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# TAX PLANNING

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 *Personal Finance Series* 

BY DELLWYN R. CALL | If you've waited in line at the post office on 15 April, chances are you've seen a few of your friends and neighbors there, too. According to the IRS, one in four Americans files taxes during the two weeks leading up to the annual deadline. | PHOTOGRAPHY BY BRADLEY SLADE



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This is the first of a five-part personal financial planning series sponsored by the Peery Institute of Financial Services. The next installment, addressing insurance, will appear in the Winter 2005 issue.

By then, you've missed the opportunity to implement many of the money-saving strategies that come with wise tax planning. As the end of the year rolls around, preparing and filing our taxes between January and April becomes merely the recording of past events with limited opportunity to change outcomes.

By determining your expected tax liability for the current tax year at the earliest date possible and estimating your liability for the succeeding year, you have the opportunity to minimize your tax liability through tax planning. Spending time now can save money later!

#### ◆ WHERE TO BEGIN

Reducing your tax liability starts with having some knowledge of the income tax system. For most of us, the income tax laws mean listing our income from various sources, reducing that income by allowable deductions, taking a deduction for the number of personal exemptions permitted, and determining the tax from rates that increase as our income increases. The process of reducing our tax cost is primarily achieved by proper timing of income, deductions, and credits and by taking advantage of all the provisions of the tax laws.

The basic strategy is timing the receipt of income so it is taxed at the lowest rate possible, timing deductions to reduce income taxed at the highest rate, and deferring tax to a future date whenever possible. A complete analysis of your current and estimated future tax picture provides the beginning point for all planning. Then by playing "what if," changing the projected taxable income by shifting income and deductions, or deferring income between tax years, you can determine the best plan for you.

Your prior year's income tax return is a good tool to get you started and will provide a point of reference. Creating and maintaining good tax records is an absolute necessity. There are many inexpensive computer programs available that will maintain your financial records and provide the necessary tax reporting information.

#### Creating a Plan

1. Use the Tax Forecasting Worksheet (p. 19) to estimate your income, deductions, exemptions, and credits for 2004 and 2005. You can extend the process to

additional years if you can accurately forecast the income and deductions in the extended period.

2. Use the 2004 Projected Tax Rate Table (p. 20) to determine the marginal income tax rate at which the next dollar of income would be taxed.
3. Identify items of income or deductions that could be shifted between 2004, 2005, or subsequent tax years to place taxable income in the lowest tax bracket for all years.
4. Determine how much tax will be due based on the most opportunistic timing of income and deductions. Compare the estimated tax obligation with anticipated withholding and estimated tax payments to make sure you have paid, or will pay, sufficient amounts to avoid underpayment penalties.
5. Review your tax strategies again to make sure you have taken maximum advantage of all available opportunities.
6. Implement your plan.

#### Reviewing Factors That Affect Your Tax Rate

There are three critical factors of tax planning: 1) Timing income to achieve lowest tax rate, 2) Timing deductions to offset income taxed at highest rates, and 3) Deferring income to future years when possible. As you apply these factors, you need to understand the impact that higher levels of taxable income have on the amount of personal exemptions and itemized deductions to which you will be entitled. Your itemized deductions and personal exemptions are reduced if your Adjusted Gross Income (AGI), a tax term meaning gross taxable income less certain deductions (refer to Tax Forecasting Worksheet), exceeds certain levels or AGI thresholds. These reductions or "phaseouts" are as follows for the year 2004 and are adjusted annually for inflation:

##### Investment Interest

The deduction for investment interest is generally limited to the taxpayer's net investment income (investment income such as nonqualified dividends and interest less investment expenses).

##### Deduction for Medical Expenses

The deduction for medical expenses is limited to the excess of such expenses over

7.5% of AGI. For example, if AGI is \$50,000 the deductions for medical expenses would have to exceed \$3,750 before any deduction is allowed.

##### Personal Exemption Deduction

(\$3,100 per dependant or exemption for you and spouse)

| Phaseout:                     | Begins At | Completed At |
|-------------------------------|-----------|--------------|
| Married,<br>Filing Jointly    | \$214,050 | \$336,550    |
| Single                        | \$142,700 | \$265,200    |
| Married,<br>Filing Separately | \$107,025 | \$168,275    |
| Head of Household             | \$178,350 | \$300,850    |

For example, a married couple starts losing the benefit of their personal exemptions for every dollar of AGI in excess of \$214,050 with a complete elimination of the deduction when AGI reaches \$336,550.

##### Itemized Deduction Phaseout

(Itemized deductions are reduced by 3% times each dollar of AGI in excess of the stated threshold amount.)

|                               |                     |
|-------------------------------|---------------------|
| Married,<br>Filing Jointly    | Begins at \$142,700 |
| Single                        | Begins at \$142,700 |
| Married,<br>Filing Separately | Begins at \$71,350  |
| Head of Household             | Begins at \$142,700 |

There are also special tax rates that apply to certain classes of taxable income, more specifically, qualifying dividend income and long-term capital gains. The 2003 tax legislation made major but potentially temporary revisions in the tax rates applicable to these two classes of income as follows:

##### Dividend Rate Reduction

Qualified dividends received after 1 January 2003 and continuing through 2008 are taxed at the same rates that apply to long-term capital gains (5% if the taxpayer is in the two lowest tax rate brackets and 15% for all other tax brackets). Qualified dividends are distributions from domestic corporations and "qualified foreign corporations." Interest paid

# TAX FORECASTING WORKSHEET

Use your 2003 U.S. Individual Income Tax Return as a point of reference.

| INCOME      |  | 2004     | 2005     |
|-------------|--|----------|----------|
| 1.          | Salaries per W-2 form  | \$ _____ | \$ _____ |
| 2.          | Dividend and interest income   | _____    | _____    |
| 3.          | Business income (loss)   | _____    | _____    |
| 4.          | Net capital gain (loss)  | _____    | _____    |
| 5.          | Passive income<br>(losses) (subject to limitations)  | _____    | _____    |
| 6.          | Social Security (85%)  | _____    | _____    |
| 7.          | Other income   | _____    | _____    |
| 8.          | Total income   | \$ _____ | \$ _____ |
| ADJUSTMENTS |  | 2004     | 2005     |
| 9.          | Education expenses   | \$ _____ | \$ _____ |
| 10.         | Keogh contributions  | _____    | _____    |
| 11.         | Deductible IRA contributions   | _____    | _____    |
| 12.         | Moving expenses  | _____    | _____    |
| 13.         | Other  | _____    | _____    |
| 14.         | Adjusted Gross Income (AGI)<br>(subtract lines 9-13 from line 8)   | \$ _____ | \$ _____ |
| DEDUCTIONS  |  | 2004     | 2005     |
| 15.         | Medical and dental expenses<br>(excess over 7.5% of line 14)   | _____    | _____    |
| 16.         | State and local income taxes   | _____    | _____    |
| 17.         | Real estate and property taxes   | _____    | _____    |
| 18.         | Home mortgage interest   | _____    | _____    |
| 19.         | Investment interest<br>(limited to investment income)  | _____    | _____    |
| 20.         | Charitable contributions   | _____    | _____    |
| 21.         | Casualty or theft losses<br>(excess over \$100 plus 10% of line 14)  | _____    | _____    |
| 22.         | Miscellaneous expenses<br>(excess over 2% of line 14)  | _____    | _____    |
| 23a.        | Total deductions (sum of lines 15-22)  | _____    | _____    |
| 23b.        | Amount deductible (line 23a less 3% of line 14 minus \$142,700<br>[\$71,350 for married filing separately],<br>or the standard deduction if greater) | \$ _____ | \$ _____ |
| 24.         | Personal exemptions (\$3,500 each)<br>(see limitation based on AGI)  | \$ _____ | \$ _____ |
| 25.         | Regular taxable income<br>(subtract lines 23 and 24 from line 14)  | \$ _____ | \$ _____ |
| 26.         | Regular tax (see tax rate tables)  | _____    | _____    |
| 27.         | Tax credits  | _____    | _____    |
| 28.         | Regular tax (net)<br>(subtract line 27 from line 26)   | _____    | _____    |
| 29.         | Alternative minimum tax  | _____    | _____    |
| 30.         | Other taxes<br>(self-employment tax, household help, etc.)   | _____    | _____    |
| 31.         | Total tax (sum of line 28, 29, and 30)   | _____    | _____    |
| 32.         | Total withholding and estimated<br>tax payments  | _____    | _____    |
| 33.         | Balance due (refund)<br>(subtract line 32 from line 31)  | \$ _____ | \$ _____ |

by some financial institutions and labeled “dividends” is not a qualified dividend.

## Capital Gains Rate Reduction

Long-term capital gains, gains on capital assets held for more than six months realized after 5 May 2003 and through 2008, are taxed at 5% (taxpayers in the lowest two tax rate brackets) or at 15% (for the other tax brackets).

As these rate reductions are temporary with “sunset provisions,” and are scheduled to revert in 2009 back to the rates previously in effect (the taxpayer’s regular tax rate for dividends and 10% or 20% for capital gains), the timing of income recognition to take advantage of these lower rates, while they are available could produce significant tax savings. With tax rates also subject to change due to political forces, there is no certainty that the reduced rates will remain in effect through 2008.

In addition to reducing the tax rates on dividends and long-term capital gains, the 2003 tax legislation also accelerated the marginal tax rates that were to be phased in over a period through 2010. These rates are scheduled to sunset in 2011, when they will revert to the pre-2001 rates (the top rate would be 39.6% while the top rate currently is 35%). See the 2004 Projected Tax Rate Table for applicable rates.

## Understanding the Alternative Minimum Tax (AMT)

As if the process of tax planning was not already complicated enough, you also need to understand AMT and how it might affect your tax planning and the timing of income and deductions. The complexities of this tax cannot be fully addressed in this article. Suffice it to say that AMT is a second system of taxation that can impact taxpayers with certain combinations of income and deductions. Most taxpayers become subject to this tax if they have unusually large itemized deductions in a single tax year.

So if you have large itemized deductions for medical expenses, taxes, interest (other than mortgage and investment interest), and other itemized deductions, be alert to the possible impact of AMT. Note that deductions for mortgage and investment interest and charitable contributions are fully deductible in arriving at alternative minimum taxable income.

## ◆ SHIFTING OR DEFERRING INCOME

### Playing the "What If" Game

With an understanding of the interplay between gross income, personal exemptions, itemized deductions, and income tax rates, you are ready to start playing the "what if" game of shifting income and deductions to get the lowest tax cost. This will necessitate making multiple computations of taxable income. If you use a computer program to prepare your tax return, you may be able to use that same program in playing the "what if" game. Certain tax computer programs will allow you to make income tax projections over several years, but if your computer program does not, you can use the program to accumulate the information and make adjustments to reflect the changes required.

The "what if" game begins with focusing on the tax strategy of shifting or deferring taxable income to tax years when the income will be taxed at a lower tax rate. This is one of the most effective techniques you can use to reduce your tax cost. It is also the method over which you may have the least amount of control. Most taxpayers use the cash method of accounting, which means that income is taken into account when received (or made available without

restrictions), and deductions are taken into account when paid.

Your objective is to equalize income between years so that income is taxed, for the current and subsequent years, at the lowest rate possible for all years. If your personal forecast of income shows that you will be in the same or a lower tax bracket next year, or the following year, you would want to delay the receipt of income to the year where it would be taxed at the lowest rate. A word of caution, however: the deferral of income should not be considered if the deferral would jeopardize the potential receipt of that income. Conversely, if current year income is projected to be less than next year, you would want to accelerate the receipt of income into the current year. Some techniques that you might use to shift or defer income could include:

#### *Year-End Bonuses*

If you expect to receive a year-end bonus, and it would be more tax effective to receive it the succeeding year, arrange with your employer to receive the bonus in January of next year. If bonuses are normally paid the following year, you could negotiate to be paid prior to year end. The employer would be entitled to deduct it in the year paid.

#### *Delayed Collection of Income*

If you are self-employed and use the cash method of accounting, you can defer income to a subsequent year by delaying your year-end billings so that collections will not be received until after the first of the new year.

#### *Proper Selection of Investments*

You can defer income through investments such as interest on T-bills and bank certificates that have a term of one year or less. Interest on the T-bills and bank certificates is not includible in income until received at maturity. Investing in growth stocks that do not pay regular dividends is another method by which income can be deferred. The income from the stock is reflected in the stock's appreciation that is realized upon sale.

#### *Exercise of Stock Options*

If you have been granted qualified or non-qualified stock options by your employer, the exercise of the option, which generally results in the recognition of taxable income for the difference between fair market value and option purchase price, should be timed to provide you the most optimum tax and economic results. If the stock options are

## 2004 PROJECTED TAX RATE TABLE

Taxable Income

### MARRIED TAXPAYERS FILING JOINT RETURNS

| OVER (\$) | BUT NOT OVER (\$) | RATE (%) |
|-----------|-------------------|----------|
| -0-       | \$14,300          | 10%      |
| \$14,300  | \$58,100          | 15%      |
| \$58,100  | \$117,250         | 25%      |
| \$117,250 | \$178,650         | 28%      |
| \$178,650 | \$319,100         | 33%      |
| \$319,100 |                   | 35%      |

### SINGLE TAXPAYERS

| OVER (\$) | BUT NOT OVER (\$) | RATE (%) |
|-----------|-------------------|----------|
| -0-       | \$7,150           | 10%      |
| \$7,150   | \$29,050          | 15%      |
| \$29,050  | \$70,350          | 25%      |
| \$70,350  | \$146,750         | 28%      |
| \$146,750 | \$319,100         | 33%      |
| \$319,100 |                   | 35%      |

### MARRIED TAXPAYERS FILING SEPARATE RETURNS

| OVER (\$) | BUT NOT OVER (\$) | RATE (%) |
|-----------|-------------------|----------|
| -0-       | \$7,150           | 10%      |
| \$7,150   | \$29,050          | 15%      |
| \$29,050  | \$58,625          | 25%      |
| \$58,625  | \$89,325          | 28%      |
| \$89,325  | \$159,550         | 33%      |
| \$159,550 |                   | 35%      |

### INDIVIDUALS FILING AS HEAD OF HOUSEHOLD

| OVER (\$) | BUT NOT OVER (\$) | RATE (%) |
|-----------|-------------------|----------|
| -0-       | \$10,200          | 10%      |
| \$10,200  | \$38,900          | 15%      |
| \$38,900  | \$100,500         | 25%      |
| \$100,500 | \$162,700         | 28%      |
| \$162,700 | \$319,100         | 33%      |
| \$319,100 |                   | 35%      |

Incentive Stock Options (ISOs), you will not recognize taxable income until you dispose of the stock. However, exercise of the option will result in recognition of AMT income for the amount of difference between fair market value and exercise price.

#### *Timing of Sales*

If you contemplate selling marketable securities and will realize a capital gain, proper timing of the sale can result in tax savings. Remember that short-term capital gains, held for fewer than twelve months, are taxed as ordinary income (using the graduated rates of up to 35%), while long-term capital gains, held for more than twelve months, are taxed at either 5% or 15% depending on your total income. Deferring the sale from one year to the next will defer the tax and possibly result in a more advantageous spreading of income between years. If you have capital losses in your portfolio, but have been reluctant to sell because you anticipate a recovery of the loss, you can sell the investment, take the loss, and then reinvest in the same security after waiting a period of thirty days.

#### **Accelerating Taxable Income**

There may be some situations when acceleration of income will provide significant tax savings. The following are examples of some of those situations:

1. Projected change in filing status such as marriage, divorce, or potential death of spouse.
2. Significant change in income level. Projected asset sale, significant bonus, or other change placing you in a higher income tax bracket.
3. Lapsing of carryover deductions such as charitable or net operating loss carryovers.
4. Itemized deductions exceed your current year's taxable income.

The acceleration of income is accomplished by reversing the strategies discussed earlier and by:

1. Accelerating that bonus into the earlier year.
2. Pushing for collections of receivables by early billing or providing incentives for early payment.
3. Exercising your stock options or sell securities at an earlier date. Pay atten-

tion to the holding period of the assets to take full advantage of the long-term capital gain rates.

4. Considering accelerating investment income into the current year if your deduction for investment interest is limited.

#### ◆ **TIMING DEDUCTIONS**

With certain deductions reducing taxable income only to the extent that they exceed stated percentages of AGI, you will need to time your deductions for best advantage. The actual payment of a deductible item gives rise to a deduction in the year paid for taxpayers using the cash method of accounting. This provides great flexibility to the taxpayer for proper timing of itemized deductions. Remember there are two potential reductions for deductions:

First, certain deductions are limited to an amount in excess of a percent of AGI. Examples:

- Medical expenses must exceed 7.5% of AGI
- Miscellaneous other deductions must exceed 2% of AGI
- Casualty losses must exceed 10% of AGI

Second, after the first reduction, the overall deductions are then reduced by 3% of AGI if in excess of the threshold amount previously discussed.

#### **Bunching**

In your planning, first determine whether you will lose a portion of your deductions because they fail to reach the limitation threshold. If this is the case, you should consider bunching deductions. Bunching payment of expenses for two years into one year can push the deduction over the threshold limitation. This technique is particularly effective if your income in one year is expected to be inflated by some unusual event.

Keep in mind that most deductions must relate to the payment of obligations that exist at the time of payment. Thus, the prepayment of expenses, such as prepaying next year's real estate taxes in the current year, will not give rise to a deductible expense. However, proper arrangements can frequently be made to defer payments for expenses of the prior year to the following January.

If you have elective medical treatments, timing of treatment and payment of the cost of the procedure can achieve the bunching result. If you have an obligation for state income taxes, you can time the year of deduction by making estimated tax payments before the end of the year, accelerating the deduction, or deferring payment until the subsequent year by delaying payment. Finally, charitable deductions are one of the most flexible of deductible expenses to assist in achieving your tax planning. Their payment is completely discretionary to the taxpayer.

If your total itemized deductions are approximately equal to your standard deduction, the bunching of deductions would allow you to use the standard deduction one year and give you the benefit of your total deductions in the next year. The sum of the deductions for the two years could exceed the total amount actually paid.

#### ◆ **TAKING ADVANTAGE OF CREDITS**

Don't forget to consider available tax credits. There are special credits available to certain taxpayers that include child tax credit, education credits, credit for child and dependent care expenses, and adoption credit. A review of the instructions provided with your federal income tax return will help you determine whether they have any application to you.

#### ◆ **CONCLUSION**

As you can see, careful analysis and the expenditure of some time are required to achieve the dollar savings from tax planning. Once you have gone through the exercise, developed skills, and gained confidence through your efforts, subsequent years of tax planning will become easier. The rewards from your patient efforts can be of significant benefit to you and your family. **M**

#### ◆ **ABOUT THE AUTHOR**

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