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Year-End Tax Planning Techniques

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Tax planning involves structuring transactions to produce the least possible tax in the light of applicable tax provisions, controlling circumstances, and your overall objectives. Effective tax planning has grown increasingly complex as an ever-changing body of tax law offers more ways to reduce taxes, but at the same time has created more interrelated tax provisions that can trigger adverse tax consequences. The 1981 Economic Recovery Tax Act (ERTA) will place a premium on effective tax planning this year. A basic understanding of the tax rules, definition of your objectives, and a knowledge of your financial position, coupled with effective planning, can produce cash savings to you.

Year-End Tax Planning Objectives

Usually the main purpose of year-end tax planning is to reduce the tax you will owe for the current year — in this case, 1981. Because the new law provides for much lower tax rates on "unearned" income in 1982 and thereafter, special attention should be given to tax planning between now and year-end. This may be done by finding ways to actually decrease taxes on transactions and investments in 1981 or by simply arranging to defer income (and thus taxes on that income) to 1982 or later.

A deferral of income to a later year is the equivalent of an interest-free loan because it enables you to use the funds from which you would otherwise have to pay the tax on the deferred income. With today's rate of inflation, any tax deferred to a later year will most likely be paid with cheaper dollars.

Highlights of 1981 Tax Legislation

The recently enacted tax changes are perhaps the most important aspect of 1981 year-end planning. These new laws include some minor cuts in 1981 for all individuals and important business tax cuts for 1981 and later years. After 1981, the top individual tax rate drops to 50% on all kinds of income, earned or unearned, from a high this year of 69.125% on earned income.

The new law also provides, beginning 1982, larger deductions for contributions to Individual Retirement Accounts (IRAs) by persons who are not covered by an employer-provided plan. For the first time, persons who are participants in qualified pension or profit-sharing plans can contribute and deduct up to $2,000 of certain voluntary contributions to the qualified plan (but only if the plan provides for this), or to their individual retirement account.

Congress also enacted a special "lifetime" exclusion for interest of $1,000 ($2,000 for spouses filing jointly) for interest paid on special "All Savers" certificates issued by certain financial institutions. The interest rate for these certificates is to be equal to 70% of the average yield of the most recently issued one-year Treasury bills. As an example of the benefit, an All Savers certificate with an interest rate of 12.5% is equivalent to a taxable instrument with a 25% interest rate for an individual in the 50% top tax bracket. These one-year certificates will be available for purchase from October 1, 1981 through December 31, 1982. By switching out of money market funds or other income-generating investments into All Savers certificates, you may be able to exclude some income for 1981.

Timing Income and Deductions

As a cash basis taxpayer, you may have considerable flexibility in managing your taxable income levels with proper planning. For instance, you usually can defer income taxes by postponing income or accelerating deductions during the closing period of the year. Likewise, you can increase current taxable income through receipt of advance payments or by postponing payment of deductible expenses.

Because of the reduction in individual income taxes in 1982, the odds are strong that you should try to obtain as many deductions as possible in 1981 and attempt to defer recognition of income until 1982 or later. Therefore, most of the moves suggested for consideration will involve that objective.

Timing Income

You may be able to defer part of your compensation. However, if your pay is available for the taking, the IRS will say you have constructive receipt and tax the income as of the time you had an unrestricted right to receive it. Some employers have deferral plans for bonuses or other compensation under which an employee may, before the beginning of the year, choose the portion of his compensation he wishes to have deferred. The deferred compensation is usually paid at some point in the future and may be spread over several years. While it is too late to do this for 1981 compensation, you might want to consider electing *in 1981* for 1982 compensation.

Payments from rent or for services you have rendered may be deferred by delaying your billing. Or, if you want to accelerate income, you can ask the lessee or the person for whom you have performed the services to pay early.

An installment sale is one way to realize your profit between now and year-end but defer tax recognition of the gain and spread it out as installment collections are received over future years. Recently enacted legislation has removed many of the restrictions previously applicable to installment sales. If you are scheduled to receive payments in 1981 on installment sales closed prior to June 10, 1981, you may want to arrange to defer the receipt of the payment to 1982 in order to qualify for the new 20% maximum capital gains rate.

Interest income may be deferred by formally entering into an agreement with the debtor, in advance of the due date, to grant him an extension of time to pay. Or if your objective is to accelerate income into 1981 you may be able to induce the debtor to prepay the interest.

Dividends from a closely held corporation could be postponed to 1982 by the controlling shareholders arranging to have a corporate resolution adopted setting the time early in 1982 for payment of the dividend. If desired, the converse could be done by setting the payment date in 1981.

The purchase of deep discount bonds — other than those originally issued at discount — on margin allows a current deduction for interest and defers the gain to 1982 or later when the bonds mature. At present, there are a number of outstanding bonds that are selling at 15% to 20% points (or more) below face value. When they mature, this difference will be reportable as capital gains.

Acquiring Treasury bills, which are issued at discount, can defer the interst income to 1982. That is because the discount is not taxed until the bills mature (or are disposed of before maturity).

Timing Deductions

State income tax deductions can be accelerated into 1981 by asking your employer to increase the amount of your state income tax withholding, or by paying your January 1982 estimated state tax installment in December 1981. In addition, you may be able to arrange for early payment on account towards your ultimate 1981 state income taxes before year-end.

A retirement plan offers an opportunity to create a deduction for funds that are set aside to be repaid to you in the future. If you have a self-employment income, such as from directors' fee or consulting fees, you can establish an HR-10 (Keogh) plan even though you may participate in your employer's qualified plan. Annual contributions you make to the HR-10 plan would be deductible in the amount of the lesser of 15% of your self-employment income, or $7,500. Beginning in 1982, the deduction limit is increased to the lesser of $15,000 or 15% of self-employment income.

If you are a salaried individual and are not already a participant in a qualified retirement plan, you can establish an Individual Retirement Account (IRA) and annually contribute and deduct the lesser of 15% of your salary or $1,500 ($1,750 if jointly with spouse). Beginning in 1982, the deduction limit is increased to $2,000 with no percentage limitation ($2,250 if jointly with spouse), and an IRA can be used even if you are a participant in a HR-10 (Keogh) or a qualified employer plan.

For both types of retirements plans - IRAs and Keogh - your contribution is deductible in 1981 as long as you make it before your tax return is due for 1981 (April 15, 1982, or the extended due date). Note, however, that although an IRA can be established as late as the due date for your tax return for 1981 and still qualify, an HR-10 plan must be set up before the end of the year for the contribution to be deductible for 1981.

Interest expense offers an opportunity for accelerating or deferring a deduction. Personal interest (department store accounts, home mortgage, etc.) are itemized deductions. A deferral of payment of interest can increase taxable income. However, decreasing taxable income by prepaying interest is severely limited, as the law, in general, bars a taxpayer from deducting interest in advance (for periods beyond the current taxable year).

Medical expenses may offer a chance to increase deductions. If your medical expenses are likely to exceed 3% of your adjusted gross income, pay all medical expenses incurred this year before yearend. Of course, if your medical expenses are under 3% floor for 1981, then you should defer paying them, if possible, until 1982.

To maximize medical deductions, try to make actual payment of as much as two years' medical expenses in one year, and attempt to defer paying as many medical expenses as possible every other year, thereby giving you a better chance of exceeding the 3% floor.

Property taxes that are due in 1982 may be payable and thus deductible in 1981. Or, if the idea is to increase income for 1981, you should consider, subject to any late-payment penalties, deferring until 1982 payment of property taxes due in 1981.

Charitable contributions offer an opportunity to accelerate itemized deductions and reduce taxable income. Consideration should be given to prepaying 1982 charitable commitments before December 31, 1981. Individuals with high 1981 income and substantial future charitable commitments should consider the creation of a charitable lead trust. In planing for the prepayment of contributions, however, the economic considerations should be paramount, and the percentage limitations on the deductibility of contributions must be carefully observed.

Year-End Securities Strategy

Securities transactions offer an excellent opportunity for year-end tax planning. The goal should be to pay the least possible tax on gains realized and to use capital losses to the maximum extent possible to offset gains. Keep in mind that this same objective applies to other capital assets, such as real estate held for investment. Certain business property may also be eligible for favorable capital gains rates.

The first planning step is to sort out what has happened so far in terms of net long-term and net short-term gains or losses on transactions already consummated this year. If you expect your 1981 tax rate to be over 50%, you will have to further separate the transactions closed before and after June 10, 1981. Sales closed after that date will qualify for the new 20% ceiling capital gains rate.

After you ascertain your net long-term and short-term gains or losses realized to date, list your holdings in which you have unrealized gains or losses. With the help of your investment advisor, consider whether it makes economic sense to take some unrealized losses on securities before yearend in order to offset a net capital gain on transactions already consummated. Excess capital losses can only be utilized to offset $3,000 of other income (in excess of net capital gains), with the balance being carried over to future years.

If you wish to realize a loss and yet retain your position in the security, you could buy the securities back after the sale. However, if you buy substantially identical securities within 30 days *before or after* the date the sale took place (total 61-day period), the loss will be deferred for tax purposes until the new securities are sold. You may avoid the effect of this limitation by buying another security likely to follow the same pattern as the loss security (e.g., similar company, same industry), and then switch back to the original loss security, if you choose, after 30 days have elapsed. Remember, there usually are brokerage expenses connected with sales of securities, and economic considerations should be paramount.

If you want to recognize a tax gain in a market security in 1981, it must be sold on or before December 24, 1981. However, if you cannot meet this deadline, your broker may be able to arrange a cash sale for you on or before December 31, 1981, usually at a slightly lower selling price. If the sale will result in a loss, you can sell as late as December 31, 1981, and the loss will still be reportable for 1981. ■

For additional information on tax planning, we invite you to request your forty-four page complimentary copy of "Year-End Tax Strategy For Individuals — 1981." Among the topics covered by this booklet are:

- *Year-End Tax Planning Objectives*
- *Highlights of 1981 Tax Legislation.*
- *Timing Income and Deductions.*
- *Timing Tax Credits.*
- *Compensation Planning.*
- *Compensation Planning.*
- *Year-End Family Tax Strategies.*
- *Tax Worksheets.*

To receive your copy of this booklet, please return the enclosed response card.

Charitable Planning

As you consider year-end tax planning strategies for 1981 we ask you to consider the advantages of making a charitable gift to Southeastern Baptist Theological Seminary either through a current gift or via one of the planned gift programs available to you. Congress through its power to enact tax legislation encourages voluntary support of institutions such as Southeastern through favorable tax treatment of gifts. Many have found that by taking advantage of incentives available with the charitable tax deduction, they can increase their spendable income. However, to take advantage of the charitable tax deduction, you must make your gift by December 31. Further, a tax deduction on your 1981 tax return could mean a larger tax savings this year than in 1982 because tax rates will be lower next year.

Finally, we hope this newsletter has been helpful in alerting you to some of the more frequently used year-end tax planning possibilities. These explanations, because of space, have been simplified, and some techniques have been omitted. For a lengthened discussion of tax planning, we suggest that you return the response card; or a discussion with your tax advisor at this time of year, while there is still time to take advantage of opportunities, may pay dividends. ■

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