

Fundamental Federal Financial & Tax Planning

Income tax planning is an essential part of facilitating capital formation for the planning client. Relevant questions in this context might include:

- 1) What is the taxpayer's current marginal income tax rate? Does that rate suggest (from the tax perspective) a shift of some investments to tax-exempt municipal bonds, including a tax-exempt bond mutual fund? Alternatively, should the taxpayer shift financial holdings to investments having a lower current yield but a higher appreciation potential (relying on the "total yield" concept of combined income and capital appreciation)? Attitudes concerning investment strategy can change significantly as (i) the ordinary income rates increase and (ii) those rates change relative to a lower capital gains rate.
- 2) Should the taxpayer acquire "tax advantaged investments"? These tax advantages might be achieved through tax deferral (such as investment in low dividend yield growth stocks) or from investments providing "tax write-offs," e.g., depreciation deductions. The estate planning advisor should caution the client that these arrangements must not only generate the desired federal income tax results, but should also constitute prudent investments. Relevant questions include whether such an investment should be in improved real estate, leased personal property, farms and agricultural activities, research and development ("R & D") projects, movies and other similar arrangements having the potential for generating income tax deductions? In this context the tax planner must consider the probable applicability of federal income tax accounting provisions such as the "at risk" rules and the "passive loss" rules which might limit the current utilization of losses.
- 3) Can current tax recognition of earned income be deferred under circumstances where the subsequent federal income tax liability will be sufficiently reduced so as to offset the loss of the current use of those funds (after reduction by the possible federal income tax liability)? What opportunities exist for deferring that income taxation through tax deductible contributions to a qualified pension or profit sharing plan? A self-employed retirement plan (SEP)? A 401(k) plan? An Individual Retirement Account (IRA)?
- 4) Will the potential application of the "alternative minimum tax" (or "ALTMIN" tax) on items of tax preference income neutralize the economic value of any income tax deferral?
- 5) What other planning opportunities exist for reducing current federal or state income tax costs? When an income tax rate differential exists between ordinary income and capital gains, appropriate investment strategy suggests that investments producing capital gains should be emphasized. Tax Code provisions might limit this planning opportunity, however. Further, the client might be concerned about the greater investment risk which might be inherent in growth potential assets.