FINANCIAL PREPAREDNESS

"One of life's most painful moments comes when we must admit that we didn't do our homework, that we are not prepared." ~ Merlin Olsen

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Year-End Tax Planning

You should always do some income tax planning in December, as it could save you a significant amount of tax. First, ask yourself these questions:

How will my income and deductions change from this year to next? Besides earned income, don't forget to consider realized capital gains, stock options, required minimum distributions from retirement accounts, etc.

Is my current situation stable, or do I expect any significant changes that could affect my finances, such as a new child, divorce, retirement, being laid off, having to take time off from work to care for children or parents, kids leaving home, having to pay for college, incurring significant health care expenses, becoming disabled, having to start taking required minimum distributions from a retirement plan (including a beneficiary IRA), the initiation of benefits from a pension, annuity or Social Security, the death of a spouse, receiving an inheritance, etc.

Are there any known or expected changes to the tax laws next year? For example, if a different political party will control the federal government next year, how might that affect your income tax rates and tax burden?

What is the current fiscal health of (or how profligate are) the federal government and my state government, what is the expected trend, and how might that affect my income tax burden in the future?

Generally, if you expect your taxable income and/or marginal income tax rate (or tax burden) to be higher next year, you should try to shift income to this year and deductions to next year, and vice versa.

Here are some ways you could shift income to this year:

Realize capital gains (preferably long term if your federal marginal tax bracket is 22% or higher). This is especially attractive if the securities you own are currently richly valued and have a low expected return.

Take a larger distribution from a traditional IRA this year and a smaller one next year.

Work more (earn more money) this year and less next year.

Collect income for work you did this year instead of next year.

Realize income related to stock options this year instead of next.

Sell property this year.

Here are some ways you could shift deductions to next year:

Harvest capital losses next year. If your realized capital losses exceed your realized capital gains, you can apply the excess loss to up to $3,000 of ordinary income and carry forward the remaining loss to future years for as long as you live.

Defer charitable donations to next year. Even better, instead of giving cash, donate assets in which you have a large unrealized long-term capital gain. You'll be able to deduct the fair market value, but no one will have to pay tax on the gain.

Due to the doubling of the standard deduction some years ago and the limit (starting in 2017) of $10,000 on deductions for state and local taxes, only about a quarter of taxpayers still itemize deductions. But if you do, you may be able to shift a few of them to next year, or bunch them up every other year (so you have a better chance of exceeding the standard deduction). Other than charitable donations, possibilities include estimated tax payments, property taxes and medical bills.

A common recommendation is to make a deductible contribution to a retirement plan such as a traditional IRA. However, retirement plans have a number of disadvantages—including, ironically, tax disadvantages—compared to a plain old taxable account, so I generally recommend that my clients avoid doing this.

If you can contribute to a 401(k) that has a generous company match in which you will vest quickly, *and* the plan has a number of decent investment options, you may want to do that, but only as much as you need to get the maximum company match.

Other tax planning tips:

If you are old enough to have to take annual required minimum distributions (RMD) from a traditional IRA or 401(k), ensure that you do so by the end of the year. Otherwise, you'll have to pay a penalty of 25% of the amount that should have been withdrawn but was not. The SECURE 2.0 Act increased the RMD age to 73 starting in 2023 and to 75 in 2033.

If you ever made after-tax (nondeductible) contributions to a 401(k) before 1986, or to a traditional IRA at any time, when you start taking distributions from these plans, a portion will be non-taxable if you kept track of your cost basis over the years (the IRS doesn't do it for you), *and* calculate the amount using Form 8606 for each year you take a distribution. If you failed to keep track of your cost basis or don't file Form 8606 with your tax return, those after-tax contributions will be taxed *a second time*. Some retirement plan!

If you take a distribution from a traditional IRA, consider withholding some or all of it for income tax, especially if the distribution is made at the end of the year. That's because for purposes of calculating the federal underpayment penalty, taxes that are withheld are deemed to have been paid evenly throughout the year, even if they were paid at the end of the year.

If you have a traditional IRA, are older than 70.5, and don't need the income from distributions, you could make an IRA qualified charitable distribution of up to $100,000 per year without owing income tax, which could also count as your RMD for the year.

Consider contributing to a flexible spending account or health savings account if you are eligible to do so. For the latter, you must be covered by a high deductible health insurance plan.

If you own dividend-paying foreign stocks in a taxable account (including any in an ETF or mutual fund), don't forget to claim the Foreign Tax Credit on your tax return for any taxes withheld on dividends by foreign governments, which reduces your U.S. income tax burden dollar for dollar.

If you receive a significant tax refund every year, you're paying too much in withholding or quarterly estimated tax payments. If you're an employee, file a new W-4 to reduce your withholding.

The greatest opportunity for income tax planning involves taking full advantage of the lower income tax brackets you'll probably be in after you retire but before you start receiving income from Social Security, pensions, annuities and required minimum distributions from retirement accounts. Most people simply want to minimize their income tax bill each year, and they judge their accountants on how well they do this. This is short-sighted because it can result in huge amounts of income getting bunched up into higher income tax brackets in later years, when tax brackets and tax burdens will probably be higher as well.

To take advantage of these low-income years, ideally you should work with a financial advisor who knows the tax law, has a good idea of how much the tax burden will be in the future, and thinks strategically instead of myopically.

Finally, the end of the year is a great time to balance all of your financial statements and enter all of your transactions into accounting software (I use Banktivity on a Mac) that can categorize them, so that when you prepare your tax returns, you can run a report that shows all of your tax-related expenses (especially any income taxes you paid).

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