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2005 Tax Planning Tips



It probably feels as if the ink on your 2004 federal income tax return hasn't even dried yet, but it's time now to focus on 2005. It's important to act now, while there's still time to make a difference. To that end, here are a few suggestions.

Learn from last year

Did income taxes owed on your 2004 federal income tax return leave you scrambling for cash? You may need to increase the amount of federal income tax that's withheld from your paycheck by completing and filing a new Form W-4 with your employer. If you're self-employed, you'll probably have to bump up your quarterly estimated tax payments. Underpaying your 2005 taxes can result in more than a cash crunch come next April 15; it can mean that you'll owe penalties and interest.

If you received a large refund for 2004, you might want to make some adjustments as well. A large refund essentially means that you provided Uncle Sam with an interest-free loan during the year. Consider reducing your withholding, and letting that money work for you during the year.

Reap the benefits of tax-advantaged savings

When it comes to setting aside money for retirement, it's tough to beat IRAs and retirement plans like 401(k)s. Traditional IRAs (assuming you qualify to make deductible contributions) and 401(k) plans allow you to contribute funds pretax, reducing your 2005 taxable income. Contributions you make to a Roth IRA aren't deductible, so there's no impact on your 2005 income, but qualified Roth distributions are completely free from federal income tax.

Increased contribution limits for 2005 mean that you can save more in these vehicles this year than ever before. With a 401(k) plan, you can contribute up to \$14,000 (\$18,000 if you're age 50 or older). If you're in the 28% tax bracket, contributing \$14,000 to your 401(k) plan can mean almost \$4,000 in tax savings this year. With an IRA, you can contribute up to \$4,000 (\$4,500 if you're age 50 or older).



Consider converting

With a traditional IRA, distributions that you take in retirement are subject to federal income tax (at least to the extent the distribution represents deductible contributions and earnings). With a Roth IRA, qualifying distributions are completely federal income tax free. If you have funds in a traditional IRA, but would prefer the benefits of a Roth IRA, you can convert your traditional IRA to a Roth IRA, provided your modified adjusted gross income (MAGI) is \$100,000 or less.

Caution: *Converted funds, to the extent they represent investment earnings and deductible contributions, are added to your 2005 taxable income.*

If you're over age 70½ and required minimum distributions from traditional IRAs have pushed your income over the \$100,000 limit, 2005 could be your year to convert. That's because, beginning this year, required distributions don't count toward the \$100,000 MAGI limit.

Benefit from your own generosity

While giving to a worthy cause may be its own reward, there's no reason why you can't benefit financially from your good deeds as well. Contributions made to qualifying charities during the year can generally be deducted on your federal income tax return, if you itemize deductions. If you make a cash contribution of \$250 or more, get written confirmation from the charity; a canceled check alone isn't enough. If you give property instead of cash, special rules apply (see IRS Publication 526). Be particularly careful if you're donating a car to charity, as the rules have changed considerably in 2005.

Tsunami relief efforts

Taxpayers who made qualifying cash donations during January 2005 for tsunami relief efforts are able to deduct the contribution on either their 2004 or 2005 federal income tax returns (but not both). If you made such a contribution but didn't claim the deduction on your 2004 return, make sure you claim it for 2005.

Time major purchases

This year, taxpayers who itemize have the option of deducting state and local sales taxes rather than state and local income taxes. The deduction can be based on the actual amount of sales tax that you pay during the year (i.e., you keep all your receipts and total them at year end), or you can utilize special

sales tax tables published by the IRS. Even if the tables are used, sales tax can still be deducted for specific purchases like motor vehicles and boats. This option is particularly valuable if you live in a state that doesn't impose an income tax.



This provision expires at the end of the year, however. So, it could pay to accelerate a major purchase planned for 2006 into 2005.

Pay attention to which investment assets you sell

If you're going to be selling investments during the year, think carefully about which investments you sell, and when you sell them. If you sell a capital asset held for a year or less, any resulting gain is considered short-term gain. If the property is held for more than a year, any gain is considered long-term gain. While short-term capital gains are taxed at ordinary income tax rates, special tax rates apply to long-term capital gains.

If you're in a marginal income tax bracket of 25% or higher, you'll pay federal tax on long-term capital gains at a rate of 15%. If you're in the 10% or 15% marginal tax bracket, you'll pay tax on long-term capital gains at a rate of 5%. This means that the tax on short-term capital gains can be as much as 20% higher than the tax on long-term capital gains.

You should generally take advantage of the lower long-term capital gains rate by selling investments that will generate long-term capital gains before selling investments that will generate short-term capital gains.

Qualifying dividends

The lower long-term capital gains tax rates also apply to certain dividends received by individual shareholders from domestic and qualifying foreign corporations

Caution: Tax considerations alone should never determine what investments you sell, or whether you sell investments at all.

Keep your eye on the alternative

Originally intended to prevent the very rich from using "loopholes" to avoid paying income tax, the alternative minimum tax (AMT) impacts more and more middle-income taxpayers every year. The AMT is essentially a separate federal income tax system with its own tax rates, and its own set of rules governing the recognition and timing of income and expenses. If you're subject to the AMT for 2005, you may end up with a higher tax bill for the year than you expect. Knowing that you're subject to the AMT may also impact your current tax planning.

According to a March 2005 Treasury Department fact sheet, the AMT will impact about 3.8 million individuals in 2005

AMT liability may be triggered by such items as:

- Large numbers of personal exemptions
- Large deductible medical expenses
- Large deductions for state, local, personal property, and real estate taxes
- Home equity loan interest where the financing isn't used to buy, build, or improve your home
- Exercising a large incentive stock option
- Large amounts of miscellaneous itemized deductions such as unreimbursed employee business expenses

If one or more of the above items apply to you, or if you've been subject to AMT in the past, you may want to look more closely at your AMT exposure. A tax professional can help you determine whether or not you should be concerned about AMT, and what steps, if any, you should take.

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