

Tax Planning Ideas to Offset Disappearing Popular Deductions

As you may very well know, the deductions and exemptions that taxpayers previously claimed on their 2012 tax returns are now being reduced or eliminated. Changes to tax laws last year reinstated income-based phase outs of the widely used personal exemptions and itemized deductions, and those affected by it will pay more tax.

If you are affected by the phase out of deductions and you need to consider some tax planning strategies that can reduce the impact on your personal situation going forward. Here are a few tax planning strategies to consider.

Claim the Home Office Deduction: If you are self employed, then take a look at claiming the Expenses for Business Use of Your Home deduction on Form 8829. When you do this, the result is that some of the disallowed deductions for interest and property taxes are deducted against your self-employment income, and therefore this portion of these deductions are not subject to the phase out. Another advantage is that this can also reduce the alternative minimum tax.

Pay-off Mortgage Debt: If some of the mortgage interest you're paying is nondeductible due to the phase out, then consider paying off some or all of this debt. Also, don't always assume that using a home equity loan is the best way to finance a car. Due to these phase outs, the interest paid on home equity loans may not be deductible, and you could get a lower interest rate on an auto loan through the dealer.

Don't Prepay Taxes: If your income is higher this year and expected to be lower in 2015, then don't prepay your real property tax and don't pay the fourth-quarter state estimated tax payments in December. You get less of a benefit from paying these taxes in a year that you are subject to the phase out for deductions.

Don't Claim Dependents: If your income is higher, you may get little or no benefit from claiming the dependent exemptions for college age children. Instead, have them claim themselves on their own tax returns, where they'll get the tax benefit of doing so.

Buy municipal bonds: Consider investing in municipal bonds or tax exempt bond funds, which pay income that is exempt from tax. Qualifying municipal bond income is not subject to federal income tax, and for taxpayers who buy bonds issued by their state of residence, the interest may also be free from state taxes as well. Just be careful to steer clear of bonds that are issued to finance so-called private activities, as the interest from these is subject to the alternative minimum tax, and therefore may become taxable. Interest from municipal bonds issued outside of your state of residence may be subject to state or local taxes.

Offset Capital Gains: Keep an eye on your realized capital gains from the sale of stocks and the capital gains distributions from funds. If you have stocks or funds that are worth less than what you paid, then consider selling these to create realized losses that can be used to offset realized gains. Of course, before you make any moves for tax planning purposes, make sure it makes sense as an investment decision. If it does make sense, then selling stocks at a loss to reduce your taxable capital gains and adjusted gross income (AGI), can help to reduce your tax burden.

Contribute to Retirement Plans: The new higher tax rates and phase out of deductions add to the list of good reasons to make pre-tax contributions to employer provided retirement plans such as 401(k), 403(b), and 457 plans. Also consider making deductible contributions to Health Savings Accounts (HSA). Contributions to all of these types of plans can reduce your AGI, and can lessen the impact of the deduction phase outs.

If you are subject to the phase outs for deductions and exemptions, then you should benefit from considering these tax planning strategies, but don't go it alone. Seek the advice of a tax professional to determine exactly which combination of strategies is the most suitable and effective for you.

If you have any additional questions feel free to contact me @ chilobe@kalambo CPA.com.