Year End Tax Planning Tips

Not all year-end tax plans are created equal. Many articles set forth general year-end tax planning tips, but it is important to consider all of your personal circumstances before implementing any tips. In other words, do not plan in a vacuum. Often, personal circumstances cause a general tax planning tip to produce a poor result. Below are some general tax planning tips with some additional considerations.

Harvest Capital Losses?

In addition to being able to recognize capital losses to offset capital gains, individuals can deduct up to $3,000 of long-term capital losses directly against ordinary income. Although the usual tax planning advice is to recognize all of your long-term capital losses, I suggest that there are other issues to consider that may reveal a better approach. Long-term capital gains are taxed at a maximum rate of 15%; thus the tax savings realized by recognizing a $3,000 long-term capital loss that offsets a long-term capital gain is $450. However, short-term capital gains and other ordinary income are taxed at rates up to 35%; therefore, the tax savings realized by recognizing a $3,000 long-term capital loss that offsets short-term capital gains or ordinary income could be more than $1,000.

Thus, my advice is to look before you sell. If you have only long-term capital gains that will be offset by realizing a long-term capital loss, consider not selling. If that capital loss can be used in a subsequent year to offset ordinary income it may produce a much greater tax savings; however, you will have to wait to enjoy the tax savings.

Accelerate Charitable Contributions?

A gift to a qualifying charity is deductible in the year the contribution is made which is not always the same as the year in which the actual payment is made. If you send a check or charge a contribution on a credit card on or before this December 31st, you are entitled to deduct the contribution on your 2005 income tax return even though the actual payment will not be made until 2006 (or even later if you carry a balance on your credit card for a long period of time, a practice that I do not advise).

The decision of whether to accelerate charitable contribution deductions depends on your current marginal income tax rate and your anticipated future marginal income tax rate. If your rate is low this year because of many other income tax deductions or if most of your income is subject to tax at low rates, such as those applied to long-term capital gains and qualified dividends, and you know that in a subsequent year you will have additional ordinary income, from a raise perhaps, it may be more beneficial from an income tax standpoint to defer the charitable contribution to a subsequent year.

Maximize Contributions to Qualified Retirement Plans?

If you have not contributed the maximum to your qualified retirement plan for 2005, it is not too late. Many plans such as the popular 401(k) require contributions to be made from 2005 earnings. Consider contributing that year-end bonus or last paycheck. However, before contributing the maximum to a 401(k) consider your current marginal income tax rate. If your current rate is less than your anticipated rate upon retirement, it is more beneficial in the long run not to contribute to the 401(k) now, but rather to invest the after tax wages.

Prepay State Income and Real Estate Taxes?

Whether to prepay state income and real estate taxes depends on whether you will be subject to the Alternative Minimum Tax (AMT) because such taxes are not deductible for AMT purposes. If you anticipate being subject to AMT, please see my recent article in which I provided specific AMT tax planning tips. For those who do not anticipate that they will be subject to AMT, the prepayment of a fourth quarter estimated tax payment on December 31, 2005 instead of on the due date for the same, January 15, 2006, may save a third of the payment in 2005 federal income tax.

As with many of the other above tips, the decision to prepay state taxes should not be made in a vacuum. Other issues must be considered. For example, suppose that you paid a large amount of sales tax in 2005. Because the sales tax deduction is permitted as an alternative to the state and local income tax deduction, the prepayment of the fourth quarter state income tax may not save any federal income tax in 2005, but it may in 2006 when the sales tax deduction is not permitted.

Prepay Medical expenses?

Medical expenses, to the extent that they cumulatively exceed 7½ % of Adjusted Gross Income, are deductible as itemized deductions for federal income taxes. Consequently, a common year-end tax planning tip is to pay all of your medical expenses prior to the end of the year with the hope of exceeding the deduction threshold. However, a better technique is to consolidate medical expenses in one year, regardless of the year, unless you always exceed the threshold for a deduction. This enables the greatest amount of medical expenses to produce a tax savings.

The above are general tips, but each requires you to consider your personal circumstances. You should always consult with a qualified professional to obtain year-end tax tips designed specifically for you. One size certainly does not fit all.

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