The Right Tax Moves for Employees to Make Before Year-End

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NEW YORK, Nov. 24 /PRNewswire/ -- As year-end approaches, many employees are faced with an array of choices that can save taxes this year and next. To help you take advantage of these special tax-saving opportunities, William E. Massey, Senior Tax Analyst at Thomson Reuters, highlights the following key year-end planning considerations for employees:

Health flexible spending accounts (Health FSAs). Many employees take advantage of the annual opportunity to save taxes by placing funds in their employer's health FSA. These employees save taxes by using pre-tax dollars to pay for medical expenses that might not be deductible. *The expenses are not deductible if the employee does not itemize.* Even for itemizers, some medical expenses are not deductible because of the 7.5 percent adjusted gross income floor beneath medical expense deductions. And a health FSA can be used to get a tax-free reimbursement for over-the-counter medications and other items (such as contact lens solution), even though they cannot be deducted as medical expenses if purchased outside of the health FSA. Plans should have a listing of both qualifying items and any documentation that may be needed from a medical provider to get a reimbursement for a qualifying item. Employees who have set aside funds in an employer's health FSA should check the balance to ensure there is sufficient time to incur additional reimbursable expenditures to prevent loss of any unused amount under the use-or-lose feature of these plans. Reviewing year-to-date expenditures now will also help the employee calculate how much to elect to set aside for next year, taking into account any changed circumstances.

To avoid the use-or-lose rule, the employee must incur qualifying expenditures by the last day of the plan year (Dec. 31, 2009 for a calendar year plan) unless the plan allows an optional grace period. Any grace period cannot extend beyond the 15th day of the third month following the close of the plan year (e.g., March 15 for a calendar year plan).

Dependent care FSAs. Some employers also allow employees to set aside funds in dependent care FSAs. They allow employees to use pre-tax dollars to pay for dependent care. In particular cases, participating in a dependent care FSA can yield greater tax savings than foregoing participation and claiming a dependent care credit. Employees who are eligible to participate in a dependent care FSA should use the FSA to pay for child care expenses if they are also in a high tax bracket and/or have only one dependent and more than $3,000 of employment-related expenses. For these employees, the FSA almost always provides greater federal tax savings than does the credit. Additionally, participating in a dependent care FSA can save on FICA taxes.

Like health FSAs, dependent care FSAs are subject to the use-or-lose rule. So now is a good time for employees to review year-to-date expenditures and project amounts to be set aside for next year.

Adoption assistance FSAs. Under an adoption assistance FSA, adoption reimbursement accounts are established for participating employees. Typically, these accounts are funded with employee pre-tax contributions uniformly withheld from each paycheck throughout the year. The balances in these accounts are used to reimburse qualified adoption expenses incurred during the year, subject to a reimbursement maximum. Like health and dependent care FSAs, these accounts are subject to the use-or-lose rule. "Predicting the amount and timing of adoption expenses may be far more difficult than projecting medical and dependent care expenses," Massey points out. "As a result, the use-or-lose rule could pose a greater risk of loss with this type of FSA. Employees should bear this in mind when deciding the extent to which to participate in an adoption FSA."

401(k) contributions. Now is also the time for employees to review and make appropriate adjustments to their contributions to an employer's 401(k) retirement plan for the remainder of this year--as well as figure a contribution rate for next year. By increasing contributions for the remainder of the year, an employee also may gain additional contributions to the extent the employer matches contributions under the plan.

Adjustments to state withholding. Employees who expect to owe state and local income taxes when filing their returns next year should ask their employers to increase withholding of state and local taxes (or they should make estimated tax payments of state and local taxes) before year-end to pull the deduction of those taxes into 2009.

Adjustments to federal withholding. Employees who face a penalty for underpayment of federal estimated tax may be able to eliminate or reduce it by increasing withholding. "Keep in mind that the Making Work Pay credit, which was enacted earlier this year, automatically lowered tax withholding rates for employees," says Massey. In many cases, the automatic reduction will produce the correct result." On the other hand, employers who hold multiple jobs, employees with working spouses, and employees who can be claimed as a dependent by another taxpayer should review their withholdings to ensure that enough taxes are being withheld.

"Employees who save money with these year-end moves are, in effect, giving themselves an extra raise," says Massey.

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Melissa Lande of Lande Communications, 1-800-993-7600, or +1-215-654-7950, mlande@landepr.com, for Thomson Reuters