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Year End Tax Planning Moves

By Shelly Gigante

Tax planning may well be a year-round job, but the fourth and final quarter of the year is where the rubber meets the road.

Many of the common strategies used for lowering the annual tax bite take weeks or months to execute, and most must be implemented by Dec. 31. (Contributions to a traditional IRA are the notable exception, as prior year contributions can be made all the way up to the tax filing deadline of the following year.

The strategies that some financial professionals suggest include:

- Accelerating or deferring income/deductions as appropriate
- Harvesting investment losses or gains
- Contributing to your 401(k)
- Making Required Minimum Distributions from your IRA, if older than age 70-1/2.

“Any tax planning that has an end of year deadline should be set up and processed by mid-December,” said Nancy Coutu, co-founder of Money Managers Financial Group in Chicago. “There is no recourse if you miss the window.”

Review Income

For many people, the starting point for year-end tax planning is calculating their projected income for the current year and comparing it with the previous year. This review is especially important for those whose take-home pay fluctuates, like independent contractors, small business owners, or commission-based sales people. If someone made significantly more, they could move into a higher tax bracket this year. They may also be subject to the dreaded Alternative Minimum Tax, or AMT, a parallel tax system that eliminates many of the most common tax credits and deductions. The AMT was originally designed to ensure wealthy individuals pay their fair share of taxes, but it increasingly ensnares middle income taxpayers, too.

Many people lean on a tax professional to help analyze income and maximize deductions, but don't wait for the last minute to seek their advice, said Coutu. "With holidays and weekends, along with millions of these types of transactions taking place at the same time, there is too much room for errors and little time to correct them," she said.

Delay Income/Accelerate Tax Deductions

Those who earned more income this year may be able to lower their tax liability by accelerating deductions and deferring compensation income where possible.
For cash basis taxpayers who report income and deductions in the year they are received, which is the case for most employees, some payroll departments are willing to distribute year-end bonuses on or after Jan. 1, 2017. Additionally it may be possible to exercise non-qualified stock options next year instead of this year.

Those who invoice for services rendered may also wish to hold off for an extra couple of weeks to ensure payment will be received after the New Year.

Another tactic some people use to potentially lower their tax bill, if they are charitably inclined, is to donate appreciated stock or securities to a qualified charity, which generally yields a tax deduction equal to the full market value as long as the asset was owned for at least a year.

Additionally some tax payers accelerate deductions they would normally take next year to the last few weeks of December, such as estimated state income tax bills, or January property tax bills.

Yet another way to potentially lower taxable income is to harvest any losses they may have in an investment portfolio to offset capital gains. The IRS allows taxpayers to offset all capital gains in a portfolio in a given year with their investment losses. Any excess loss can be used to offset ordinary income up to $3,000 per year ($1,500 for married individuals who file separately) until the loss is used up.

Investors should be cautious about using this strategy, tax professionals point out. "You wouldn't want to sell an investment you would otherwise want to hang onto just to claim the loss," said Mark Luscombe, a certified public accountant and attorney, and principal federal tax analyst for Wolters Kluwer Tax & Accounting, a tax, accounting and auditing services firm in Riverwoods, Illinois. The sale must make sense for your overall investment strategy, he said in an interview.

Investors also need to be aware of the wash sale rule. Taxpayers cannot claim a deduction when they sell or trade stocks at a loss and then repurchases those shares (or a substantially identical security) within 30 days before or after that date.
Accelerate Income/Delay Deductions

The reverse is true for those who anticipate a higher tax bill next year. In that case, it may make sense to accelerate income into this year and delay generating deductions, which could have greater value in 2017, said Coutu.

For example, a taxpayer may be able to collect on debts and accounts receivable owed, settle any taxable lawsuits or insurance claims, or take distributions from an IRA or retirement plan (if the circumstances are such that it will not produce an early withdrawal penalty).

Taxpayers can also consider postponing charitable gifts until next year (to save the deduction for when it's needed more), or pay December's deductible expenses on Jan. 1, 2017, assuming they can do so without late payment penalties.

Similarly, in a lower tax bracket year, it may make sense for individuals to sell highly appreciated stocks, bonds, funds and other assets (that no longer fit with investment goals) to harvest capital gains.

Fund Your 401(k), 403(b) and 457 Plans

One of the more common ways people lower their tax liability is to increase contributions to a tax deferred retirement savings plan, like 401(k), 403(b) or 457 plans. If payroll deductions are not on track to take 401(k) contributions to the limit, which is $18,000 for 2016, a taxpayer could adjust his or her elective deferral higher for the remaining weeks of the year. Those 50 or older can make additional catch-up contributions of $6,000. (Related: Retirement Plan Contribution Limits: Your Need-to-Know)

Those who can't afford to max their account shouldn't despair. Even a small increase in annual contributions can potentially boost their savings especially if their retirement savings plan involves an employer's matching contribution. Plus, of course, there is an immediate tax benefit for your contribution. (Related: Retirement Income Calculator)

Watch Your RMDs

Sometimes, the best way to minimize a tax bill is by dodging avoidable penalties. Those age 70-1/2 or older are required to start taking minimum distributions every year from most tax-deferred accounts, including their traditional IRA and your 401(k).
In most cases, the deadline for taking an RMD is Dec. 31. An exception is made for those taking their first RMD, in which case they have until April 1 of the year after they reach 70-1/2 to take their distribution. (Those who do so, however, will need to take two RMDs that first year, one for the prior year, and one for the current.)
Failure to take an RMD, or the full amount, by the appropriate deadline will result in a hefty 50 percent excise tax on the amount not withdrawn. (Related: Know Your RMDs)

Put more simply, if one were required to take out a minimum $5,000 from an IRA, but missed the deadline, he or she would owe the IRS $2,500, plus the ordinary income tax owed on the RMD because the contributions were originally made on a pre-tax basis. "The top of the Baby Boomers (born 1946) are age 70 this year and some have turned 70-1/2 already," said Coutu.

For the ultimate tax deduction, some also consider donating their RMD to charity. "If you are making charitable contributions this year, consider contributing your RMD directly to a qualified charity in order to avoid paying income taxes on the distribution, up to $100,000," said Coutu, noting tax-free gifts yield a bigger benefit for both the donor and the charity. "To make sure that the transaction is completed prior to the end of year deadline, allow extra time for the transaction to be completed."

Other Tactics

For those who pay for individual or family high-deductible health insurance that qualifies for a Health Savings Account, there is the potential to roll over money tax-free from an IRA to fund the HSA, said Coutu. (Generally, that only makes sense if the taxpayer has no other funds with which to make an HSA contribution. Otherwise, they would typically be better off leaving their IRA untouched and funding their health savings account with deductible contributions from other income.)

The contribution is limited to the 2016 contribution limit, which is $3,350 for individuals and $6,750 for families. (That limit is $1,000 higher for those 55 or older.) To qualify, the deductible has to be at least $1,300 for an individual or $2,600 for a family, said Coutu.

"You can then get this money out tax-free from the HSA if used for medical expenses," she said, noting such rollovers can only be done once in a lifetime.

Another move for some taxpayers that is not tied to Dec. 31: If you completed a Roth IRA conversion in 2016 and the value drops between now and Oct. 15, 2017, you can still recharacterize, or undo, the conversion.

You would not then owe income taxes on the higher value, said Coutu. You are permitted to reconvert as soon as the later of: the year following the year of the initial conversion or more than 30 days after the recharacterization. "With the stock market volatility this could save a significant amount of taxes," said Coutu.