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BETTER PLAN NOW FOR NEXT YEAR

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After the hoopla over last summer's Taxpayer Relief Act of 1997, taxpayers woke up to an unhappy fact: The reform won't do much for this year's bill. True, Congress made the biggest cut--lower rates on capital gains--effective at once. That's good for anyone who cashed out profitably during the stock market's run. But most of the rest of the goodies don't take effect until 1998 or later.

That deferred gratification puts a premium on yearend planning. Traditional yearend tax advice is to delay income and accelerate deductions. That strategy postpones taxes and can even reduce the bite if you expect to slip into a lower bracket next year. But this year, in certain cases, you might want to do the reverse. And with many new breaks available on Jan. 1, the timing of income and deductions is more important than ever. Your ability to control your 1998 income may determine whether you qualify for such breaks as the new Roth individual retirement account (IRA) and education savings accounts and credits. On the expense side, putting off a first-home purchase until January can let you tap an IRA for the downpayment without the penalty you would pay for the same move in December.

Accelerating income into 1997 and deferring expenses is especially important for couples who expect their 1998 adjusted gross income (AGI) to fall near $50,000, $80,000, $100,000, or $150,000. Those are the levels at which couples start to lose eligibility for, respectively, deductible IRA contributions, new higher-education tuition credits, converting a traditional IRA into the new Roth IRA, and contributing new funds to a Roth or education IRA. (For single taxpayers, the comparable AGI figures are $30,000, $40,000, $100,000, and $95,000.) For all but the IRA-to-Roth conversion, these breaks are phased out over a range of $10,000 or $20,000. (With the education IRAs, you can work around the limits by making $500 gifts to grandparents. They can then direct the money into an account foreach grandchild.)

ARTFUL DODGING. How can you keep your 1998 AGI under the limits? Talk to your employer about getting yearend bonuses this year rather than in January. If you're self-employed, delay expenses and speed up collections--or offer clients a discount if they'll prepay 1998 services. If you planned to sell property early next year, unload it now. Switch from taxable bonds to tax-exempts. Of course, don't make these moves if they cost more than your anticipated tax savings.

Financial planners are focusing on the $100,000 ceiling for converting traditional IRAs to the new Roth accounts.

Under the old accounts, contributions were sometimes deductible, and earnings could grow without being taxed until they were withdrawn. Roth IRAs eliminate the up-front deduction, but they exempt withdrawals made after age 59 1/2. The law lets taxpayers convert traditional IRAs to the new accounts--but only if they pay the taxes they've deferred. If you took deductions for your contributions, you'll owe tax on the full amount you switch. If your contributions were non-deductible, you'll pay tax just on the earnings. The tax will be levied at your ordinary income rate. If you convert in 1998, you can pay those taxes in four installments from 1998 to 2001. For conversions after 1998, the taxes will all be due when the switch is made.

That deadline "puts a premium on figuring out now whether to make an IRA conversion in 1998," warns Brent Kessel, principal at Abacus Financial Planning in Santa Monica, Calif. The calculation is most important if you have a large traditional IRA--due, perhaps, to a pension or 401(k) rollover. The Roth IRA is generally considered a better deal. But taxes on the conversion have to be paid out of other funds, so you must consider the IRA's return relative to your other investments. Paying taxes on your IRA now makes no sense if you will drop into a much lower bracket in retirement.

By contrast, two other IRA ideas are no-brainers. If you expect your 1998 AGI to fall below $100,000, put $2,000 into a traditional IRA now, even if you can't deduct the contribution. After Jan. 1, switch the funds to a Roth IRA. "You can jump-start your IRA with $4,000, not just $2,000" that you could contribute in 1998, notes Paula Hogan, who owns Milwaukee's Hogan Financial Management. You'll pay tax on earnings at the switch, but they'll be minimal.

Starting in 1998, you can withdraw up to $10,000 from any IRA to help buy a first home without paying the 10% early-distribution tax. Penalty-free withdrawals also are available to pay for higher education. In either case, you can use the funds for your children or grandchildren.

One change investors don't have to rush to take advantage of is the capital-gains cut. Congress established two new rates for property held more than 18 months: 10% for couples with taxable income below $41,200 (or singles below $24,650) and 20% for those with higher income. Gains on investments held between 12 and 18 months are now classed as "medium-term" and taxed at 15% or 28%. Planners say many clients want to take gains immediately, as if the new rates are about to vanish. "These rates are safe for at least three years," notes Cooper & Lybrand's Steven Woolf.

OFFSETS. But investors who have realized gains, perhaps during Wall Street's Oct. 27 sell-off, need to take a yearend look at their portfolios. Since the new law added a "medium-term" classification, Congress is in the process of clarifying how losses in one category could be used to offset gains in others. The likely result would create an extra

gift for investors: Net losses on long- and medium-term property could be used to offset short-term capital gains.

Thus, an investor who took profits on stocks held for less than 12 months could reduce taxes by selling off property held 18 months or longer that's worth less than its purchase price. That will increase the tax-saving value of the loss from 20% to as much as 39.6%. As yearend approaches, investors should look for ways to match gains with losses.

Congress was less generous to investors who try to lock in investment profits while putting off taxes. The new law eliminates a technique called "selling short against the box." In such a sale, the owner of a block of stock would execute a yearend short sale--selling similar shares borrowed from a broker--while keeping the original shares. The short sale protected the owner against any drop in the stock price, without incurring taxable profits. The new law says short sales against the box will be treated as if the original shares were sold, forcing investors to report profits immediately. Now, investors who want a yearend hedge will have to use "collars," combinations of put and call options that can limit, but not eliminate, any risk that their shares will drop.

Lower capital gains rates also put a new twist on yearend gifts to children. Parents who use their $10,000 annual gift exclusion to fund investments for the kids might want to consider giving stock or bonds that appreciated sharply. A teenager in the 15% bracket could sell the stock now and pay just 10% tax on the gain--half the parents' rate. A younger child could hold the securities until 2001 and pay as little as 8% tax.

Capital gains changes won't affect anyone receiving nonqualified stock options, the most prevalent options plan today. Recipients are taxed at ordinary-income rates on the difference between the option price and the market price when they exercise their options. But executives who receive incentive stock options (ISOs) will benefit from the new law. Those exercising ISOs will be able to pay the lower capital-gains rate if they hold their newly purchased shares 18 months. For them, "exercise-and-hold makes a lot more sense than exercise-and-sell," says planner Robert Siefert at Back Bay Financial Group in Boston. A yearend review of your options will help you figure out if you want to start the clock ticking on that strategy.

One pitfall: The exercise-and-hold tactic could subject you to the alternative minimum tax (AMT). Taxpayers who make heavy use of certain deductions and exclusions--such as deferred income from ISOs or depreciation deductions--must refigure their tax under AMT rules, which reduce or disallow many deductions. Since AMT exclusions and brackets aren't indexed for inflation, more taxpayers are falling into them every year. The rush to take capital gains this year could trip the AMT for moderate-income taxpayers.

Planners agree that the Taxpayer Relief Act extracts a high price, in paperwork and complexity, for the breaks it offers. But if you want to keep the most you can from the tax collector, now's the time to make sure your finances are in shape. By next April, it could be too late.

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