How Bunching Can Preserve Your Right to Itemize

Tax laws are at times nothing if not infuriating. Indeed, with phaseouts and sunsets coming and going, taxpayers may find it difficult planning from one year to the next.

Case in point: In 2006 and 2007, the overall limitation on itemized deductions that reduces the value of certain itemized deductions claimed by upper-income individuals is scheduled to be phased out.

In effect, higher income individuals will have a small tax rate reduction, according to PricewaterhouseCoopers 2007 Guide to Tax and Financial Planning.

By way of history, the tax law limits the amount of certain itemized deductions that individuals can use to reduce their taxable income. For instance, miscellaneous deductions are limited to those in excess of 2 percent of Adjusted Gross Income or AGI.

But Congress has also placed what's called an "overall" limitation on the deductibility of itemized deductions, according to The Ernst & Young Tax Guide 2006. For 2007, the total of this group of deductions must be reduced by 2 percent (down from 3 percent) of the amount of your AGI in excess of $156,400 for married couples filing jointly and $78,200 for married filing separately. Itemized deductions will, however, never be reduced by more than 80 percent of the amount by which they exceed a specified group of deductions, including, but not limited to, medical expenses, investment interest, and theft losses.

This reduction in itemized deductions is applied after the taxpayer has used any other limitations that exist such as the AGI limitation for charitable contributions and miscellaneous itemized deductions. The reduction falls to 1 percent in 2008 and 2009 and is phased out in 2010. Medical expenses, casualty and theft losses, investment interest expense, and gambling losses are not subject to this rule, insofar as calculating the 80 percent limitation is concerned, according to the Ernst & Young Tax Guide.

So what happens to taxpayers who for whatever reason (a bonus, a salary increase, or new job) will find themselves losing their ability to use itemized deductions fully in 2008? What kind of planning can they do in 2007?

Among other things, taxpayers may want to consider a technique called "bunching," otherwise accelerating or deferring itemized deductions where possible. Bunching may work if the taxpayer is able to accumulate deductions so that they are high in one year and low in the next.

According to Deloitte Tax's Essential Tax and Wealth Planning Guide, taxpayers should explore opportunities to time deductions for charitable contributions, state and local taxes, and other payments within the taxpayer's control. In some cases, it may be better to take deductions in the current tax year; the caveat emptor of this strategy is Alternative Minimum Tax or AMT.

For instance, if the taxpayer isn't subject to AMT in 2007, they should consider paying 2008 real estate and property taxes before yearend. Also, the taxpayer might consider paying any remaining state and local estimated income tax payments before the end of the year. State and local taxes are not deductible for AMT purposes, so taxpayers should consider the consequences of AMT before bunching these or other "non-deductible for AMT" itemized deductions in one year.

In another example, taxpayers might also accelerate mortgage payments. According to Deloitte, cash-basis taxpayers can, in most cases, deduct expenses in the year paid. Thus prepayment of mortgages due in 2008 may provide a deduction for interest to 2007.

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According to Ernst & Young's Tax Guide, in certain situations, it's possible for the 2 percent limitation to reduce allowable itemized deductions below the standard deduction. Thus, it's worth considering this possibility when choosing whether to itemize or not.

Taxpayers contemplating bunching should read the Instructions for Schedules A & B for Form 1040, which is available on the IRS' Web site at www.irs.gov. In order to make sure that the strategy of bunching deductions makes sense in your particular situation, it is generally a good idea to consult with a tax professional before proceeding. At the very least it is important that you are comfortable using tax planning software and are capable of identifying all of the ramifications of any tax planning technique.

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