . One key area is the defined contribution plan.

Roth 401k

In 2006, plan sponsors will be able to amend their 401k plans to allow participants to make after tax salary deferrals to an investment account that will shelter any future gains from taxation. This Roth 401k option is a powerful tool for savings.

Unlike the current Roth IRA, there is no means testing to determine whether an individual qualifies for contributions. Secondly, the allowable contribution limits are much higher. The Roth 401k deferral caps are the same as for traditional 401k plans. That's $15,000 in 2006 plus $5000 in catch-up provisions for participants that are 50 an older.

Roth contributions are irrevocable; once they are allocated to a Roth 401(k) account, they cannot be shifted to a pre-tax account. Tax-deductible employer contributions will continue to be made to the pre-tax account. After leaving his employer, the participant can roll Roth 401(k) assets into a Roth IRA, and traditional 401(k) funds into a regular IRA.

It is noteworthy that, under current law, the Roth 401k sunsets after 2010. That still leaves 5 calendar years of excellent tax shelter opportunities. If an individual contributes $15,000 annually during those five years are earns 8%, the Roth 401k will accumulate nearly $300,000 by 2025!

While the Roth 401k is generally superior to the traditional 401k, this is not uniformly the case. In principle, the difference between the two is that the Roth is a pay now/enjoy later arrangement and the traditional 401k offers immediate shelter at the cost of converting future gains to ordinary income.

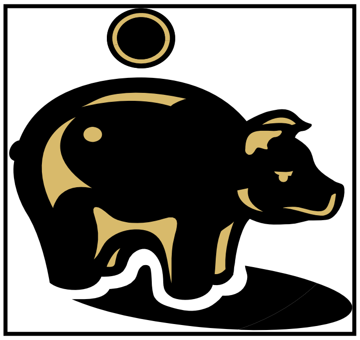
If a plan participant believes that their current tax rate is higher now that it will be in the future, it may make sense to take current tax deductions. The mathematics favoring the Roth 401k are fairly robust to varying economic assumptions, however. Tax rates are not likely to fall much from today's low levels.

So far, employers have been slow to adopt. Only about one third responded positively to a Hewitt Associates survey as to whether they would offer a Roth 401k in 2006. Even self-employed individuals may need to wait. Neither TD Waterhouse nor Charles Schwab have yet implemented turnkey Roth 401k programs for individuals. This is likely to change once treasury regulations governing their implementation have been finalized.

Tax Credits for "Green" Behavior

Some key "green" tax incentives roll into place after the first of the year. Homeowners will be able to claim up to $500 in tax credits for home improvements that reduce energy consumption. Covered items include hot water heaters, new windows, doors, and skylights.

Incentives for the installation of solar



Tax Savings Opportunities (Cont)

paneling to generate electricity are even stronger. Tax credits for up to 30% or $2000 will be available in 2006.

Many cities, including Austin, already subsidize eco-friendly home improvements. Solar paneling is a case in point. Austin Energy offers one of the highest solar rebates in the country at $4.00 per watt ($4.50 for nonprofit organizations). This rebate level will pay between 45% and 75% of the cost of installation of a solar system.

For a residence, the cost of installation of a 1-kilowatt (kW) solar system is expected to cost between $6,000 and $10,000. The Austin Energy rebate will pay $4,000 toward its installation. With the tax credit and city rebate in effect, the cost of solar paneling could be reduced up to 80%. The installation of a 1000 kW array in Austin can save a customer more than 10% of their electric bill.

The tax subsidy on the purchase of hybrid cars increases as well. In 2005, there is $2000 tax deduction for the purchase of a qualified hybrid vehicle. At the top federal tax rate, that amounts to a $700 savings. Buyers of hybrids in 2006 are eligible for tax credits based on the fuel efficiency of the vehicle. A Toyota Prius pegs the scale with an estimated tax credit of $3150 while the Accord Hybrid should generate a credit of $650.

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President's Advisory Panel on Federal Tax Reform

Delayed over a month by Hurricane Katrina, the President's bipartisan Advisor Panel on Tax reform released its key proposals to simplify the federal tax code on November 1st . The sum total of the panel's program are intended to be revenue neutral.

One recommendation is the reduction in the number of ordinary income tax brackets from 6 to 4. A secondary proposal, which includes a consumption tax, would leave only 3 brackets.

The Alternative Minimum Tax (AMT) is targeted for elimination. Originally enacted in an attempt to compel the very wealthy to pay some tax, the AMT has become a monster. By 2010, it is estimated that some 30 million taxpayers will have to pay some AMT – affecting perhaps the majority that earn over $100,000 annually. In principle, the AMT has lower tax rates and higher exemptions but disallows many deductions to income used in the ordinary income tax calculation.

Several deductions in the ordinary income tax code are at risk. The panel has recommended a drastic lowering in the cap on deductible home mortgage interest. The report also called for the discontinuation of the federal tax deduction for state and local taxes. Another proposal called for employees to recognize some fraction of their health benefits as ordinary income.

The panel also recommended the consolidation of the various retirement plans. All taxpayers would be eligible for a single "Save for Work" account that would supplant the various 401k, 403b, and 457 options currently available. A new "Super IRA" would also be available to all taxpayers regardless of income level or employment. Each account would allow for maximum after tax contributions of $10,000 and allow for tax free gains.

Notably, these reforms would at once eliminate the AMT while making the ordinary tax code more like it. Fewer tax brackets and fewer deductions coincide with principles of the AMT.

One might also argue that the thrust of the reforms tends to benefit the lower taxed red states. After all, most of the nation's expensive homes and highest local tax jurisdictions reside in the Northeast and California. Former Senator John Breaux of Louisiana, who is the panel's vice chair, explained part of the panel's reasoning this way: "If people in California want to pay extra taxes to have their trash picked up, people in Texas shouldn't have to subsidize it."

It will be interesting to see whether a weakened president will be able to enact some measure of his tax reform agenda in the coming months. ll.