Tax Information

Tax Saving Strategies, Part 2

A Helpful Checklist

Since the demise of the tax shelter, strategies for saving individual income taxes are harder to come by. But they do exist. This Financial Guide provides tax saving strategies for deferring income (often through the use of retirement plans), and maximizing deductions. It includes some strategies for specific categories of individuals, such as those with high income and those who are self-employed.

Before getting into the specifics, however, we would like to stress the importance of proper documentation. Many taxpayers forgo worthwhile tax deductions because they have neglected to keep receipts or records. Keeping adequate records is required by the IRS for employee business expenses, deductible travel and entertainment expenses, and charitable gifts and travel. But don't do it just because the IRS says so—neglecting to track these deductions can lead to overlooking them. You also need to maintain records regarding your income. If your receive a large tax-free amount, such as a gift or inheritance, make certain to document the item so that the IRS does not later claim that you had unreported income.

To use the checklist, quickly scan the listed items. They are of general application only and should be tailored to your specific situation. If you think one of them fits your tax situation, discuss it with your tax adviser.

AVOID OR DEFER INCOME RECOGNITION

Deferring the taxability of income makes sense for two reasons. Most individuals are in a higher tax bracket in their working years than during retirement. Deferring income until retirement may result in paying taxes on that income at a lower rate. Additionally, through the use of tax-deferred retirement accounts you can actually invest the money you would have otherwise paid in taxes to increase the amount of your retirement fund. Deferral can also work in the short term if you expect to be in a lower bracket in the following year or if you can take advantage of lower long-term capital gains rates by holding an asset a little longer.

> **TIP:** You can achieve the same effect of deferring income by accelerating deductions—for example, paying a state estimated tax installment in December instead of at the following January due date.

Max Out Your 401(k) or Similar Employer Plan

Many employers offer plans where you can elect to defer a portion of your salary and contribute it to a tax-deferred retirement account. For most companies these are referred to as 401(k) plans. For many other employers, such as universities, a similar plan called a 403(b) is available. Check with your employer about the availability of such a plan and contribute as much as possible to defer income and accumulate retirement assets.

> **TIP:** Some employers match a portion of employee contributions to such plans. If this is available, you should structure your contributions to receive the maximum employer matching contribution.

If You Have Your Own Business, Set Up and Contribute to a Retirement Plan

If you have your own business, consider setting up and contributing as much as possible to a retirement plan. These are allowed even for sideline or moonlighting businesses. Several types of

plans are available which minimize the paperwork involved in establishing and administering such a plan.

Contribute to an IRA

If you have income from wages or self-employment income, you can build tax-sheltered investments by contributing to a traditional or a Roth IRA. You may also be able to contribute to a spousal IRA — even where the spouse has little or no earned income. All IRAs defer the taxation of IRA investment income and in some cases can be deductible or be withdrawn tax free.

> **TIP:** To get the most from IRA contributions, fund the IRA as early as possible in the year. Also, pay the IRA trustee out of separate funds, not out of the amount in the IRA. Following these two rules will ensure that you get the most possible tax-deferred earnings from your money.

Defer Bonuses or Other Earned Income

If you are due a bonus at year-end, you may be able to defer receipt of these funds until January. This can defer the payment of taxes (other than the portion withheld) for another year. If you're self employed, defer sending invoices or bills to clients or customers until after the new year begins. Here, too, you can defer some of the tax, subject to estimated tax requirements. This may even save taxes if you are in a lower tax bracket in the following year. Note, however, that the amount subject to social security or self-employment tax increases each year.

Accelerate Capital Losses and Defer Capital Gains

If you have investments on which you have an accumulated loss, it may be advantageous to sell it prior to year-end. Capital losses are deductible up to the amount of your capital gains plus $3,000. If you are planning on selling an investment on which you have an accumulated gain, it may be best to wait until after the end of the year to defer payment of the taxes for another year (subject to estimated tax requirements). For most capital assets held more than 12 months the maximum tax is reduced to 15% for sales after May 5, 2003 and before 2009. However, make sure to consider the investment potential of the asset. It may be wise to hold or sell the asset to maximize the economic gain or minimize the economic loss.

Watch Trading Activity in Your Portfolio

When your mutual fund manager sells stock at a gain, these gains pass through to you as realized taxable gains, even though you don't withdraw them. So you may prefer a fund with low turnover, assuming satisfactory investment management. Turnover isn't a tax consideration in tax-sheltered funds such as IRAs or 401(k)s. For growth stocks you invest in directly and hold for the long term, you pay no tax on the appreciation until you sell them. No capital gains tax is imposed on appreciation at your death.

Use the Gift-Tax Exclusion to Shift Income

You can give away $11,000 ($22,000 if joined by a spouse) per donee, per year without paying federal gift tax. You can give $11,000 to as many donees as you like. The income on these transfers will then be taxed at the donee's taxrate, which is in many cases lower.

> **NOTE:** Special rules apply to children under age 14. Also, if you directly pay the medical or educational expenses of the donee, such gifts will not be subject to gift tax.

Invest in Treasury Securities

For high-income taxpayers, who live in high-income-tax states, investing in Treasury bills, bonds, and notes can pay off in tax savings. The interest on Treasuries is exempt from state and local income tax. Also, investing in Treasury bills that mature in the next tax year results in a deferral of the tax until the next year.

Consider Tax-Exempt Municipals

Interest on state or local bonds ("municipals") is generally exempt from federal income tax and from tax by the issuing state or locality. For that reason, interest paid on such bonds is somewhat less than that paid on commercial bonds of comparable quality. However, for individuals in higher brackets, the interest from municipals will often be greater than from higher paying commercial bonds after reduction for taxes. Gain on sale of municipals is taxable and loss is deductible. Tax-exempt interest is sometimes an element in computation of other tax items. Interest on loans to buy or carry tax-exempts is non-deductible.

Give Appreciated Assets to Charity

If you're planning to make a charitable gift, it generally makes more sense to give appreciated long-term capital assets to the charity, instead of selling the assets and giving the charity the after-tax proceeds. Donating the assets instead of the cash prevents your having to pay capital gains tax on the sale, which can result in considerable savings, depending on your tax bracket and the amount of tax that would be due on the sale. Additionally you can obtain a tax deduction for the fair market value of the property.

> **TIP:** Many taxpayers also give depreciated assets to charity. Deduction is for fair market value; no loss deduction is allowed for depreciation in value of a personal asset. For contributions of property, whether appreciated or not, you must file an information return on contributions of $501-$5,000, and you need a qualified appraisal on contributions over $5,000 (except for publicly traded securities).

Keep Track of Mileage Driven for Business, Medical or Charitable Purposes

If you drive your car for business, medical or charitable purposes, you may be entitled to a deduction for miles driven. For January through August 2005 it's 40 ½ cents per mile for business, 15 cents for medical and 14 cents for charitable. For mileage from September 1, 2005 through December 31, 2005, it's 48 ½ cents for business, 22 cents for medical and still 14 cents for charitable. For driving in 2006, the mileage rate is 44 ½ cents for business, 18 cents for medical and 14 cents for charity. You need to keep detailed daily records of the mileage driven for these purposes to substantiate the deduction.

Take Advantage of Your Employer's Benefit Plans to Get an Effective Deduction for Items Such as Medical Expenses

Medical and dental expenses are generally only deductible to the extent they exceed 7.5% of your Adjusted Gross Income. For most individuals, particularly those with high income, this eliminates the possibility for a deduction. You can effectively get a deduction for these items if your employer offers a Flexible Spending Account, sometimes called a cafeteria plan. These plans permit you to redirect a portion of your salary to pay these types of expenses with pre-tax dollars. Another such arrangement is a Health Savings Account. Ask your employer if they provide either of these plans.

Check Out Separate Filing Status

Certain married couples may benefit from filing separately instead of jointly. Consider filing separately if you meet the following criteria:

- One spouse has large medical expenses, miscellaneous itemized deductions, or casualty losses.
- The spouses' incomes are about equal.

Separate filing may benefit such couples because the adjusted gross income "floors" for taking the listed deductions will be computed separately. On the other hand, some tax benefits are denied to couples filing separately. In some states, filing separately can also save a significant amount of state income taxes.

If Self-Employed, Take Advantage of Special Deductions

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You may be able to expense up to $100,000 each year for the years 2003 through 2007, in equipment purchased for use in your business immediately instead of writing it off over many years. The $100,000 amount is indexed for inflation and is $102,000 for 2004 and $105,000 for 2005.. Additionally, self-employed individuals can deduct 100% of their health insurance premiums as business expenses. You may also be able to establish a Keogh, SEP or SIMPLE plan, or a Health Savings Account, as mentioned above.

If Self-Employed, Hire Your Child in the Business

If your child is under age 18, he or she is not subject to employment taxes from your unincorporated business (income taxes still apply). This will reduce your income for both income and employment tax purposes and shift assets to the child at the same time.

Take Out a Home-Equity Loan

Most consumer related interest expense, such as from car loans or credit cards, is not deductible. Interest on a home-equity loan, however, can be deductible. It may be advisable to take out a home-equity loan to pay off other nondeductible obligations.

Bunch Your Itemized Deductions

Certain itemized deductions, such as medical or employment related expenses, are only deductible if they exceed a certain amount. It may be advantageous to delay payments in one year and prepay them in the next year to bunch the expenses in one year. This way you stand a better chance of getting a deduction.

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