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Taxes

One Last Tax Look

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4/27/2006 7:37 AM EDT
URL: http://www.thestreet.com/funds/taxes/10281906.html

Certain things in life are very difficult to plan.

Oh sure, we all try to plan the ultimate family vacation, but inevitably someone pukes on the roller coaster. And too many brides plan a lavish outdoor wedding only to have it interrupted by a monsoon.

While you can't plan around Mother Nature, you can attempt to plan around Uncle Sam. And your 2005 tax return can help. Before you officially file it away, take one more look for some simple 2006 tax planning.

Wages and Withholdings

Start with line 7 of your 2005 Form 1040. That's where your W-2 wages are reported. You should know by now that the best way to minimize the tax hit on those wages is to max out your 401(k) contributions, because those contributions come out of your paycheck before your tax bill is calculated.

For 2006, you can contribute up to $15,000 to your 401(k). And if you're 50 or older before Dec. 31, your contributions can jump to $20,000.

Next, did you get a big refund? If so, Uncle Sam got to play with your money all year. Why let him make interest on your money when you can just as easily throw it in a savings account? You probably have too much money withheld from your paycheck.

On the flip side, did you owe big? Unless it was from a one-time capital gain or an unexpected win in Vegas, you might need to have more money withheld each pay period so that you don't have to cough up your life savings next April.

In addition, think about this year. Are you expecting a big bonus? Planning to exercise some stock options? If so, you could adjust your withholdings now to help cover that bigger tax bill next year.

If any of the above scenarios pertain to you, pull up a Form W-4 at irs.gov. That's the annoying form you filled out when you first started your job. Maybe it's time you adjusted it for 2006.

Figure out how much you want withheld from your check for the rest of the year, divide it by the number of pay periods left and give the number to HR. That's a much easier method than having to deal with all those "1's" on the form.

Portfolio Planning

You'd be surprised, but your tax return can actually be used to help tweak your portfolio.

While you never want to make investment decisions strictly based on taxes, the two work in tandem. So consider both ends.

To start, look at the interest income on line 8 of your 1040. If it was a big number in 2005, you may want to consider rejiggering things to reduce your future tax bills, says Richard Coppa, president and founder of Wealth Health, a financial planning firm in Roseland, N.J.

Remember, if you have interest-bearing investments in your IRA or 401(k), you won't owe tax on that interest until you start to take withdrawals in retirement. If you hold a regular investment account, you'll owe tax on those interest payments every year.

You need to consider your tax bracket in retirement, though. If you think you'll be in a higher bracket when you retire, then it might make sense to gain the interest, and taxes, now. If your bracket will be lower, then shift the interest-bearing products to your IRA.

Big note, though: You can't just move your assets from a taxable account to a tax-deferred account. You'd have to sell from one and repurchase in another.

And while you're thinking that you don't want to incur a big capital gains hit to do that, move on down your tax return to line 13.

Did you have a big capital loss in 2005? Were you able to declare it all or did you have to save some of it for future years and carry it forward?

Remember, tax rules say you can offset your losses against your gains and then declare another $3,000 in losses. So if your losses exceeded that, you had no choice but to hold the excess and carry it forward to next year.

If you happen to have a loss carryforward, now could be a good time to rebalance your portfolio. Many people are reluctant to take gains off the table and replenish other areas of their portfolio, says Coppa.

You don't want to be greedy -- especially if you have a carry-forward loss to offset any potential gains you may generate. So consider rebalancing now.

And along the same "greedy" lines, look at your mortgage interest deduction on line 10 of your *Schedule A -- Itemized Deductions*. If you bought that McMansion with an interest-only mortgage, you may have had a pretty juicy deduction in 2005. But think long and hard about that mortgage product. Before interest rates really ratchet up, consider getting a fixed-rate loan that lets you pay both interest and principal each month. Your mortgage interest deduction may decrease, but the equity in your home will increase more.

Brace for the AMT

If you had to pay that dreaded alternative minimum tax in 2005, you really need to plan ahead. Typically, folks who live in areas with high state and local taxes, like New York or California, make around $100,000, own a home and have kids become AMT victims.

So unless you're willing to move to Texas or Florida or get rid of the kids (wishful thinking), you might be stuck until you start making the big bucks and move out of this AMT purgatory.

But if you're in AMT because of a particular event, or if you know your situation will change in the future, then there's some hope.

Let's say you plan to exercise some incentive stock options in 2006. You can't really say "ISOs" without saying "AMT" in the same breath, so prepare yourself.

Consider deferring any deductions that you know will be disallowed under the AMT to 2007; that way you won't be losing their benefit. For instance, try to pay your December state and local tax bill in January 2007. Consider waiting until next year to take out that home equity loan, because that interest is disallowed. Try to push off your miscellaneous itemized deductions as well.

Those are just some of the things you can do to save yourself from the AMT ogre. But know this: Once the AMT enters your home, it's imperative you get professional help to better understand your options.

Try not to get too disappointed when things don't go according to plan. Some things are just out of our hands. But fortunately, we can control what happens in tax land -- so make sure you do.