

Tax Planning

Over the many years of preparing tax returns, one of the most difficult parts of my responsibility is to have to break the news to a tax client, after completing their tax return, that they have to pay a big tax bill. Unfortunately, many financial decisions are made with no forethought of the tax consequences of those decisions. In most cases, it is because the client is simply not aware of the potential adverse tax consequences of those decisions. However, by the time I get the client's tax information at year end, it's too late to take the corrective actions necessary to reduce the tax burden on the client. The year is over and all I can do at that point in time is report what occurred in the preceding year.

This is why proper tax planning is so vitally important. Proper tax planning is simply developing a strategy for the client to minimize their tax liability and maximize their tax deductions or credits. Sometimes this means foregoing the decision to purchase or sell an asset until a time that would be more advantageous to the client. Sometimes it means selling a poor performing stock at a loss to offset the gain created by selling a great performing stock. Sometimes it means cleaning out your closet or attic to make a non-cash charitable contribution to offset a taxable windfall you might have come into. And the list could go on endlessly.

As an example of a typical tax planning strategy, I was approached some time back by a person in business who was looking for ways to reduce his tax liability each year. After reviewing this person's books, understanding the nature of his business, and how his business was organized, it became clear that this person's greatest tax liability was the amount of self-employment tax he had to pay in his sole proprietorship. After looking at several different options, we determined that his best course of action was to incorporate his business as an S-Corporation. S-Corporations are pass through entities that are not subject to the self-employment taxes a sole proprietorship is. In addition, because this taxpayer would be an employee of the corporation, all payroll taxes are deductible by the corporation and thus reduce the amount of taxable income that would pass through to his personal income tax return. The end result was a savings of several hundreds of dollars in tax liability each year for this individual.

Another situation that taxpayers often find themselves at tax preparation time is trying to determine the cost basis of stock that was sold during the year. All too often the broker that acted as the agent to sell the stock does not have and cannot compute the cost basis of the stock that was sold. This is because the stock was transferred to him/her sometimes years after the original purchase. If the cost basis of the stock cannot be determined, then, the tax preparer has no alternative but to record the cost basis of the stock as zero (0) resulting in the 100% of the selling price having to be recognized as gain in the sale of the stock. Because of this I advise all my clients to consult me prior to selling any stock during the year so that we can ensure that we have an accurate cost basis in which to properly determine gain or loss on the sale of the stock.

The sale of assets that are inherited is another challenging area for both the tax preparer and the taxpayer. Assets that are inherited are valued at what is called a "stepped up basis" from the decedent. The basis of the inherited asset, in most cases, is the fair market value of the asset on the date of death of

the decedent. Sometimes this takes some real leg work to try to determine an accurate cost basis of the inherited asset if no appraisal of the item is made at the decedent's death.

It is advisable to consult with your tax advisor prior to the sale of any inherited asset so that an accurate cost basis can be determined on the asset and to determine the potential tax consequences that could occur as a result of the sale.

Over the years I have encountered several cases in which clients were invested in taxable funds that paid very good dividends in 2008. Their plans, however, were structured to automatically re-invest any dividends (that were distributed) back into the fund. While this is a great strategy for the long term for tax deferred funds, it's not necessarily the best strategy for taxable funds, as several of my clients realized when they learned of the amount of taxes they owed at year end. While they never received any of the dividends, all dividends that were distributed from taxable funds and thus automatically re-invested in the fund, are fully taxable in the year in which they are distributed. Some proper tax planning could have significantly reduced the amount of taxes these clients had to pay through possible restructuring of the client's investment program to minimize the tax consequences, maximizing other tax deductions available to the client, or insuring that sufficient resources were set aside to meet the tax liability due from their current investment program.

As you can see from these few examples, proper tax planning can reduce or eliminate some potential tax consequences that you might face as a result of some financial decisions that you make. The time to consult your tax advisor is before you make the financial decision. Once the decision is made and the year comes to a close there is very little if anything your tax advisor can do to correct actions that occurred during the previous year.

For this reason, I have decided to spend the next several months discussing some strategies for dealing with the current financial conditions that we now find ourselves facing. Needless to say, that because of the new administration's policies, we will all experience some significant changes in the tax laws in 2009, as well as the continuation of some of the most challenging economic times that we have seen in our lifetime (at least for the foreseeable future).

How we approach these times financially is sure to have consequences that could affect us well into our retirement years. If we fail to plan and act without a long range strategy, the consequences could be disastrous. My goal is to try to provide you with as much information as possible to help you make the best decisions for your financial future.

Til next time,

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