

>: 6 Tips for Year-End Tax Planning

Wednesday, December 19, 2007 / Dylan Jovine

WHO ON EARTH WANTS TO THINK ABOUT THIS NOW?

I know I don't! Between recent family health-related issues and a generally long and challenging work year, I feel just utterly exhausted.

(Have you been having a good year, bad year or just a typically challenging year? Would love to hear how you're doing. Feel free to comment below if you'd like to share.)

But even though I've been feeling beat to the bones these days, I do have to spend some time thinking about taxes. And since it's the end of the year, you have to, as well.

Below, I share six tips that may help you reduce the taxes you owe to Uncle Sam.

To put that into perspective: Every \$1,000 you save today that is invested at 15% annually for 20 years will be worth \$16,366. If you're able to increase your annual returns to 20% annually, that same \$1,000 will be worth \$38,337 in 20 years.

Bottom Line: An hour or two of tax planning may not only save you thousands of dollars today, but may pay for your vacation house when you retire (or your child's college education or your health care or whatever you can imagine).

So, no matter how long a year it's been for you, simple tax planning is the best year-end deal you'll find anywhere!

Tax Tip #1: Manipulate Your Income

The most basic form of year-end planning involves pushing tax bills into the future by deferring income into the next year and accelerating deductions into the current year. One example would be to postpone an IRA withdrawal, another would be to prepay your Jan. 1 home mortgage interest in December. Unfortunately, it's not quite that simple these days.

You must be aware of the "side effects" of any action that changes your adjusted gross income from one year to the next. Our example of postponing the IRA distribution would reduce your current AGI (good) but increase the next year's figure (bad). Higher AGI can increase the taxable amount of Social Security benefits, reduce or eliminate the ability to make deductible IRA contributions, "phase out" your itemized deductions and personal exemptions, and trim your write-offs for medical expenses, casualty losses, charitable gifts and rental real estate losses. Higher AGI could also cut back or eliminate the tax credits for dependent children and college education expenses, Roth IRA contributions, conversions of regular IRAs into Roth IRAs and college education loan interest deductions.

The bottom line: Consider the effects of potential year-end tax moves on AGI and AGI-related tax breaks for both this year and next, and implement only those ideas that will put you ahead over the two-year period.

Tax Tip #2: Make the Most of Year-End Selling

If you have a few loser stocks that you wouldn't mind unloading, now is the time. If you have them, you can sell enough dogs to wipe out all your realized capital gains for the year, plus another \$3,000 (\$1,500 for married filing separately) in regular income. Be careful to avoid a wash sale? buying the same security within 30 days before or after you dump shares. Tax rules disallow the loss.

If you have realized losses over \$3,000, consider selling enough winners to get back to that magic number. Taking the gains will add zero to your tax bill. (However, remember our earlier advice, and sell only shares you can kiss goodbye without regret.)

If you have both unrealized gains and losses in your portfolio, but want to make some sales, here is how to match them to best effect.

First, the obvious general rule is try to sell long-term winners (held over 12 months) first to benefit from the 15% maximum long-term capital gains rate. Then, unload your short-term holdings.

But which dogs do you sell to offset those gains? You will generally get the most tax-saving bang for the buck with a short-term loss. This is because short-term losses first go to offset short-term gains that would otherwise be taxed at your regular income tax rate (which can be as high as 35%). Any leftovers then offset long-term (15%) gains.

Last but not least, remember you can further reduce taxes by telling your broker to sell your highest-cost shares when unloading part of your holdings in a stock. Using this "specific ID method" requires you to identify the shares to be sold by specifying their cost and purchase dates. You must also receive a written confirmation of your instructions from the broker or keep a record of your oral instructions. Put this in your tax file for

safekeeping.

If you don't follow this procedure, you must use the first-in, first-out (FIFO) method, meaning the shares you bought first are considered sold first. Those were likely the cheapest ? giving you the biggest possible tax hit. The point to remember is that you must take action at the time of sale to use the specific ID method.

Tax Tip #3: Time Your Mutual Fund Buys and Sells

If you own appreciated mutual fund shares held over 12 months and are contemplating bailing out toward year's end, sell before the December dividend. This way, your entire gain ? including the amount attributable to the upcoming dividend ? will qualify for the 15% rate. If you wait, part of your dividend will almost certainly consist of ordinary income. You'll owe up to 35% on the ordinary part.

Alternatively, if you want to make a year-end purchase of mutual fund shares, wait until the distribution has been made. If you buy just before the ex-dividend date, you'll get back part of the money you just invested and owe taxes on it. To avoid this outcome, call the fund. Ask for the ex-dividend date and the estimated payout. Then make your purchase after the magic date if the dividend is big enough to concern you. (Of course, the ex-dividend issue doesn't apply to shares held in tax-exempt accounts like IRAs and qualified retirement plans.)

Tax Tip #4: Retirement Distribution Planning

It can make sense to put off distributions if you expect to be in a lower tax bracket in future years or to avoid the 10% penalty tax that hits most withdrawals from IRAs and qualified plan accounts before age 59 1/2. You can also consider taking your benefits in the form of an annuity. This avoids the 10% penalty and allows you to spread the income out.

Also, retirement plan distributions (other than certain lump sums eligible for special treatment) will increase this year's AGI, which can result in the negative side effects mentioned earlier.

IRA withdrawals can be taken to pay qualified higher education expenses for you, your spouse, or your child or grandchild without owing the 10% penalty. (You'll still owe income tax.)

Penalty-free IRA withdrawals can also be taken to finance a first-time home purchase for you, your spouse, or a child, grandchild, or ancestor of either you or your spouse. There's a \$10,000 lifetime limit on withdrawals for this purpose.

Tax Tip #5: Plan Ahead at Your Job

If you have a 401(k) plan at work, now's the time to state how much you'll contribute next year. We suggest setting aside as much as you can stand, at least up to the 2007 deductible maximum of \$15,500 (\$20,500 if you will be age 50 or older at year end). This advice goes double if your employer makes matching contributions, which amount to "free money".

This time of year is also when employees must specify how much salary they will contribute to their medical and child-care flexible spending accounts. Tax-free withdrawals can then be taken from these accounts for medical and dental insurance premiums, uninsured medical and dental expenses, and child-care costs.

By the way, if you leave a balance in your spending account at year's end, you'll lose the money. So make sure you drain the account. For example, you can get new glasses and contacts, fill prescriptions a bit early, and have some long-deferred dental work taken care of.

Tax Tip #6: Business or Pleasure?

You may be able to claim tax losses from activities the IRS might consider hobbies. This includes things like breeding animals or restoring and selling antique cars, from which you have some revenue but perhaps not enough to be profitable every year. The tax rules allow you to say an activity is a for-profit business as long as it runs in the black at least three out of every five years (two out of seven for horse racing, breeding, showing or training). The beauty of this rule is that if you can turn your hobby into a business, at least for tax purposes; you can deduct losses in years when expenses exceed revenue. For hobbies that don't qualify, by contrast, you can use expenses only to offset income, but you can't deduct overall losses.

The trick is to time your revenue and expenses, so you eke out a profit three out of five years (or two out of seven for horses). Then you can claim big losses in the intervening years. If your activity is on the cusp of qualifying as a business, consider accelerating income into this year and deferring some deductible expenses into next year. Showing a current-year profit could set you up for a big deductible loss next year. Beware: The IRS can challenge your claimed business losses. But the onus is on the agency to prove that your activity is a long-term loser, and the expectation

of future gains from selling your assets ? horses, cars, whatever ? can defuse the government's arguments.

Cheers (and have a good Holiday Season)!

A handwritten signature in black ink, appearing to read 'Dylan Jovine', with a stylized flourish at the end.

Dylan Jovine
Chief Investment Officer

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