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Year-end tax planning vexing as "cliff" looms

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There are mere weeks left to maneuver so you keep as much of your money as possible without overpaying taxes for 2012.

But this is no typical year. You are flying blind as Congress dawdles over the actions it must take by Dec. 31 to avoid tax increases in 2013 for virtually all U.S. taxpayers. Since you don't know whether Congress will save you from a tax increase, or let your taxes go up on Jan. 1, any tax move you make between now and the end of this year may turn out to be less than optimal later.

The reason, of course, is the so-called "fiscal cliff," or the popular way of talking lately about $500 billion in tax increases that will raise the average middle class household's taxes $2,200 next year if Congress doesn't step up by Dec. 31 and halt tax hikes for a wide range of taxpayers.

In other words, even a married couple with an income of $17,400 or less, will no longer be in the 10 percent tax bracket. Instead, they will be bumped up to 15 percent and have to pay more than they do now as the 10 percent bracket disappears Jan. 1. Likewise, if you have been in the 10 percent or 15 percent tax brackets, and paying nothing for capital gains on the stocks, bonds, real estate or other investments that provide your retirement income, you will start paying 15 percent on those gains. The highest earners will have to pay 23.8 percent.

If you have been enjoying relief on college tuition, that gets ratcheted down. Parents will also see their $1,000 tax credit for each child cut to $500 along with a decline in help for day care expenses. Dividend taxes will start going up too. Lowest income taxpayers will face a 15 percent rate, while those at the highest income will face 43.4 percent. That includes a new 3.8 percent Medicare surtax on investments for high income people.

There's more, with about 70 changes coming next year if Congress doesn't stop them. Of course, as taxpayers start seeing the impact on their paychecks in 2013, they might call for relief and politicians might make some retroactive changes.

So what's an individual supposed to do?

"Normally, you'd be postponing income and accelerating deductions into 2012," said Mark Luscombe, a tax analyst with CCH. That's the usual strategy at this time of year. Maybe you'd try to get an annual bonus in January instead of December.

But since next year's taxes now look like they could be higher than this year's, tax advisers are telling many people — especially the wealthy — to take the income in 2012 when taxes might be lower. Then, in 2013, try to take as many deductions as possible to whittle down the tax bill. Of course, that plan could go awry too if Congress gets into the so-called "loophole-closing" that's been discussed.

Under some plans, you could lose some or all of your mortgage deduction, your deduction for charitable contributions, and even the deduction for contributions to your 401(k) plan. Of course, this is all talk at this point and the loophole cutting seems more likely to hit singles earning over $200,000 and couples at over $250,000.

Because of the potential, advisers are suggesting that people consider taking some capital gains this year if it makes sense based on the investment, rather than taking the gain next year when it will be more costly at tax time.

Financial planner Francine Duke, of Vernon Hills, Ill., has had clients sell some dividend paying stocks that they've owned for more than a year in taxable accounts, and buy them back in IRAs instead. If someone earns dividends in IRAs, they aren't taxed.

Still, before selling investments and playing with deductions, Luscombe says people should make sure they do not accidentally force themselves into a tax mess — possibly by pushing themselves into the alternative minimum tax (AMT) for 2012. The AMT is a higher tax than regular taxes.

Certain deductions that can be helpful in keeping tax bills low are worthless if you are in the AMT. Among them are deductions you get for paying state income taxes, local property taxes or mortgage interest. In a year when you are going to be in the AMT, it's best — if possible — to delay paying taxes and mortgages in December and pay them in January. A certified public accountant or tax software can help you understand the possibilities.

Think twice before actions that could give you a major tax bill this year. For example, converting an IRA to a Roth IRA makes sense for many people, because it will help them avoid paying taxes when retired, but it can also trigger taxes that aren't affordable in 2012.

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