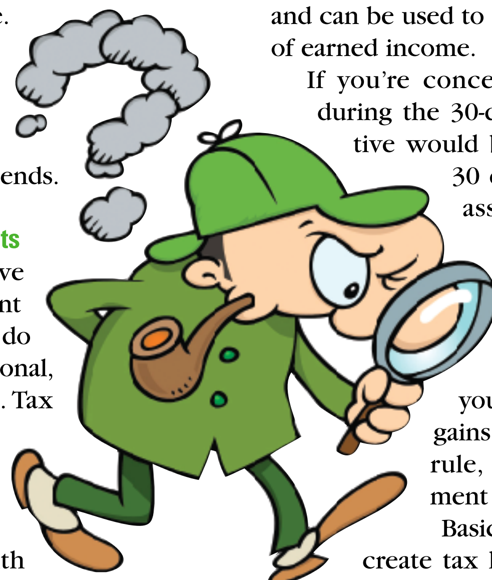
You Almost Have to Be a Sherlock to Decipher Today's IRS Rules

Reducing Your Income Tax Bill

by Alexandra Armstrong, CFP, and Kelly Wright, CFP

We watch very little TV but have become entranced with BBC's "Sherlock" — thank goodness for Netflix! The protagonist Sherlock Holmes is arrogant to a fault, yet brilliant in the way he can tie together details to solve a puzzle. In one episode, he deduced that a painting was a forgery because it depicted a supernova in the sky that happened many years after the painting was supposedly painted.

We feel a good tax adviser is required to build a puzzle out of pieces in a similar manner, hopefully in a more client-friendly way. Our last several articles have discussed some of the ins and outs of the tax code. In this article, we give you some ideas of how you might reduce your income tax. We recommend you discuss these ideas with your tax adviser before the taxable year ends.



The Starting Point — Know Your Facts

First and foremost, you must have some understanding of your current income tax structure. Whether you do this work yourself, or pay a professional, you must be aware of the basics. Tax professionals know taxes, but they may not be as well-informed about your specific circumstances. If you know the basics, it facilitates better communication when dealing with your own tax adviser.

Start by reviewing last year's tax return. Are you an alternative minimum tax taxpayer (Line 45 on your federal Form 1040)? Do you have capital loss carry-overs (Line 14 on your 2013 Schedule D)? Are you in the new "high income" tax category (Line 37 of your federal Form 1040 and Line 29 of your 2013 Schedule A).

Knowing the basics of your income tax structure by examining last year's return is a crucial step before considering any changes. Once you have a starting point, then what? Armed with some basic knowledge, you can see whether any of these strategies might work for you.

Timing of Taxable Income

One obvious way to lower taxes is to lower the amount of taxable income. One of the most effective ways to do this is to contribute to a qualified retirement plan such as a 401(k) or a deductible individual retirement account. Doing so will reduce your current year's taxable income by the amount you contribute. If you have the option of shifting earned income into a different tax year when your other income would be lower, this may be beneficial as well.

Timing of investment sales can also be an important factor. If you plan on selling investments in a year when you expect your other income to be higher, you may wish to sell those investments that result in offsetting losses.

If you like the stock, you can buy the asset back, but the Internal Revenue Service requires you to wait 30 days to do so to avoid erasing the tax loss (the so-called wash rule). This is called harvesting capital losses and can be used to offset capital gains and up to $3,000 of earned income.

If you're concerned about the stock moving up during the 30-day waiting period, another alternative would be to buy more of a position, wait 30 days, and sell the top-costing shares assuming they're still at a loss — if you can accomplish this before year-end.

If you expect your taxable income to be low this year, you can do the opposite and take some profits in your investments and pay tax now on gains. In this case, there's no 30-day wash rule, so you can repurchase the investment immediately.

Basically, you may want to fill tax holes or create tax holes. If you have offsetting deductions and you're in a low-tax year, filling the tax hole with some kind of recognizable income may be advantageous.

This can be accomplished by selling investments for a gain, or possibly by withdrawing extra money from an IRA or even doing a Roth conversion.

Deductions

Unfortunately, more often than not, the opposite problem

Base Amount of Modified Adjusted Gross Income Thresholds for Federal Income Tax on Social Security

Filing Status	50% Taxable	85% Taxable
Married Filing Jointly	$32,000	$44,000
Single	25,000	34,000

exists and we want to create tax holes. This can possibly be accomplished by accelerating itemized deductions, such as paying your following-year January mortgage payment in December or donating either cash or goods to charity before year-end.

Certain investments have accrued capital gains or dividends and will pay them at year-end, so taking care in purchasing certain investments where this may happen is definitely warranted.

It may be better to wait to invest until the beginning of the next year depending on your investment strategy and tax situation.

Note that taxes should be a factor in investment strategy, but not an overriding one. One important caveat: If you're an AMT taxpayer, be careful to examine closely whether accelerating itemized deductions will actually work.

As we discussed in our article about rental real estate, it's possible that purchases and repairs before year-end may also help reduce your taxable income.

Social Security

Social Security retirement benefits are 0 percent, 50 percent or 85 percent taxable. The chart on the bottom of the previous page illustrates the thresholds over which the tax changes. Oftentimes a spike in taxable income elsewhere can affect the portion of Social Security that's taxed. It's important you be aware of how other tax factors affect the taxation of Social Security benefits if you're planning to receive them.

Make a Model

It's important to know whether you'll be affected by the new net income investment Medicare surtax, or the earned income Medicare surtax, or AMT, or the limitations on itemized deductions or personal exemptions. Even the means testing on Medicare itself can be a factor depending on income.

Parts of the tax code have become sufficiently complex that the only way to determine the effect of a tax event is to project it.

> "If you expect your taxable income to be low this year, you can take some profits in your investments."

If you're thinking of selling an investment, selling a home, selling a rental house, making a donation to charity, considering an IRA distribution in excess of what's required, starting Social Security benefits or undertaking any other event that may have a significant tax implication, it's wise to seek the assistance of a tax adviser who can show you the ramifications of your decisions. We recommend you not take any significant action without a projection. You can do this yourself if you're well-versed in this area.

If not, it's important to work with a tax adviser who can create "what-if" scenarios. So much of the tax code is intertwined that things that seem obvious are often not.

The Biggies

Here's a recap of some strategies that may lower your income tax if you take action before year-end:

- Contribute to retirement plans or deductible IRAs.
- Contribute to flexible spending accounts or health care spending accounts.
- Donate goods or assets to charity.
- Purchase items used in a business if self-employed before year-end.
- Purchase items used for a rental property or any other rental expenses before year-end.
- Pay large medical expenses.
- Liquidate any investment assets at a loss.
- Accelerate income to fill a tax hole so that deductions aren't wasted.
- Delay income from IRA or retirement plans if possible.
- Delay receiving Social Security retirement benefits — and get delayed credits!
- Accelerate itemized deductions — though be wary of AMT!
- Choose educational tax benefits — American Opportunity Credit or Lifetime Learning Credit (these benefits will be covered in a subsequent article).

Most of all, if your situation is sufficiently complex to warrant expert tax advice, get it. There can be no substitute for a thorough evaluation.

Elementary my dear, Watson. Well, maybe not so much. ■

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