



Faculty Advisor E-News

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2002 Year-End Tax Planning Strategies

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Last year President Bush signed into law an enormous tax relief program called *The Economic Growth and Tax Relief Reconciliation Act of 2001* (EGTRRA). The effective date for many provisions was January 1, 2002. On March 9, 2002, the President signed into law the *Job Creation and Worker Assistance Act of 2002*. That act has provisions that are retroactive to September 2001. The new legislation invokes significant income tax changes, but its broad sweep also has enormous implications for IRAs, retirement plans, minimum distributions and estate taxes. For more details on the changes, we recommend that you read our articles: "The Economic Growth and Tax Relief Reconciliation Act of 2001 Summary" (www.faculty-advisor.com/economicgrowth.htm) and "Finalized Regulations for Retirement Plan Distributions" (www.faculty-advisor.com/retirementplan_regulation.htm).

This newsletter concentrates on how to take advantage of the major income tax provisions that we think will have an impact on our readers' taxes. Please get paper and pen ready to make a list of your personal "action points."

Tax Loss Harvesting

Most investors lost money in the stock market. Tax planning can't restore your losses, but it can soften the blow. Using losses to reduce taxable gains by means of tax-savvy realization of losses to match gains is referred to as *loss harvesting* or *tax-loss selling*. For many readers, *tax loss harvesting* is the single most important area for reducing taxes now and in the future. Financial planners and advisors who understand and apply these principles really do offer "value added service." Proper tax loss harvesting strategies can save you taxes and help you diversify your portfolio in ways you may not have considered. Now is the time to start thinking about harvesting losses to offset unrealized capital gains.

Example:

Assume you have a winner; you bought it for \$50, it is now worth \$100 and there is no adjustment to the basis.

Also, please assume, you have a loser; you bought it for \$100 and now it is worth \$50. What are your options?

Idea 1: Buy and Hold

Do nothing, buy and hold. No taxes on any transaction. Next year, if you sell the winner,

perhaps in a rebalancing or diversification attempt, and hold on to the loser, you will have to pay \$10 in capital gains tax ($\$50 \times 20\% \text{ tax} = \10 tax).

Idea 2: Dump the Loser

Assume your capital gains rate is 20%. Sell the loser and deduct \$50 in losses. This means you will pay \$10 less in taxes than you would have if you had done nothing (Idea 1). Knowing that you will pay \$10 less in taxes (the 20% of your losses that you can deduct), you can afford to reinvest \$60 (the \$50 sale price of the investment, plus the \$10 tax savings; subject to limitations), which is 20% more than your losing investment was worth (\$60 is 20% more than \$50). So, you get an immediate \$10 benefit. When you add state capital gains taxes, the savings are greater.

If you later sell the winner for \$100 and have to pay capital gains tax of \$10 ($\$50 \times 20\%$) at least you enjoyed the time value of your \$10 while you held the stock. If you can use other losses to offset the winner, you would be \$10 ahead plus the growth on the \$10 over time.

Idea 3: Dump the Loser and Repurchase

Let's assume you like the loser or it is a "core holding" of your portfolio or you think the loser will come back. Sell the loser and then, subject to the wash rules, buy it, or something similar to it, back. Assume you made the correct decision to sell and repurchase. After repurchasing the loser for \$50, it goes back to \$100. Except for transactions fees, you would have the benefit of the \$10 savings you made by deducting the loss, and you have the growth. Furthermore, you have maintained the integrity of your portfolio.

Idea 4: Use Your Losses to Diversify Your Portfolio

Let's assume you have a heavy position in a particular stock or mutual fund in a particular sector (like a large cap fund) that has a low basis. You have avoided selling it for years because you are too cheap to pay the capital gains tax. (Let's be honest here.) Then, either your advisor nags you or the fear of an Enron scenario makes you want to diversify. Let's assume that the basis is \$10,000, and the value is \$100,000. You never sold it because you didn't want to pay the \$18,000 in taxes ($\$100,000 \text{ proceeds} \text{ less } \$10,000 \text{ basis} = \$90,000 \text{ gain} \times 20\% = \$18,000$).

Let's also assume you have a loser or losers with a combined loss of \$90,000. You sell both, winner and loser, offset the gains and the losses and pay no capital gains. Lo and behold, you just opened up your window to diversification and getting out of that heavy concentration in one stock or sector problem. You repurchase the winner and the loser or whatever you like, and your basis will be your purchase price.

The best losses are short-term capital losses. This is because the IRS forces you to match short-term gains against short-term losses and long-term gains against long-term losses first. Then the net short-term results are netted against the net long-term results. If the result is a gain, it will be taxable as short-term, long-term, or a combination thereof. If the losses incurred were short-term rather than long-term, there will be a better chance

that your gain will be long-term instead of short-term and taxed at lower rates. The short-term gains tax rate can be almost twice the long-term gains tax rate. Therefore, if you own losing investments that you have owned for less than a year, they are a better choice for tax-loss selling than long-term investments.

The following example is somewhat complicated but it demonstrates why it is critical to think ahead and map out a strategy to capitalize on gains and losses.

Imagine you hold an investment that qualifies for a short-term capital loss (i.e., a losing investment held for less than a year) with an unrecognized loss of \$20,000. You also have a long-term winner with an unrecognized gain of \$20,000. You decide not to sell either prior to year-end. After all you haven't really lost any money on paper. (Hint: this may be bad logic.)

The following year you decide it's time to sell the long-term winner and recognize a \$20,000 long-term gain at a long-term tax rate of 20%. In this same year, you also incur a short-term capital gain of \$10,000 from the sale of another stock. You now have \$30,000 in taxable income to recognize.

In the meantime, the loser is still down \$20,000. Fine you think, let's sell the \$20,000 loser, offset it against the \$20,000 gain, and pay tax on the \$10,000 gain. (By the time you decide to sell the loser, it is no longer a short-term transaction because you have held it for over a year.) When you prepare your 2002 Schedule D, you report a long-term gain and long-term loss that net to \$0. You also report a short-term gain of \$10,000 taxed at your ordinary rate of 30% that costs you \$3,000 of federal income taxes.

What you *could* have done was sell the loser while you could still realize the short-term capital loss, and deduct a \$3,000 loss at your ordinary tax rate of 30%, or \$900 ($\$3000 \times 30\% = \900) and recognize a \$17,000 short-term loss carryover. In the following year, using the netting rules, the \$10,000 short-term gain would be offset by the \$17,000 short-term loss carryover. The excess short-term loss of \$7,000 would then offset the long-term gain of \$20,000 leaving you with a long-term taxable gain of \$13,000. This gain would result in tax of \$2,600 ($\$13,000 \times 20\%$). The net tax over these two years is only \$1,700.

In summary, recognizing the short-term loss when you had the chance would have saved you \$1,300 or 43% of the total taxes.

If your net capital losses exceed your net capital gains, you can deduct up to \$3,000 of the losses (short or long-term) against ordinary income. That adds up to a \$900 tax savings for an individual who is in a 30% tax bracket. *Be careful to avoid a wash sale*, i.e., buying the same security back within 30 days before or after you sell the shares. Tax rules will disallow the loss. Keep in mind, however, that with all the stock and mutual fund choices, there is probably a similar investment available for you to park your money in for 30 days. This may be a better strategy than keeping funds in cash for 30 days waiting to repurchase the same stock since the market or the sector may move up significantly in 30 days.

Selling investments to realize net losses in excess of \$3,000 is a good idea too. The

losses will carry over to future years when future gains can be reduced. Plus, up to another \$3,000 per year can be deducted from ordinary income. Even if investments you currently hold recover in value, you would have been much better off by selling them at a loss and reinvesting the proceeds in similar investments. Using this strategy, you will hold investments of the same value, but with a lower cost basis and have additional tax savings each year. To the extent that the \$3,000 net loss is deducted against ordinary income every year, you save money at ordinary tax rates. The loss carryover can also eliminate future short-term and long-term capital gains and will free you from subsequently sticking with investments only because of the holding period. If the remaining investments are subsequently sold at a gain, it will be taxed at lower long-term gain rates, and the overall result will be less tax than holding the original investment. If the investment with a lower basis remains to become part of your final estate, the heirs will get a step-up in basis and avoid the tax altogether.

Harvesting your investment losses can reduce your capital gain income to zero and give you a bonus of a \$3,000 ordinary income reduction each year. It's a great way to increase the after-tax rate of return on your portfolio without the risks of active trading. In combination with a good asset allocation and reallocation strategy, you can add value to your investment portfolio without increasing your investment risk.

If you find all of this too overwhelming, and yet you see the inherent value of the advice, perhaps you would be well advised to consult with your financial advisor and your tax advisor.

ALERT-Special Allowance Depreciation

If you filed your 2001 tax return prior to June 1, 2002, and did not claim the new special depreciation allowance for new cars and qualifying property (for example—new items such as equipment, computers, furniture, etc.) resulting from the *Job Creation and Worker Assistance Act of 2002*, you should consider filing an amended return to get a 2001 refund. The amended 1040X return must be filed by April 15, 2003. See IRS publication 3991 for specific details of qualifying depreciable property and details on how to compute the additional depreciation.

Alternative Minimum Tax

With the four top income tax rates falling by another half-point in 2002, the popular recommended strategy of accelerating deductions this year and deferring income into next year can be advantageous. In recent years, many individuals have used this strategy to defer taxes and take advantage of the time value of money concept. Add to the equation real tax savings because of lower tax rates, and this strategy makes even better sense. Before you jump headfirst into this strategy, please be aware that Alternative Minimum Tax (AMT) rules can totally offset the benefits. Top factors leading to AMT liability are an increased number of personal exemptions, limited medical expenses, disallowed items such as miscellaneous itemized deductions and certain home equity interest. Unfortunately, if you have an excessive amount of these deductions, you are a very good candidate for the AMT. Because the IRS has failed to index the AMT exemption in 2002, more taxpayers will be subject to the AMT. In general, you compute your tax liability using both regular

tax rates and the AMT tax rates and pay the higher of the two. If you determine that you may fall prey to AMT in 2002, holding off paying certain deductible expenses such as state and local taxes, real estate taxes, etc. until next year may prove to be advantageous.

There was some positive movement in this area due to changes introduced in the *Job Creation and Worker Assistance Act of 2002*. Education credits, dependent care credit and other credits that were allowed to reduce both regular tax and AMT were due to expire at the end of 2001. This provision has been extended and will be in effect for 2002 and 2003.

Qualifying Taxpayers Should Plan to Convert a Portion of their Traditional IRA to a Roth IRA

The benefits of converting a traditional IRA to a Roth IRA are discussed at length in our peer-reviewed article, *Roth IRAs: Accumulating Tax Free Wealth Conversion*, in the recommended reading section of our web site (www.faculty-advisor.com/roth.htm). The conversion must be completed before year-end and many brokerage houses recommend getting the Roth IRA conversion form to their offices well before year-end to qualify for a year 2002 conversion.

Current law dictates that tax rates will be lower in the upcoming years. But waiting to convert to a Roth IRA until rates are lower is risky. Yes, the converted amounts would be taxed at a lower rate but considering the current market conditions, your IRA account value may be at its lowest point. A 3% recovery in your account value between now and 2005 would offset the 2% tax rate reduction savings that is in effect for tax years 2004-2005.

Consider Recharacterizing your Roth IRA

A complete discussion of Roth IRA converting and unconvertng is found in a separate article on our web site, *Finessing Market Uncertainties: Roth IRA Conversion Strategies* (www.faculty-advisor.com/rothira_uncertainty.htm).

Transfer Appreciated Stock to Children 14 Years Old or Older

Consider transferring stock to your child. For example, assume you are in a 27% tax bracket and are planning to sell some appreciated long-term held stock (at least five years) to pay for your child's education. Your child is in a 10% tax bracket. 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 20% taxation rate to your child's long-term capital gains tax rate of eight percent.

Financing an Education for Your Children and Grandchildren

Let's start with my favorite way to finance the education of your family.

Section 529 Qualified State Tuition Plans

The 529 Plans, which are distinct from the prepaid tuition plans, provide an excellent way

to save for college. The 529 Plans now allow *tax-free* withdrawals for all “qualifying educational expenses.”

529 plans also have significant estate tax advantages. Ideally, they can be considered a gift to children or grandchildren who will eventually go to college. However, if you decide for whatever reason you want to take the money back and use it for yourself, you may do so—a little like a gift with a string attached that you can yank back if and whenever you want.

If you currently have UTMA/UGMA accounts for your children or grandchildren holding their “college funds,” now may be the ideal time to liquidate those accounts and establish a 529 Plan account. There is a very good chance that minimal or no income taxes would be incurred due to depressed market prices. Any future market appreciation would escape from income taxes if used for “qualifying educational expenses.” Due to increased competition between state programs, setup and maintenance costs are lower than ever.

A disadvantage of the 529 Plan is that your investment options are limited. Also, 529 Plans may be inappropriate if you can afford to pay tuition directly *and* make a personal gift.

For example:

You have a potential federal estate tax and are trying to reduce your estate with gifts to children or grandchildren. Your grandchild is 18 and you want to take care of his tuition and give him an additional \$11,000. If you put \$11,000 in a 529 Plan account, that is deemed a gift to him; however, if you pay his tuition directly, that is not deemed a gift and you can give him an additional \$11,000 without eating into your once-in-a-lifetime exclusion. Under these circumstances, you would be better off not establishing a 529 Plan account.

Some financial planners feel that because of the shift from the need-based scholarships to the merit-based scholarships, parents are well advised to concentrate their effort on qualifying for aid rather than saving for college in a tax efficient manor. I disagree because I assume most of my clients' children and grandchildren will not qualify for aid and prefer the certainty of the tax savings.

A more detailed discussion of 529 Plans is found on my web site at (www.faculty-advisor.com/collegesaving.htm).

Tax Planning for Education Tax Credits

You can help yourself to a lower tax bill if you follow some of the steps below. Be sure to maximize any available education credits that you qualify for. Knowing when and when not to prepay tuition expenses could save otherwise reduced or lost college tax credits. You might want to contact your tax advisor for assistance in this area.

New in 2002: Deduction for Qualified Higher Education Expenses. Beginning in 2002, these expenses are now eligible for an above-the-line deduction. Taxpayers may claim

this deduction whether or not they itemize their deductions. Taxpayers with an adjusted gross income not exceeding \$65,000 (\$130,000 in the case of married couples filing joint returns) are entitled to a maximum deduction of \$3,000 per year. These gross income limits are higher than the levels necessary for qualifying for the Hope and Lifetime Learning education credits.

Maximize Student Loan Interest. More college grads will be eligible to deduct student loan interest in 2002. Deductions will no longer be limited to the first 60 months that payments are required on the loan. More importantly, the income eligibility limits will rise to \$65,000 for singles and \$130,000 for couples.

Let your Child Claim the Hope or Lifetime Learning Credits. If you're tired of losing education tax credits because of your income bracket, all is not lost. If you are eligible to claim your student child as a dependent, but choose not to, your child may be able to claim a Hope Scholarship or Lifetime Learning Credit for the qualified tuition and related expenses that you paid. This move can be a family tax saver if your income level is above the phase out range for claiming the tax credit. Of course your child must have a taxable income to claim the credit. Note that the child cannot claim the forfeited dependency exemption on his own return. This is really good when your child's dependency exemption is partially or fully phased out on the parent's return.

For example:

The parent(s) give appreciated stock to the child as a gift. The child, in turn sells the stock to pay for qualifying tuition expenses. The capital gain is reported and taxable on the child's return at a much lower tax rate. The tax savings could be as much as 12% on the long-term gain. The tax liability is now offset by the education tax credit claimed on your child's return. If you are applying for financial aid, keep in mind that the student's assets are a much bigger factor in the financial aid formula than the parents' assets. However, if you are incorporating this strategy, you probably don't qualify for financial aid assistance.

Contribute to a Coverdell Education Savings Account (formerly called Education IRAs). There are two significant changes in education savings accounts beginning in 2002. First, the contribution limit has increased from \$500 to \$2000 per designated beneficiary per year. Second, these tax-free accounts can be used to pay for elementary and high school expenses. Now parents and grandparents have a tax-free savings vehicle to meet education costs from kindergarten to graduate school. Beginning in 2002, taxpayers are allowed to make contributions until April 15 of the following year. In addition, contributions may be made to both an Education Savings Account and a 529 Plan for the same designated beneficiary.

There are income limitations on the Coverdell Education Savings Account. One way to avoid the income limitations is to give your children or grandchildren money and have them purchase their own Education Savings Account.

New in 2002

Eligible educators- kindergarten through grade 12 teachers, instructors, counselors, etc.,

can deduct up to \$250 in qualified expenses (basically classroom supplies and computer expenses) as an adjustment to gross income. As usual, there are a few requirements that must be met in order to qualify.

Oldies, But Goodies

Make or Increase Retirement Plan Contributions: Business owners can reduce AGI by increasing contributions to pre-existing retirement plans or establishing a new plan such as 401(k) plans, SIMPLE pension plans, SEPs, Keogh plans, or regular (deductible) IRAs. Most self-employed retirement plans allow for deductions in tax year 2002, although payment can be postponed until the extended due date for filing the return. In other words, payment of 2002 deductible retirement plan contributions can be postponed until October 15, 2003 in certain cases.

Maximize Loss Situations: If you are experiencing an unusual tax year where you may be in a much lower tax bracket than usual or even in jeopardy of wasting itemized deductions and personal exemptions, careful tax planning can be more crucial than ever. Make sure you project your taxable income before the year-end has passed and examine all your alternatives.

Enroll in a Cafeteria or Flexible Spending Plan: If you have not yet done so, please enroll in your employer's Cafeteria or Flexible Spending Plan for the year 2003. This strategy allows you to pay for medical, child-care and other qualified expenses with pre-tax dollars. Medical expenses are rarely fully deductible on Schedule A due to the 7.5% of AGI limitation. Medical costs paid for through your company's cafeteria plan, however, will allow you to fully deduct your medical expenses from your W-2 wages that include social security taxes.

Make a good estimate of your projected qualified expenses for the year. If you set aside more pre-tax dollars than you will be able to claim, the unused portion is forfeited. Don't let the forfeiture risk deter you from participating, just be a little more conservative in your estimate. If you are currently enrolled in a program, review your outstanding balance, and if necessary, schedule a dentist, doctor, optometrist, chiropractor, etc. appointment before December 31st.

Calculate Medical Expenses: If this year's out-of-pocket medical expenses are larger than usual and your company doesn't offer a flexible spending account, it makes sense to compute if you're eligible to write-off your medical expenses. The total medical expenses must exceed 7.5% of your adjusted gross income to qualify. Because very few people normally beat the 7.5% test, be sure to pay as much as you can before the year-end in a year that you qualify for medical itemized deduction.

Take Advantage of Pre-Tax Parking Breaks: If your employer offers pre-tax dollars to be used for parking, mass transit or van pools, take advantage of the tax savings. Many individuals are not afforded the luxury of being able to deduct personal parking costs.

Make a Roth IRA Contribution: If you qualify, making an annual \$3,000 Roth IRA contribution (up to \$3,500 if over the age of 50 by the end of 2002) both for you and your

spouse will help you accumulate tax-free wealth. ***You have until April 15, 2003 to fund a 2002 Roth IRA even though the deadline for converting a traditional IRA to a Roth is December 31, 2002.***

Recognizing Losses on IRA Investments: If you have a loss on your traditional or Roth IRAs, you can recognize a loss on your income tax return, but only when all the amounts in all your IRA accounts of that type (Roth or Traditional) have been distributed and the total distributions are less than your unrecovered basis, if any. You claim the loss as a miscellaneous itemized deduction subject to 2% of adjusted gross income limits on Schedule A. See IRS **Publication 590** for details if you think you may qualify. This is useful if your IRA was basically wiped out and you are holding worthless paper. In that case, at least enjoy the tax savings. If your IRA suffered but there is still some value, then retaining the IRA will likely be more valuable than the limited tax benefit of claiming the loss.

Make your Non-Cash Charitable Deductions before December 31: *The IRS allows a deduction for the lower of cost or fair market value for your non-cash contributions. Please remember to ask for a receipt. You must provide a schedule if your non-cash contributions exceed \$500.*

Donate Stock Instead of Cash to your Favorite Charity: If you hold an appreciated publicly traded stock for more than one-year, you can donate the stock and get a charitable deduction for the full market value of the stock *and* avoid paying any capital gains tax. You must give the stock directly to the charity. The opposite is true for stocks that have gone down in value. Never donate stocks that have declined in value, but rather sell the stock at a loss and donate the cash to charity.

Avoid Doubling Up on First Year Minimum Distributions: It's possible to receive two minimum distributions in the year after you reach age 70 1/2. This may push you into a higher tax bracket, or even worse, cause some of your social security benefits to become taxable. Analyze your situation to see what strategy benefits you the most. Please see details in our Minimum Distribution Calculator on our web site, (www.faculty-advisor.com/calculator), by entering 1930 or 1931 in the year of birth column.

Self-Employed Individuals Should Consider Employing their Child(ren): Employing your child (age permitting) offers great tax-saving opportunities. Assuming your child has no unearned income, the parent could pay the child wages up to \$4,700 in 2002, and the child would not have to pay any federal income taxes. The next \$6,000 would be subject to a 10% tax rate. If the parents' marginal income tax bracket were 27%, the \$10,700 wage deduction would generate \$2,289 in federal income tax savings. Furthermore, when you employ a child under 18-years-old, neither the employer nor the employee is subject to social security tax on the child's wages. The wages your child earns will qualify as earned income for the purpose of establishing a Roth IRA. A Roth IRA will provide your child with an exceptional opportunity to accumulate money with tax-free growth.

Self-Employed Individuals with No Employees Should Consider Employing Their Spouse: A self-employed individual may be able to deduct all of their health insurance premiums and medical expenses by setting up a medical reimbursement plan with his/her spouse as the only employee of his/her business. Your spouse must become a bona fide

employee of your business. Theoretically, that means your spouse will be working under your control. Good luck.

Last, But Not Least

High-income taxpayers should consider investing in tax-exempt investments.

Middle- or low-income taxpayers should consider selling tax-exempt investments and aim for greater appreciation or income.

Be sure that you meet the requirements for excluding gain on the sale of your principal residence. The exclusion amounts are up to \$250,000 for single filers and \$500,000 for married taxpayers filing jointly.

Conclusion

We hope this year-end planning letter has been helpful. These strategies are aimed at reducing both your short-term and long-term tax burden. Please take a moment to review your personal game plan to be sure you are not missing any opportunities.

If you are in need of tax planning and/or income tax preparation, the CPA side of our business stands prepared to help you. Client satisfaction was at an all time high last tax season. This year, we happily report that all five tax-preparers are returning, and we expect an even better year.

We wish you and your family a happy, healthy and profitable holiday season and New Year!

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