

Tax Planning in a Changing Tax World



FPA

FINANCIAL PLANNING ASSOCIATION

The Heart of Financial Planning™

The Financial Planning Association® (FPA®) is the leadership and advocacy organization for those who provide, support and benefit from professional financial planning. FPA believes that everyone, no matter what their situation or economic status, can benefit greatly from the experience and advice of a competent, ethical financial planner.

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As Ben Franklin quipped, “nothing is certain but death and taxes.”

These days, tax changes are also certain.

Major or minor tax acts seem to debut nearly every year, compounded by additional regulations and opinions from the Internal Revenue Service (IRS) and rulings from the tax courts.

Consider the massive 2001 and 2003 tax acts. Various provisions of the acts went into effect on different dates and applied for different lengths of time. And the entire 2001 act is scheduled to revert to prior tax law by 2011—unless Congress extends some of the act’s provisions! Like the 2001 and 2003 acts, the Pension Protection Act of 2006 has a major and broad-based impact on tax policy and law as well.

So how do you navigate this complex, shifting, and often confusing maze of tax laws? More importantly, how do you best take advantage of these changing laws in order to improve your financial life and accomplish your family’s dreams?

This brochure, produced by the Financial Planning Association (FPA), the membership association for the financial planning community, shows you how to be a proactive taxpayer. Whether you work with a tax professional or go it alone, you can become a more nimble taxpayer, avoid tax mistakes while employing tax strategies and learn tips that may help you better meet your life’s financial goals.

Stay informed and flexible...

The first key to making the most of changing tax laws is to stay informed and be flexible. That’s not easy at first blush. It’s the rare taxpayer who has the time or knowledge to monitor or comprehend all the nuances of the tax code.

Are you aware, for example, that changes in the tax code in recent years have:

- Necessitated the rewriting of estate planning documents such as wills and trusts
- Dramatically influenced how families save for college and pay for health care and long-term care needs
- Altered the design of retirement accounts and how beneficiaries can withdraw funds from those accounts

Still, at least you can keep up on the basics of the changes and how the changes might affect your financial life. There is plenty of information in newspapers, magazines, brochures and online that discusses new tax laws and regulations. FPA itself provides such information for the public.

In addition, talk to your tax adviser, whether it is your accountant, financial planner or other professionals that you trust are knowledgeable about both tax laws and about your personal financial situation.

And don't forget your own changing personal circumstances. Life changes such as marriage, divorce, death, or the birth of a child can have as profound an impact on your tax liabilities as tax law changes — sometimes more so.

It's challenging, but well worth the effort. Avoiding costly tax mistakes and taking advantage of available tax breaks can save you hundreds or thousands of dollars every year.

...But don't let taxes dominate

While keeping up with tax changes is important, don't let tax laws dictate your financial life. Fundamental money management principles are always in style, such as the need to save and invest, to budget, to be properly insured, and to have estate and retirement plans.

Consider the challenge of saving for college education. Tax laws, particularly since 1997, have created an abundance of tax breaks and benefits for funding college education. Nevertheless, they haven't altered the underlying principle of college planning: the smartest way to pay for your children's college education is to save regularly!

It's also wise not to base your tax and financial planning too heavily on what you think future tax laws might be. While it can be prudent to consider their potential impact, proposed tax law changes often have a way of never materializing or materializing in a significantly different version.

Don't confuse tax preparation with tax planning

Most families think about taxes only when they, or a professional tax preparer, sit down to complete their federal, and maybe state, income tax return for the previous year. That's "after the fact" tax planning. By then, it's too late to take certain tax deductions and credits based on strategies that needed to have been implemented during the tax year.

Unlike tax preparation, tax planning is a year-round process. Most tax-saving strategies must be carried out no later than December 31 of that tax year, and often well before that. Examples include selling losing investments to offset other income, making certain retirement plan contributions, and taking actions that realize valuable medical and charitable deductions. Especially critical these days is planning for the dreaded alternative minimum tax (more on this later), which is hitting even middle-income taxpayers.

The same advanced planning process applies to estate taxes. Failure to establish and revise plans well before death or possible incapacity could cost your beneficiaries thousands of dollars. And don't overlook other types of taxes such as property, sales and payroll taxes, which can present tax-planning opportunities.

Good year-round tax planning also requires good year-round record keeping. You need to be able to substantiate your claims or else you may lose out on valuable tax deductions.

Time-honored tax-saving strategies

While tax laws change frequently, taxpayers can generally count on certain tax-saving strategies and principles that have endured over the years, such as deduct, divert, convert, and defer. Here are a few, and your financial planner can identify many more.

- **Determine your marginal tax bracket.** That's the rate at which your last dollar of taxable income is taxed. This rate can tell you whether it's worth investing in a taxable versus tax-favored asset, the potential tax benefits of a particular charitable contribution, whether to take advantage of certain employee benefits such as flexible spending accounts, or other deductions.
- **Calculate your effective tax rate.** This is determined by dividing your total income into your total tax bill. It shows you the impact of taxes on every dollar you earn and can help you with everything from calculating accurate estimated tax payments to putting together a realistic household budget.
- **Save in tax-favored accounts.** The number and complexity of these accounts have multiplied over the past 20 years but the principle remains the same: saving in tax-deferred accounts is a powerful tool for funding a long-term financial objective, such as retirement or college.
- **Don't tap retirement savings before age 59 1/2.** This may be the most costly mistake a taxpayer makes.

- **Look where you borrow.** Deductions for many interest payments have been eliminated over the years, but interest on loans secured by the equity in your home, within limitations, remain tax deductible. Many taxpayers can also deduct interest on college loans and investments.
- **Time income and expenses.** Depending on your tax situation, you can reduce your tax bite by bunching together deductible expenses such as medical bills, or by accelerating or delaying receipt of taxable income.
- **Shift income.** You may be able to save taxes by shifting assets to family members such as children who are in lower tax brackets. However, consideration should be given to the potential adverse impact on student-loan applications if assets are shifted to child.
- **Use charitable gifting strategies.** Simply gifting cash to your favorite charity isn't always the best tax-saving method. The right charitable gifting technique or vehicle can save you more tax dollars, which may mean more money for the benefit of the charity.

Don't let taxes control investment decisions

Taxes can eat away a significant portion of an investment's return. Yet at the same time, financial planners caution against allowing the "tax tail to wag the investment dog."

Investment decisions should be based first on the economics of the investment — its risk, the likely direction of its future returns, and whether it fits your current investment plan. Tax planning should be coordinated with investment planning as a secondary consideration. For example, the reluctance to pay capital gains taxes on stock profits accumulated during the bull market of the late 1990s, resulted in many investors hanging on to losing stocks during the bear market of 2000–2002.

Nonetheless, numerous tax strategies and techniques can reduce the tax bite on your investment returns without compromising the investment itself.

- **Keep records that show the cost basis of your investment.** Cost basis is essentially the cost of buying or taking ownership of an investment, plus or minus adjustments. An accurate basis is needed when determining an investment's gain or loss from its sale in order to calculate the amount of the tax liability (or deduction). Failure to adjust cost basis for such factors as fees or commissions paid when buying the investment, stock splits, or inheriting the investment could lead to a higher tax bite than necessary.
- **Don't forget reinvested profits.** When calculating their cost basis after selling mutual fund shares, investors often neglect to include reinvested dividends or capital gains. In taxable accounts, those dividends and gains are taxed annually, even if reinvested in the same fund. Shareholders who fail to include them in their basis end up paying taxes twice on those capital gains and dividends. The same principle can apply to some discounted bonds, earned/paid dividends and interest on individual securities and investments.

- **Keep an eye on mutual fund tax efficiency.** Some mutual funds, or types of mutual funds, are more “tax efficient” for their investors than other funds by actively matching gains and losses within the fund to minimize annual tax liabilities.
- **Know when you bought your investment.** Holding an investment for longer than a year provides substantial tax breaks — as long as holding it that long is worth the investment risk.
- **Offset capital gains and losses.** You can offset gains from the sale of investments with corresponding sales of losing investments, or vice versa.
- **Choose tax-favored investments and strategies.** You can minimize, delay, or even eliminate investment taxes through such vehicles as retirement accounts, annuities, municipal bonds, life insurance, or “like-kind” real estate exchanges.
- **Employ certain estate planning techniques.** Tried-and-true techniques such as annual tax-free gifting or the gifting of appreciated assets can save substantial estate and income taxes.

Avoid common tax-filing mistakes

As with time-honored tax-saving strategies, there are common tax-filing mistakes that seem to snag taxpayers year in and year out, regardless of the changing tax code.

- **Filing the wrong tax status or overlooking certain exemptions.** For example, qualified taxpayers often fail to file as head of household or as a qualifying widow or widower.

- **Failing to contribute after the tax year ends.** Didn't contribute the maximum to your retirement account in the previous tax year? Depending on the account, you may still be able to contribute as late as your tax return filing date, or even later.
- **Using the IRS as a savings account.** Many taxpayers have too much withheld from their paycheck for income taxes. Some think of it as a forced way to save. But the IRS doesn't pay interest on refunds. Adjust your withholding and invest the savings or pay down debt from each paycheck.
- **Assuming you don't have to pay the alternative minimum tax (AMT).** Congress designed the AMT to ensure that high-income earners did not escape paying federal income taxes by taking excessive advantage of numerous tax breaks. But the AMT is snaring more and more middle-income taxpayers. You need to calculate your taxes under both sets of rules and pay whichever is the higher amount. Due to the complexity of these calculations, however, you should seek professional tax assistance, or at a minimum, use tax software to help guide you through the nuances of the rules.
- **Taking the standard deduction instead of itemizing.** A U.S. General Accounting Office study estimated that roughly two million taxpayers overpaid their taxes an average of \$500 each by failing to itemize for such things as their mortgage interest and charitable deductions.

Should you use a CFP professional for your taxes?

Over half of all taxpayers have their taxes prepared professionally, according to the IRS. Many CFP professionals are among those who prepare taxes.

But where a CFP professional can be especially helpful is through more long-range tax planning. As observed earlier in this brochure, many tax-saving techniques must be completed during the tax year. Your planner can make tax projections and identify appropriate strategies in time to carry them out.

But even more important is that this tax planning is done in the context of your overall financial picture, which your planner knows well. That way, a given tax-saving strategy can be implemented that supports all of your important financial goals.


Tax planning for life

Ultimately, smart year-round tax planning is less a goal in itself than a means to help achieve the personal goals of your life. Each saved tax dollar frees that dollar for such goals as funding a comfortable retirement, putting children through college, buying a business or a dream home, taking an exotic vacation, or leaving money to heirs. Saving taxes should complement, not dominate, your financial life.

By paying attention to your taxes year-round instead of just at tax-preparation time, you can make the most of tax planning strategies and, more importantly, enhance the quality of your overall financial well-being.

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