Tapping in to Year-End Tax Savings: Nine Ways to Cut Your Tax Bill Before You Sing Auld Lang Syne

by Jim Lange

New tax laws could mean extra savings for you when it comes time to file your taxes. But CPA/Attorney Jim Lange says you need to learn how the new laws affect you now to ensure you take advantage of the full savings.

The end of the year is fast approaching. Time for the usual indulgences: eating too much at parties, spending too much on holiday gifts, and planning overly ambitious New Year's resolutions to undo the damage caused by the first two. What you're probably not focused on, but should be, is another kind of excess. Taxes. Before you let out a please-let's-put-this-off-till-April moan, take a moment to consider what you can do before year's end to help you out when tax time rolls around. Jim Lange says two new tax laws could mean big savings for you.

"I know that deciphering the relevance and nuances of new tax laws is, for most people, about as much fun as drinking castor oil," says Lange, author of Retire Secure! Pay Taxes Later: The Key to Making Your Money Last as Long as You Do (Wiley, 2006, ISBN: 0-470-04354-7, $24.95). "However, taking the time to understand what they mean for youâ€"which, by the way, I'm here to help you withâ€"can save you a lot of money. That knowledge should make the process much less painful.

"Everyone should know there have been two major tax bills passed this year that have important implications for taxpayers," he continues. "The bills, the Tax Increase Prevention and Reconciliation Act, also called TIPRA, and the Pension Protection Act, or PPA for short, offer enormous tax savingsâ€"if you respond appropriately right now."

Here is a summary of the best strategies for making these new tax laws work for youâ€"strategies that could help you save thousands of dollars and potentially much more in the long run.

Create nondeductible IRAs now to convert to Roth IRAs in 2010. TIPRA permits all taxpayers to make Roth conversions beginning in the year 2010, regardless of their income level. For the family, the long-term benefit of a Roth IRA conversion is simply phenomenal. The new provision will particularly benefit high-income taxpayers who have not had the opportunity to make significant contributions to a tax-free Roth account. High-income taxpayers are likely to have the longest time horizon to grow the funds tax-free and may not have to pay a higher marginal tax rate on the conversion income. Roth IRA conversions have been a valuable tool in maximizing financial security for the family. While each individual's case will benefit from an individualized analysis of the merits of the conversion, the critical feature of the Roth is that, once the initial taxes are paid on the conversion, income taxes will never be due on the growth, capital gains, dividends, interest, etc.

"Here's a sleeper idea for the wealthy," says Lange. "If you currently cannot even make Roth IRA contributions because your income is over $160,000 (joint filers) or $110,000 (single filer), consider making nondeductible traditional IRA contributions now and then convert the IRA to a Roth IRA in 2010. If those are your only IRAs, you may pay much less in tax on the conversion since you will have basis equal to the amounts contributed."

Maximize retirement plan contributions through your plan at work. The PPA has also made permanent the laws allowing higher contributions to your retirement plans and the catch-up contributions for individuals over age fifty. In 2006, individuals can contribute $15,000 per year ($20,000 per year if age fifty and older) to their retirement plans. If you haven't already, now is the time to review your 2006 year-to-date retirement plan contribution opportunities. In many instances, your employer plan will allow you to make changes for the remainder of 2006 to contribute more if you have not maximized your 2006 contributions to your desired level. Even more liberal savings opportunities exist in 2007 with the increase in the contribution limit to $15,500 per year ($20,500 per year if age fifty and older). These elective deferrals can be made on a pre-tax basis or, if your employer offers them, through the new Roth 401(k) and 403(b) plans. Keep in mind that contributions to elective deferral retirement plans and self-employed retirement plans will reduce your adjusted gross income.

Save money through tax-loss harvesting. Using capital loss carry-forwards to reduce taxable gains by offsetting the losses against the gains is referred to as "tax-loss harvesting or tax-loss selling." Now is the time to review your investment portfolio and make some decisions that will generate tax savings. It is required for income tax purposes to match your short-term gains with short-term losses and your long-term gains with long-term losses. If you can avoid it, you do not want to end up with short-term taxable gains because you failed to sell, prior to year-end, securities that would have created a loss to offset these short-term gains. Short-term gains are taxed at ordinary income rates that are as high as 35 percent in 2006. "Ideally, you want to generate losses because you can deduct up to $3,000 per year of losses against ordinary income," says Lange. "That adds up to an $840 tax savings for an individual who is in a 28 percent tax bracket. Be careful to avoid a wash sale, i.e., buying the same security within thirty days of the time you sell the sharesâ€”the tax rules will disallow the loss."

Roths available for everyone who works: new Roth 401(k) and 403(b). Effective January 1, 2006, employers were able to add a Roth feature to 401(k) and 403(b) retirement plans to their employees. The Roth 401(k) and/or Roth 403(b) plans were originally scheduled to last only through 2007, so employers were hesitant to make the changes to their plans to allow this option. However, the PPA has now made these plan options a permanent addition to the tax code. Therefore, more employers have now adopted these features, and many employers who did not offer these in 2006 will now begin the feature in 2007.

"This really is a great new addition to the retirement plan arena," says Lange. "By now most taxpayers have heard of Roth IRAs and I am an advocate of using them, when possible, to take advantage of the tax-free growth of the account. In the past, many of my clients made too much money to qualify for Roth IRA contributions. Well, that statement is now old news since all taxpayers whose employers offer Roth 401(k) or Roth 403(b) plans are now eligible to make contributions to these plans, regardless of their income."

If you are over 70 Â½ years old, reduce your taxable income by directing your IRA minimum required distribution to charity. Under the PPA, effective for years 2006 and 2007, if you are over 70 Â½ you can make a qualified charitable distribution directly from your IRA to the charity of your choice (subject to some restrictions). This provision applies to IRAs only and not qualified plans. The money transferred from the IRA does not count as income. You don't get a charitable deduction, but for many taxpayers, this is a good trade. A key provision of this new law is that the IRA amount donated in this fashion counts toward your minimum required distribution (MRD). Also, if you have after-tax dollars or nondeductible IRAs, the donated part comes out of only the taxable part and does not diminish your after-tax or nondeductible portion of the IRA. This may set you up for a more favorable Roth IRA conversion in future years since fewer dollars would be taxable.

Go ahead and make non-cash charitable contributionsâ€"but keep good records. The PPA also made a significant number of rule changes on the requirements of charities and individuals claiming non-cash contributions. Among other things, the IRS now will allow donations of clothing and household items only in "good used condition or better." Although the IRS cannot define exactly what that means, it is an indication that they are cracking down on a much-abused deduction. In order to better document your contributions, we suggest keeping a detailed list of what was donated, with values of individual items and original costs, if known. Taking a picture of donated items is also suggested. "Another quick tip: for money denominated contributions over $250, the IRS now requires a cancelled check or credit card statement as backup in addition to the letter from charities," says Lange. "Cash contributions that do not have this backup are no longer deductible. Therefore, we suggest using checks for all contributions instead of cash. This new rule change discourages the age-old gifts to the collection plate at a church, synagogue, or other organizations that pass around a collection plate."

Think before transferring investment assets to your kid: the new "kiddie" tax rules. TIPRA rules now will classify children as those through age seventeenâ€”not just youngsters through age thirteen, as before. This means that if your child under age eighteen has investment income over $1,700 in 2006, the child will pay tax at the parent's tax rate and must file Form 8615. It is still a good tax planning strategy to transfer investments to your child up to the point where the income from them is $1,700. If your child is eighteen years old, it is still prudent to transfer investments earning over $1,700 to him/her. For example, assume you are in a 25 percent tax bracket and are planning to sell some appreciated long-term stock to pay for your eighteen-year-old's education. Consider making a gift and transferring the stock to your child, who subsequently sells the stock. You have effectively shifted long-term capital gains from a 15 percent taxation rate to your child's long-term capital gains tax rate of 5 percent. You should keep in mind that there are no strings attached to these types of gifts. Keep in mind that with this type of transaction, the money becomes your child's money. Also, make Roth IRA contributions for your kids if they have any earned income.

Buy a hybrid car. Beginning in 2006, there are tax credits available for purchasing Alternative Technology Vehicles, the most common of which are the hybrid vehicles that use both gas and electricity to propel the vehicle. This credit reduces federal tax bills on a dollar-for-dollar basis and replaces the clean-fuel vehicle deduction allowed in prior years. Unlike many tax credits in the Internal Revenue Code, these energy tax credits are not phased out for higher-income individuals.

Caution is needed in quantifying the benefits, however, for two reasons. One is that its apparent benefit may be offset by the Alternative Minimum Tax (AMT). The other is that the full credit is available only until the end of the first calendar quarter after the quarter in which the manufacturer records its sale of the 60,000th vehicle. The two quarters thereafter, you get only 50 percent of the full credit. The two quarters after that, you get only 25 percent of the full credit, and after that, nothing.

Make energy-efficient improvements to your home and reap tax benefits. A tax credit is also available for the purchase of energy-efficient improvements to existing homes located in the United States. Qualifying property includes insulation, windows, doors, furnaces, and hot water heaters. A qualifying purchase will mainly be based on manufacturer certifications in the materials that come with their products. The credit is based on a percentage of the cost of the qualifying item. For example, you will take 10 percent of the cost of qualifying windows up to a maximum credit of $200. There is a maximum lifetime credit of $500 for all of the qualifying purchases mentioned above.

"If you don't take the time right now to review your financials to see which of these new provisions will benefit you, you are missing out on potentially saving thousands of dollars," says Lange. "I know a lot of this material can be very heavy. If you're just not sure what all of this means for you, sit down with your financial advisor and let him or her explain it. I know it doesn't fit with your festive mood, but make an appointment and grab some holiday cookies to take with you to lighten the mood. Come April 15, you'll be very glad you did."

About the Author:

James Lange, CPA/Attorney, is a nationally recognized IRA, 401(k), and retirement plan distribution expert. With over 27 years of experience, Jim offers unbeatable recommendations when he tackles the number one fear facing most retirees: running out of money. Jim has also developed "Lange's Cascading Beneficiary PlanTM," which is widely regarded as the "gold standard" of estate planning for IRA and retirement plan owners.