



Other Tax-Advantaged Strategies

What are some other tax-advantaged strategies?

When engaging in income tax planning, you may be able to reduce your overall tax burden by employing specific strategies to generate tax-free income, shelter earned income from taxes, and defer taxes. However, other tax-advantaged strategies exist as well. You might wish to create passive income to take advantage of passive losses, and you might wish to engage in year-end tax planning.

Additionally, it may be wise to consider the tax benefits of generating capital gains, investing in real estate, and receiving annuitized payments.

Why should you create passive income to take advantage of passive losses?

A passive activity involves the conduct of any trade or business in which you do not materially participate. For example, if you have an interest in a limited partnership and the partnership generates income, it is likely that your share of partnership income will be classified as passive. In addition, real estate rental activities are generally considered passive activities.

Caution: There are special rules if you actively participate in a passive real estate rental activity.

Generally, a loss from a passive activity cannot simply be deducted outright on your personal

income tax return; rather, a passive loss can only be used to offset passive income.

Accordingly, if you have passive activity losses, you can take advantage of the offset provisions by creating passive income. In effect, you will have created tax-free income, because your income will be offset by otherwise unusable passive losses. Generally, unused passive losses can be carried over to offset income in subsequent years, and unused passive activity loss carryforwards are allowed to be used in full when you dispose of your entire interest in the activity generating the passive losses in a fully taxable transaction.

Why should you engage in year-end tax planning?

Year-end tax planning may often result in substantial tax savings. Tax planning primarily concerns controlling the timing and the method by which your income is reported and your deductions and credits claimed. The basic strategy for year-end tax planning is to time your income so that it will be taxed at a lower rate and time your deductible expenses so that they may be claimed in years when you are in a higher tax bracket. In a nutshell, you should try to:

- Recognize income when your tax bracket is low
- Pay deductible expenses when your tax bracket is high
- Postpone tax whenever possible

See disclosures on final page.

By using these methods, you can lower your overall tax liability.

Why is it useful to generate capital gains?

If you can generate net capital gains (instead of ordinary income), you may save considerably on your taxes. This is because the top capital gains rate is substantially lower than the marginal rate applicable to ordinary income. You generate capital gains by selling capital assets. Another advantage to investing in capital assets involves the timing of income. You usually have the flexibility to control when you recognize the income or loss because, in most cases, you determine when to sell your assets.

How is investing in real estate beneficial, from a tax standpoint?

One big advantage of investing in real estate is that any appreciation in value is a tax-deferred gain that will not be recognized until the real estate is sold at a future point. Moreover, if the real estate you invest in is used as your personal residence, it may be possible for you to exclude all or a portion of the capital gain income when you sell the residence (if certain conditions are met).

If, on the other hand, you purchase real estate for investment purposes only, you may be able to take advantage of depreciation and other

deductions.

What is the tax advantage to receiving annuitized payments?

When you receive income in the form of periodic annuity payments, you'll pay a smaller amount of taxes in a given year than you would if you received the money all at once; receiving a lump sum could push you into a higher tax bracket. With an annuity, on the other hand, part of each annuity payment is taxable, and part is nontaxable. Moreover, it's possible for the taxable amount to be so small that it will have no impact on your tax bracket.

Basically, each annuity payment you receive represents a return of principal (or your nontaxable investment basis), plus a taxable interest portion. If you want to figure out which payments are taxable, multiply each payment received by an "exclusion ratio." The exclusion ratio is determined by dividing your nontaxable investment in the contract by the contract's expected return (value).

If you purchase a deferred annuity, the annuity can earn interest tax-deferred on an annual basis. The interest is not taxable in the current year as long as no withdrawals are made. Since you're likely to be in a lower tax bracket by the time the annuity is paid out (during retirement, perhaps), the income tax effect should be minimal.

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