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# Tax Planning for Income



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## Tax Planning for Income

The goal of income tax planning is to minimize your federal income tax liability. You can achieve this in different ways. Typically, though, you'd look at ways to reduce your taxable income, perhaps by deferring your income or shifting income to family members. You should also consider deduction planning, investment tax planning, and year-end planning strategies to lower your overall income tax burden.

### Postpone your income to minimize your current income tax liability

By deferring (postponing) income to a later year, you may be able to minimize your current income tax liability and invest the money that you'd otherwise use to pay income taxes. And when you eventually report the income, you may be in a lower income tax bracket.

Certain retirement plans can help you to postpone the payment of taxes on your earned income. With a 401(k) plan, for example, you contribute part of your salary into the plan, paying income tax only when you withdraw money from the plan (withdrawals before age 59½ may be subject to a 10 percent penalty). This allows you to postpone the taxation of part of your salary and take advantage of the tax-deferred growth in your investment earnings.

There are many other ways to postpone your taxable income. For instance, you can contribute to a traditional IRA, buy permanent life insurance (the cash value part grows tax deferred), or invest in certain savings bonds. You may want to speak with a tax professional about your tax planning options.

### Shift income to your family members to lower the overall family tax burden

You can also minimize your federal income taxes by shifting income to family members who are in a lower tax bracket. For example, if you own stock that produces a great deal of dividend income, consider gifting the stock to your children. After you've made the gift, the dividends will represent income to them rather than to you. This may lower your tax burden. Keep in mind that you can make a tax-free gift of up to \$13,000 per year per recipient without incurring federal gift tax.

However, look out for the kiddie tax rules. Under these rules, for children (1) under age 18, or (2) under age 19 or full-time students under age 24 who don't earn more than one-half of their financial support, any unearned income over \$1,900 is taxed at the parent's marginal tax rate. Also, be sure to check the laws of your state before giving securities to minors.

Other ways of shifting income include hiring a family member for the family business and creating a family limited partnership. Investigate all of your options before making a decision.

### Deduction planning involves proper timing and control over your income

Lowering your federal income tax liability through deductions is the goal of deduction planning. You should take all deductions to which you are entitled, and time them in the most efficient manner.

As a starting point, you'll have to decide whether to itemize your deductions or take the standard deduction. Generally, you'll choose whichever method lowers your taxes the most. If you itemize, be aware that some of your deductions may be disallowed if your adjusted gross income (AGI) reaches a certain threshold figure. If you expect that your AGI might limit your itemized deductions, try to lower your AGI. To lower your AGI for the year, you can defer part of your income to next year, buy investments that generate tax-exempt income, and contribute as much as you can to qualified retirement plans.

Because you can sometimes control whether a deductible expense falls into the current tax year or the next, you may have some control over the timing of your deduction. If you're in a higher federal income tax bracket this year than you expect to be in next year, you'll want to accelerate your deductions into the current year. You can



accelerate deductions by paying deductible expenses and making charitable contributions this year instead of waiting until next.

## Investment tax planning uses timing strategies and focuses on your after-tax return

Investment tax planning seeks to minimize your overall income tax burden through tax-conscious investment choices. Several potential strategies may be considered. These include the possible use of tax-exempt securities and intentionally timing the sale of capital assets for maximum tax benefit.

Although income is generally taxable, certain investments generate income that's exempt from tax at the federal or state level. For example, if you meet specific requirements and income limits, the interest on certain Series EE bonds (these may also be called Patriot bonds) used for education may be exempt from federal, state, and local income taxes. Also, you can exclude the interest on certain municipal bonds from your federal income (tax-exempt status applies to income generated from the bond; a capital gain or loss realized on the sale of a municipal bond is treated like gain or loss from any other bond for federal tax purposes). And if you earn interest on tax-exempt bonds issued in your home state, the interest will generally be exempt from state and local tax as well. Keep in mind that although the interest on municipal bonds is generally tax exempt, certain municipal bond income may be subject to the federal alternative minimum tax. When comparing taxable and tax-exempt investment options, you'll want to focus on those choices that maximize your after-tax return.

In most cases, long-term capital gain tax rates are lower than ordinary income tax rates. That means that the amount of time you hold an asset before selling it can make a big tax difference. Since long-term capital gain rates generally apply when an asset has been held for more than a year, you may find it makes good tax-sense to hold off a little longer on selling an asset that you've held for only 11 months. Timing the sale of a capital asset (such as stock) can help in other ways as well. For example, if you expect to be in a lower income tax bracket next year, you might consider waiting until then to sell your stock. You might want to accelerate income into this year by selling assets, though, if you have capital losses this year that you can use to offset the resulting gain.

**Note:** *You should not decide which investment options are appropriate for you based on tax considerations alone. Nor should you decide when (or if) to sell an asset solely based on the tax consequence. A financial or tax professional can help you decide what choices are right for your specific situation.*

## Year-end planning focuses on your marginal income tax bracket

Year-end tax planning, as you might expect, typically takes place in October, November, and December. At its most basic level, year-end tax planning generally looks at ways to time income and deductions to give you the best possible tax result. This may mean trying to postpone income to the following year (thus postponing the payment of tax on that income) and accelerate deductions into the current year. For example, assume it's December and you know that you're in a higher tax bracket this year than you will be in next year. If you're able to postpone the receipt of income until the following year, you may be able to pay less overall tax on that income. Similarly, if you have major dental work scheduled for the beginning of next year, you might consider trying to reschedule for December to take advantage of the deduction this year. The right year-end tax planning moves for you will depend on your individual circumstances.



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