Tax Strategies, Year-End 2007

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"The avoidance of taxes is the only intellectual pursuit that carries any reward."

— John Maynard Keynes

Overview

Tax planning primarily concerns the timing and the method by which income is reported and deductions and credits are claimed. The basic strategy for all year-end tax plans is to time your income so that it will be taxed at a lower rate and to time your deductible expenses (and any tax credits) so that they can be claimed in a year in which you are in a higher tax bracket. The tax planning rules are simple (while their execution may be more complicated). They may be summed up as:

- Postpone payment of taxes whenever possible.
- Recognize income in a year with the lowest possible tax rate.
- Pay and deduct expenses (and claim any tax credits) in a year with the highest possible tax rate.

Generally the best tax advice is to defer income to 2008 and accelerate your tax deductions into 2007. Both those moves delay the payment of income taxes for an entire year and give you "the use of the money."

Defer Taxable Income to 2008

Many of you can make various arrangements that will delay December 2007 bonuses, salaries, commissions and fees until January 2008. If you are self-employed, postpone sending out further bills until January 2008. Don't cash any savings bonds until next year. Delay all legally possible retirement plan distributions or dividend payments, and stay the exercising of stock options until next year.

Accelerate Tax Deductions to 2007

This has the same tax effect as deferring income to 2008, since it decreases your 2007 net taxable income by the amount of the increased deductions. The most obvious ones you can control and accelerate are: (1) charitable contributions (the best, most flexible, and discretionary); (2) real estate tax installments; and (3) state income tax payments. However, those last two tax deductions can help trigger the Alternative Minimum Tax (AMT), so don't overdo them, until you get some expert advice. Further, you can make your January 2008 mortgage or home equity payment in December 2007 to increase your 2007 interest deductions (but do it early enough in December, so that it is reported to the IRS on Form 1098 as a year 2007 payment).

Whenever possible, make every charitable contribution in the form of appreciated property that you have held over one year.

TAXTIP: You can always augment your state income tax deduction, if you simply increase your state tax withholding in the last periods of the year. We have had some clients triple and quadruple their end-of-the-year tax withholdings — and a few desperate individuals have even applied 100% of their December salaries as withheld income taxes! This technique is also used to avoid underpayment penalties at both the federal and state levels, since all withholding is considered to be paid in evenly ("ratably") over the year — regardless of when it is actually withheld.

For cash-method taxpayers (almost all individuals and many businesses), an expense is deductible when "paid." Checks should be dated and mailed before January 1. Credit card charges made before January 1 also qualify — even though the credit card company is paid next year (or the year after, or the year after that, for some of you). Giving a seller or service provider an IOU does not create a tax deduction for you cash-basis folks. Accrual-method businesses can generally deduct expenses when there is: (a) an obligation to pay and (b) "economic performance" has taken place.

"Bunching" Certain Tax Deductions

In two special cases, the excess of certain expenses are only deductible above their (non-deductible) "floors," which represent a percentage of Adjusted Gross Income (AGI). For medical expenses the floor is 7.5% of AGI and for miscellaneous itemized deductions, (which includes unreimbursed business expenses (unless you are a "statutory employee"), the floor is 2% of AGI.

In both instances, you must ignore the general advice to accelerate deductions into 2007 and only do so if these added deductions will permit you to exceed the floors. If you are approaching the 7.5% medical floor, pay all additional medical expenses in 2007 — and have elective surgery, dental work, eye exams, prescription glasses and/or contact lenses completed by year-end. Conversely, if you are way under the 7.5% floor, defer all remaining payments and elective procedures to 2008 — where they may provide you with a tax benefit. Do the same for miscellaneous itemized deductions and its 2% floor. "Bunch" into 2007 or defer until 2008, depending on whether you can exceed that 2% floor in 2007.

Assorted TAXTIPS for Year-End Tax Planning

Donations from your IRA to charity: There are four absolute requirements to take advantage of this new option: (1) you must be age 70½; (2) you only have this opportunity in 2007; (3) you can contribute up to a maximum of $100,000; and (4) payment must be made by the IRA trustee directly to a qualified charity. The distribution is tax-free to you, but you do not get a charitable tax deduction. Still big advantages for some of you, so see your own tax advisor quickly!

Make your $12,000 (single) or $24,000 (married) tax-free annual gifts to as many individuals as you choose to reduce potential estate taxes in the future. There is no carryover of this annual gift tax exclusion. Use it or lose it — before December 31st.

Whenever possible, make every charitable contribution in the form of appreciated property that you have held over one year. You generally get a tax deduction for the full market value of the property and there is no longer any alternative minimum or regular tax to worry about in this particular case. (Excess deductions exceeding 50% or 30% of your current AGI can be carried over for an additional five years.) On the other hand, if you have property that has decreased in value (e.g., most stocks that I buy), always sell it yourself, so that you can claim the tax loss personally — and then contribute the cash proceeds from the sale to charity (if you wish).

Legal fees paid by individuals can represent a tax deduction, if you can get your lawyer to itemize the bills, to separately indicate tax-deductible amounts paid for: (1) general tax advice, including services related to estate tax planning; (2) obtaining or maintaining alimony awards; (3) relating to income-producing property, or investments; (4) tax advice related to a divorce.

Contribute the new higher maximums to any and every kind of retirement plan. This should be among your very highest priorities.

You must "establish" your Keogh (H.R. 10) or Solo 401(k) plan by December 31, 2007, if you want to claim such a tax deduction for the year 2007 — you cannot wait until April 15, 2008. Once created, you can pay the bulk of the contribution in 2008 — and still claim a full 2007 tax deduction.

Claim any worthless bad debts and losses from Section 1244 business stock. Any Section 1244 losses represent an ordinary (not capital) loss deduction up to the annual limits ($100,000 — joint tax return; or $50,000 — single) and thus are quite valuable. Claim any other worthless bad debts. If possible sell any worthless or near worthless securities (say for $1 or $10), as this positively establishes both your exact loss and the year.

If you have unused passive losses which have been carried into 2007 (frequently from real estate limited partnerships) and you would like to claim them in 2007 (because this is a high-income year, or for other reasons), consider this option: If you sell the activities with the suspended losses in 2007, those losses then become "ordinary" losses and can be used to offset all your ordinary income this year!

TAXTIP: You must sell to an "unrelated third party" or this idea will not work, but your son-in-law or daughter-in-law are both considered unrelated third parties (as is your CPA).

Hire your children to work in your business — this is almost always worthwhile — and they can establish a Roth IRA with those earnings, or help pay for their college education.

The "wash-sale" rule: You cannot claim a current loss for the sale of a stock (or other security), if within 30 days before or after that sale — you buy the same ("substantially identical") stock (or other security). *See more later.*

Business start-up costs of over the first $5,000 must now be written off over 15 years instead of 5 years. However, the first $5,000 can now be deducted immediately. There are two categories covered by this provision. "Organization costs," incident to the creation of a corporation or organization of a partnership, and "start-up costs" that are business expenses paid before the business began.

If your income is too high to qualify for education tax credits (that you are otherwise entitled to), consider not claiming that student as a dependent. Then the student may be able to claim the education credit (depending on his/her income), even though you actually paid the tuition.

If you are reporting huge capital gains in 2007 (e.g., sale of your business), or very high ordinary income, consider making a very substantial state income tax payment (by estimate or extra withholding) before December 31, 2007. This "matches" the extra-large income with an extra-large itemized tax deduction in the same year and is far more beneficial than having that big state tax deduction in 2008 — when your income may be much lower, and a huge state tax deduction in 2008 could easily make you liable for the AMT.

The standard business mileage rate for 2007 is 48.5¢. This is for both tax-free reimbursements and tax-deduction purposes. If you have been reimbursing employees at a lower rate per mile, you could retroactively (to January 1, 2007) increase their reimbursements to 48.5¢ — tax-free. This could even represent a tax-free Christmas bonus, or be paid in lieu of (taxable) salary.

Remember — all cash donations to charity must now be documented — from $1 up! A cancelled check, credit card receipt, or a written confirmation from the charity is mandatory. For donations of $250 and up you must obtain a charity-provided acknowledgment.

If you own "nonqualified stock options," consider whether it may be prudent to exercise them (all, or a portion) in 2007. This action will generate taxable income, so from both a tax and investment perspective — get expert advice as to whether this is a smart thing to do.

The exercise of "incentive stock options" (ISOs) generally does not trigger regular income taxes — but can subject you to the AMT on the" bargain element" of the option. If you qualify — you will again need some expert advice as to in what year and how much to exercise. (Personally, I don't have this problem, as I exercise very little.)

Under IRC Section 179 taxpayers can immediately charge to expense up to $125,000 (2007 amount) of qualifying assets acquired, with a $500,000 property cap on such asset purchases; and providing you show a profit. (**CAUTION:** Many states, including California, have not adopted this new write-off amount, so it's frequently just a federal tax deduction, which means two sets of depreciation records and more work for us accountants.)

Taxpayers can elect to either deduct state and local income taxes or sales taxes, whichever is higher.

If you refinanced your home mortgage in 2007, the general rule is that any points paid on a re-fi can only be deducted ratably (i.e., evenly) over the life of the loan. However, if the new loan proceeds were used entirely to improve your principal residence — you can deduct the entire points paid in 2007. (If part of the proceeds were used for home improvement, you can immediately deduct that pro-rata share of the points.)

Verify that you have substantiated all your reimbursed business expenses with your employer, or do so immediately. Unsubstantiated business expense reimbursements will end up being reported as additional income on your Form W-2. As a general rule, expenses should be substantiated within 60 days after they are incurred and excess reimbursements repaid to the employer within 120 days.

Some investors think that because the interest earned on municipal bonds is tax-free — that any losses on such bonds cannot be deducted. Any loss on the sale of the actual bond represents a tax-deductible capital loss. Consider "bond swapping." If you have a tax-exempt bond that has gone down in value, you can sell it to obtain that tax loss. Then, you buy back similar (not identical) bonds that deliver about the same amount of steady income. And voila — you have a tax-deductible loss and the same income as before.

Remember the current rules regarding the sale of your principal residence. If you qualify, you can now pocket, tax-free, gains of up to $500,000 (joint tax return) or $250,000 (all others) — every two years.

Exchange business or investment property for "like-kind" property — tax-free. This option (IRC Sec. 1031) lets you take the profit on one piece of property and roll all the proceeds over into another property, without incurring any tax on the gain. (However, you cannot do a 1031 exchange of your stocks and bonds.) This technique has been used with incredible success in the currently rising real estate market. Some of the largest real estate fortunes in the country have been created by using this concept (along with the tax-free and steady refinancing of increasingly valuable properties — to buy more properties). Consult an expert.

Also check out the new Sec. 1031 exchange rules that now let you swap your property for fractional interests in real

Hire your children to work in your business — this is almost always worthwhile — and they can establish a Roth IRA with those earnings, or help pay for their college education.

> "The way to make money in the stock market is to **only buy the stocks that will go up** ...and if they don't go up, don't buy them." — Mark Twain

estate syndications, tenants-in-common investments and the like.

Accelerate advertising expenditures to maximize your tax deductions. Whatever is spent (whether cash or accrual basis) for general advertising is fully deductible in 2007 — even if the primary benefit from the advertising is obtained in the following year.

Businesses can write down obsolete or damaged inventories to their reduced market values (this will decrease the profit for the year). To accomplish this, within 30 days after the inventory date, such items must be offered for sale at the price to which they were written down. (**CAUTION:** This method cannot be used for those on the LIFO method of inventory valuation.) For excess or slow-moving inventories, they must be actually disposed of before any reduction in value can be claimed, so consider doing so quickly.

If you have business travel scheduled for early next year, and you have some leeway in scheduling the dates — consider moving the travel into this year to accelerate your tax deductions.

Assorted TAXTIPS for Capital Gains

While we usually refer to the current long-term federal capital gains tax rate as (a maximum of) 15%, here is a reminder of some special rules. The sales of "collectibles" (e.g., works of art, stamps, coins, rugs, gems, antiques and similar) are taxed at a maximum federal tax rate of 25% — and not 15%. Further, there is a special rate of 25% applied to some of the profit from real estate sales, to the extent that profit is the result of depreciation previously claimed. Sometimes, the entire profit is represented by that depreciation recapture and thus taxed at 25% — to the chagrin of many unsophisticated taxpayers.

Long-term capital gains are defined as capital assets held over one year before the sale or other disposition. In other words, at least a year and a day — or more.

Try to take capital losses to offset short-term capital gains (capital assets sold in one year or less). In that manner you are offsetting the losses against income taxable at up to 35%. If you offset those losses against long-term capital gains, you are reducing income that is only taxable at a maximum of 15% anyway.

In general, try to balance amounts of capital gains and losses for the year — since capital losses are fully deductible only against capital gains. In addition, you can deduct $3,000 each year of excess capital losses against all your other income (and any losses of more than the $3,000 can be carried over to future years indefinitely).

If you inherited investment property from a decedent, any gain from the sale of that property is always a long-term gain — even if it was not held for over one year by you. This is because of a special rule, under IRC 1223(11). Also remember that the inherited property currently gets a tax basis equal to the fair market value on the date of death — and not the original cost.

You have the option of reporting your capital gains using the installment method of tax reporting — if payments are going to be received in more than one year. This permits you to pay the tax as you receive the payments, rather than all in the year of the sale. (You cannot use this for the sale of publicly traded stocks or securities.) **CAUTION:** However, if real property is being sold on the installment method — you still must report all of the profit provided by prior depreciation deductions in the year of sale (and at 25%, see earlier). This can represent a huge tax trap that catches many taxpayers by surprise.

Conversely, if you already have an installment note and 2007 is a low-income year — you can try and accelerate all that future years' installment income into 2007. Any of these methods will work: (a) if the buyer agrees to pay off the note before year-end (perhaps with a discount); (b) you sell the note to a third party; or (c) you use the note as collateral for a loan.

If you sold securities or mutual funds in 2007, be aware that there are four different methods you can use to calculate your tax-cost basis — and you may want to sell the shares with the highest tax basis:

- **First-in, first-out** — required by the IRS if no other method is indicated.
- **Specific shares** ("specific identification") — allows you to select specific shares for the sale.
- **Single category, average cost** — averages the cost of all the shares in a single account and applies that cost to all the shares sold.
- **Double category, average cost** — allows you to separate the costs between long-term shares (held over one year) and short-term shares (held one year or less) and then determine separately the average cost for each category.

Be sure to elect and select the most advantageous method (and you must so indicate on your tax return if you use other than the first method) and don't forget to add any reinvested dividends and reinvested capital gains to your cost basis in all cases (a common error). Also, be sure to avoid the 30-day "wash sale" rule when selling securities at a loss and then repurchasing the identical ones (see following).

The Wash-Sale Rule and How to Avoid It

You cannot claim a current loss for the sale of a stock (or other security), if within 30 days before or after that sale — you buy the same ("substantially identical") stock or other security. Here are three ways to avoid the wash-sale rule:

Sell the stock you hold and then wait 31 days to buy it back. Your risk is that the stock will go up during the 31-day waiting period.

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Buy more of the stock first and then sell the older stock 31 days later. Your risk is that the stock will decline during the 31-day waiting period.

Simultaneously sell and buy the stocks of similar companies, which avoid the wash-sale rule completely — since they are not considered "substantially identical" (e.g., you simultaneously sell General Motors stock and buy Ford — or maybe Studebaker and Pierce-Arrow). Then, after 31 days, you can sell and buy back — to restore your original position (if you wish).

One set of transactions that puzzle the IRS and about which they appear unsure, is this one. You personally sell 1000 shares of XYZ stock at a loss — and simultaneously buy 1000 shares of XYZ in your retirement plan. Does this come under the wash-sale rule, or not? What are the chances of both these transactions ever being matched by the IRS?

In general, when buying stocks, remember the sage advice from Mr. Mark Twain: "The way to make money in the stock market is to only buy the stocks that will go up — and if they don't go up — don't buy them."

Conclusion

To repeat a favorite quote of ours: "As the clock ticks away towards the end of 2007 — don't just stand there with your tax return hanging out — do something!"

Watch for Mel's column next month on "Latest IRS Audit Figures."

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