



Top 10 Year-End Tax Tips

Whether you are flying high with savvy investments, rebounding from recent losses, or still struggling to get off the ground, you can save a bundle on your taxes if you make the right moves before the end of the year. But be careful. Some easy-to-follow advice that you read in the papers, or hear on TV, can backfire.

Before you do anything, consider making income tax projections for this year and next (at least). If your situation is complicated enough, you will need a software program or help from your tax preparer. Once you have the numbers, however, you can see how any actions you take will affect your tax bill each year. With that information in hand, these tips can help you hang onto your cash.

1. Defer Income

Most folks on salary don't have much choice on when they get paid. But if you are one of the lucky ones in line for a year-end bonus, consider asking your employer to give it to you in January. Some companies will be able to help you out, but because of stringent rules, others can't. If you have consulting income, you might want to delay billing so that you will get paid next year.

Of course, it only makes sense to defer income if you think you will be in the same or lower tax bracket next year. You don't want to be hit with a bigger tax bill next year if an extra chunk of income could push you into a higher income tax bracket.

2. Take Last-Minute Deductions

Contributing to charity is a noble way to get a deduction. You can make the process easier on yourself if you donate appreciated stock or property rather than cash from the proceeds of a sale. You may be able to give more to the charity, and you avoid paying capital gains. Be sure to give yourself plenty of time because it can take several weeks to transfer the stock or property.

Young taxpayers who may not have itemized deductions before should try bundling miscellaneous deductions such as tax preparation fees, job-hunting expenses, and professional dues to meet the IRS threshold of 2% of adjusted gross income. (Your miscellaneous deductions must add up to more than that, and you only get to deduct the amount above that level.) Paying some of next year's expenses in December might give you enough expenses to put you over the line.

Accelerating major deductions such as state income taxes, property taxes, and mortgage interest may help anyone, especially during a high-income year. But if your income is too high, look out.

"The trick is that there are phase-outs for itemized deductions at higher income levels," says Suzanne Brubaker, director of financial counseling services for Deloitte & Touche in Los Angeles. "You might get more benefit from the deductions next year."

3. Beware of the Alternative Minimum Tax

Sometimes accelerating deductions can cost you money because you inadvertently trigger the Alternative Minimum Tax (AMT). Originally designed to make sure wealthy people paid their fair share of taxes, the AMT is now affecting the middle class, in large part because of incentive stock options and lower tax rates.

And that can be a particular problem for people who are not used to figuring out sticky tax issues.

The AMT is figured separately from your regular tax liability, and you may have to pay it rather than a lower tax bill if 1) your itemized deductions are too high, 2) you have a large state tax liability, 3) you exercise incentive stock options and hold the shares, or 4) you experience another triggering event. You are more likely to be an AMT candidate if your income is above \$100,000 a year. The AMT rates are 26% for AMT income up to \$175,000 and 28% for AMT income over \$175,000.

Calculating your taxes for more than one year may help you avoid the AMT. You may also need to consult your tax adviser to decide when you should exercise incentive stock options or pay certain expenses, says Karen Goodfriend, a CPA and partner at Goldstein Enright in Palo Alto, California.

In some cases it might make sense to pay the AMT because it will put you in a better position the following year, she says.

4. Sell Loser Stocks to Offset Gains

With the roller coaster stock market, you may have a mix of winners and losers in your portfolio. If you have a big capital gain, consider selling some of the losers. You can erase your tax liability on the gain with a corresponding loss. Then you can apply a maximum of \$3,000 in net capital losses against ordinary income, reducing the amount of income on which you must pay taxes. Any additional losses in excess of \$3,000 can be rolled over to subsequent years.

This strategy also works with mutual funds, which may have generated capital gains when the portfolio manager sold some holdings (even if the value of the fund has plummeted).

"It's really important to make good investment decisions and not sell a stock that might be down just to trigger a loss," Brubaker says.

Also: You can't just sell a stock and then buy it right back. That violates the federal "wash sale" rule, which prohibits quick flips of stocks and mutual funds to realize a tax loss. You must wait 31 days to buy back the same stock or fund. You can, however, buy a similar stock in the same industry. With mutual funds you can buy a similar fund with the same objectives in another fund family.

5. Do a Bond Swap

Bond prices tend to fall when interest rates are rising. It's very easy to sell a bond — corporate, government, or municipal — and then turn around to buy a similar one. If bond prices are falling, you will have essentially the same investment but with a little more money in your pocket. Your broker should charge you only a small transaction fee to do the swap. But you should be sure that your broker understands how to do these deals.

You also can sell bonds that are down to generate a tax loss.

6. Call your Mutual Fund for the Distribution Date

What a nasty surprise to find that your mutual fund is down for the year and you still have to pay taxes on large dividends and capital gains. If you sell before the fund's distribution date, you can avoid paying taxes on the upcoming distribution of dividends and capital gains. You need to wait 31 days to buy the same fund back again although you can buy a similar fund with another fund family immediately.

On the other hand, if you intend to buy a fund, wait until after the distribution date. Otherwise, you will end up with a tax bill right away without actually participating in the fund's gains.

7. Contribute the Maximum to Retirement Accounts

There may be no better investment than tax-deferred retirement accounts. They can grow to a substantial sum because they compound over time free of taxes. Company-sponsored 401(k) plans may be the best deal because employers often match contributions.

Bump up your 401(k) contribution so that you are putting in the maximum amount of money allowed (\$13,000 for 2004, so start early). If you think you can't afford it, run the numbers. Amazingly enough, these payroll deductions may not reduce your take-home pay as much as you think, because they reduce your taxable income.

"If you haven't been contributing the maximum, some employers allow you to catch up for the current year," Goodfriend says. Consider it, if you have the cash available.

Also consider contributing to an IRA for yourself and your spouse. Your \$3,000 contribution is fully deductible if you did not participate in a company-sponsored retirement plan or if your income falls below \$45,000 in 2004 for single filers and \$65,000 for married couples.

Even if you did participate in your company's plan, your spouse also can generally contribute a fully deductible \$3,000 to an IRA as long as your combined adjusted gross income is \$150,000 or below and your spouse isn't a participant in a company-sponsored plan.

And, best of all, if you'll be age 50 or over at the end of 2004, that \$3,000 goes up to \$3,500 – giving you an opportunity to “catch up” your contributions if you haven't put enough away.

Self-employed people should set up Keogh plans by December 31. Once the plan is in place, you can contribute up to \$41,000 until the tax filing deadline (including extensions) for your 2004 return.

8. Decide Whether to Convert to a Roth IRA

A Roth can outperform regular IRAs because you don't pay taxes on your withdrawals. The catch is that you can't deduct your contributions. You might want to convert to a Roth if you have many years to go before you take out your funds. You also should be in the same or higher income tax bracket when you retire so that you pay taxes on the conversion now, while you are in the same (or a lower) tax bracket.

Another reason to convert to a Roth is to pass on money to your heirs. Unlike a regular IRA, the Roth has no requirement that you must withdraw your money at some point. And your heirs will not be liable for income taxes.

To convert, your annual income must be \$100,000 or less for married couples and singles, and you must pay taxes on contributions and accumulated earnings in the year of conversion. That can be a hefty bill. If you need to take money out of your IRA to pay the taxes, it will cost you too much to convert.

9. Plan IRA Distributions

If you have reached 70 1/2, don't forget to take at least the minimum distribution from your IRA or you will face a 50% penalty on the shortfall. How much you need to withdraw is based on your life expectancy. Fortunately, penalties have been eliminated on annual withdrawals over a certain amount.

If you are younger than 59-1/2 there is an exception to paying penalties on IRA distributions. You must continue taking out substantially equal payments for at least five years and be at least 59-1/2 when you stop. Otherwise, you will be liable for back penalties plus interest.

10. Update Flexible Spending Accounts

If your company provides flexible spending accounts, sign up before the end of the year. These programs deduct money from your paycheck on a pre-tax basis to pay for a wide range of health care expenses not covered by insurance and for childcare or elder care. You typically can contribute a maximum of \$3,000 annually to a health care FSA and \$6,000 annually to a dependent care FSA. The exclusion of account contributions from taxable income in effect produces tax savings of 40% or more.

The catch is that you forfeit any money left in your account at the end of the year. So budget carefully and be sure you use up all the money.