End-of-year tax planning

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THE KIPLINGER TAX LETTER

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THE KIPLINGER WASHINGTON EDITORS

1729 H St., N.W., Washington, D.C. 20006 Tel: 202-887-6400

Cable Address: Kiplinger Washington D C

Dear Client: Washington, Nov. 6, 1981.

Your year-end tax planning is in a new setting this time...
A general lowering of income tax rates...for years to come.
There are many changes to keep track of, beyond the rate cuts, for this year, next year and afterward as a result of the new tax law.
You still have eight weeks to influence your own tax liability, based on changes now in effect, plus others to take effect next year.

We are devoting this Letter to suggestions that might help you... reminders and pointers you can adapt to your own needs before Jan. 1982.

There are two major objectives to year-end tax planning:
To defer income to a later year, which is the same as getting an interest-free loan because YOU can use the funds you would have used to pay the tax on the deferred income. And, with continued inflation, you most likely will end up paying that tax with cheaper dollars.
To decrease the total tax you will pay over the two years.

The keys to successful year-end tax planning have NOT changed:
Looking at two years together...your income tax for both years.
Estimating your income & deductions for each year...which of them fall into 1981, which into 1982, and which can be moved to either year.
Noting the type of income...salary, investment, capital gain, etc.
Knowing the tax rules...old and new rates, the old rules and new. Many of the changes won't apply to your 1981 return, but they will affect what you do for the rest of 1981 because they will trim your 1982 taxes.

Those with investment income taxed at rates over 50% can save most by delaying income into next year when top tax rate on all income is 50%. Or shifting deductions into this year when they trim up to 70% from tax. (Actually, after allowing for the effect of the 1¼% credit that applies to income this year, the top effective rate for 1981 is 69⅛%, not 70%.)
But those whose top rate is lower still can save...from two points to five points, depending on their bracket, by shifting between the years.

Some provisions haven't changed...and won't next year either:
Personal exemptions...still $1000 for yourself and dependents.
The standard deduction...zero bracket amount as it's now known... the threshold for itemizing deductions. Singles, $2300. Marrieds, $3400.

Shifting deductions often is easiest maneuver. Consider these:
Medical expenses. Insurance policy premiums. Some prepayments.
State & local taxes. Early payment of income taxes due next year. Or paying property taxes early where allowed. Or buying big-ticket items that carry hefty state or local sales taxes, such as a car, plane, etc.
Other expenses also can be shifted...professional dues, purchases of business tools and uniforms, publications and similar delayable items.

Charitable donations are another item that can be juggled from year to year as best fits in with your own income tax picture. But bear in mind that donations are deductible in the year they are paid, not in the year you give your own note or in which you make a pledge.

You can double up...give contributions for two years in one year.

Gifts of appreciated property are fully deductible for most folks without gain being taxed to donor, provided asset was held over a year.

"Charitable lead trusts" are another approach that tax experts are currently recommending for clients in the over-50% tax brackets.

Work this way: You put sum of money or securities in trust, with the income paid to the charities that you name for a period of years. After that, the principal is returned to you or whomever you designate.

You deduct the full value of the income interest this year... deducted at rates over 50%, up to 70%. But as income is paid to charity, it is taxed to you...at no more than 50% though deducted at a higher rate.

Tax shelter investments are another easy way to shift income. They reduce your income tax bill by shielding ordinary income this year, when the tax rates are as high as 70%...and by postponing income taxes to later years when your maximum income tax rate will not exceed 50%.

There's still time for shelters to generate losses and credits, for assets put in service before Jan., under the new cost-recovery rules. Equipment leasing, for example. Also real estate...new & used buildings.

Oil & gas shelters are popular at year end for one main reason... ability to deduct payments for drilling scheduled for the following year. But IRS is more strict on this now, especially when parties are related.

But watch out for phony tax shelters, especially those involving investment tax credits for records, video discs, etc. Values of assets are inflated beyond reason, with the reproduction rights given low values. IRS reallocates values so that investment credit is far less than touted. And starting with 1981 returns, overvaluations will draw extra penalties.

There's now a new rule controlling investment tax credits... aimed especially at some tax shelters. The credit can not be claimed on assets financed by debt...unless the buyer is liable for the debt or the amounts are borrowed from banks, S&Ls, insurance companies, etc.

Tax shelters aren't for everyone, including many in high brackets.

You should look ahead, to when the tax deductions have been used and a profit shows up. Consider the bracket at which the profit is taxed as well as whether there will be any cash flow available to pay the tax.

Also look at the 15% add-on minimum tax...additional tax required because of fast write-offs, including the ones enacted earlier this year. You risk having to pay this if your deductions for these exceed $10,000.

And if you have income eligible for the 50% maximum tax in 1981, think carefully before getting into tax shelters. Income from salary, bonuses, fees, commissions, etc., which qualifies for the 50% maxi-tax, is taxed at higher rates to the extent that you have excess write-offs from depreciation, etc...the items that could trigger the add-on mini-tax. (Won't occur next year...when the top rate on all income will be 50%.)

You can avoid the minimum tax and loss of maximum tax for 1981 by paying close attention to the rules for each. Also note exceptions that don't affect the mini or maxi taxes, such as investment credits.

Having too much capital gain can increase your INCOME tax bill because it can trigger an alternative minimum tax. This alternative tax is paid if it yields more revenue for IRS than your regular income tax.

You count only the 60% of capital gain that you excluded. (But none of the gain from sale of your home is counted as part of this.)

You also add in some itemized deductions if over 60% of AGI... Adjusted Gross Income. Charitable gifts, interest deductions are counted.

If these add up to $23,300, you may face an alternative mini-tax.

You should have your tax adviser look over your situation quickly.

You may have to defer donations and interest payments until 1982.

And possibly even accelerate ordinary income into 1981.

The 50% maximum tax rate on earned income still applies for 1981, while 1981 tax brackets on most other income still go above the 50% level. (Next year the top income tax rate on ALL types of income will be 50%.)

Applies to income from salaries, bonuses, professional fees, etc.

Income averaging is another way to trim your 1981 income tax. See if your 1981 income will be 20% above 1977-80 average...plus $3000. If your income for 1977 was abnormally high, consider delaying averaging until 1982 when 1977 won't be a base year and pushing 1981 income to 1982.

You can not use income averaging and the 50% maxi-tax together.

Married couples may want to juggle income of the lower paid spouse so that more of her (or his) employment income falls into next year.

There is an extra deduction for marrieds in 1982...equal to 5% of the lower paid spouse's salary and wages as shown on the 1982 return. Only first $30,000 of earnings counts...deduction can not exceed $1500. However, remember that the $30,000 is trimmed by some business deductions.

This is in addition to the benefit from the lower income tax rates and other recent changes that reduce your personal tax burden next year.

A change in your marital status before 1982 could raise or lower the tax you pay. Two singles now tend to pay a lower tax on same income than marrieds. Will be corrected somewhat next year, but not completely.

Single folks may qualify for a lower tax as heads of household. Must support a dependent in the taxpayer's home for the WHOLE year... except that dependent parents of a single person can live somewhere else. Temporary absences are OK...vacations, hospitalization, child at school.

Keep an eye on your dependents' income also. Too much could lose $1000 personal exemptions for you...if their 1981 income is $1000 or more and they are 19 or older and were not full-time students for five months. You also must supply over half the dependent's support to take exemption.

Tax planning is a year-round job...requires constant attention. But year-end moves can be influential. Hope this Letter helps with yours.

We'll have additional tips for you in our next several Letters... while you still can act...for your personal and business tax planning.

Yours very truly,

The Kiplinger Editors

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Income also can be shifted in many situations...pushed back to a later year or accelerated into an earlier year if that's better.

Employers can help by delaying year-end employee bonuses to 1982. And perhaps by paying for December's work in January when rates are lower. Best to consult with employees beforehand...but decision is employer's.

Closely held corporations can pay year-end dividends in the year that's better for shareholders...probably 1982 with its top rate of 50%. Delaying the dividend won't trigger an accumulated earnings penalty... provided the dividend is paid within 2½ months of end of firm's tax year.

Professionals should be careful about using an old tax device... delaying or speeding up client billings. IRS watches this more closely to see if method changes from year to year AND heavily distorts income.

Interest income can be deferred as well. For example, interest that would be paid by a money market mutual fund could easily be avoided by shifting investment into T-bills that would pay interest in 1982. Also, you can give private debtors until 1982 to pay 1981 interest to you.

For most folks, capital gains offer the greatest flexibility... taking them this year or next...or later. Make sure you know the rules, separately netting short-term gains & losses and long-term gains & losses. If one net is a gain and the other net is a loss, you then net them.

Gain on assets held a year or less, short-term...ordinary income. Exception: Commodity futures are considered long-term after six months.

Assets held more than one year are long-term...with gains taxed more favorably than others. You include only 40% of such gains in income. The 40% that is included in income is then taxed under the normal rates.

If your top tax rate will be over 50% for 1981, you must separate sales occurring before June 10, 1981, from those occurring after June 9. This is because gains after June 9 won't be taxed at more than a 20% rate, 20% of the full net long-term capital gain...instead of as much as 28%. Means people above the 50% bracket have no TAX reason to delay gains.

Up to $3000 of losses can be deducted from ordinary income... after offsetting losses against gains. But there is an important catch:

A net short-term loss is fully deductible up to the $3000 limit.

A net long-term is not...must be cut in half. Thus, it takes $2 of long loss to offset $1 of regular income, or $6000 to offset $3000.

Any excess losses can be carried over and used in future years.

You should review your holdings now...from an investment viewpoint and with the tax rules in mind so you can make the proper moves this year.

You should strive for long-term gains and short-term losses. But taking a short-term gain makes sense if it offsets a long-term loss. Otherwise long loss offsets long gain, only 40% of which is in income.

Keep several special points in mind:

The wash sale rule, which denies deductions for losses on stocks and bonds when the same security is bought within 30 days of the sale.

Instalment sales that can defer gain until next year or later. (Note: The special 20% tax cap on gains after June 9 does not apply to instalments received in 1981 unless sales also occurred after then.)

Sales of depreciable property might better be delayed until 1982 because any unearned depreciation could be taxed at rates up to 70%.