



News Release

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For Immediate Release

COUNTERINTUITIVE TAX RETURN STRATEGIES

RIA Tax Analyst Explains How Strategies for Maximizing Tax Savings Are Not Always “What You Think”; Sometimes They Even Involve Passing Up Tax Breaks

NEW YORK, January, 2007 – “Not everything available for the taking is worth grabbing. In fact, claiming some tax breaks on your return may actually *increase* your family’s overall tax bill,” warns Bob D. Scharin, Senior Tax Analyst from Thomson Tax & Accounting. Scharin offers the following examples of how this may occur and strategies you may want to implement to avoid paying more tax than is necessary:

Trade exemption for tuition credit. If your child is an under-age-24 student and does not provide more than half of his or her own support, you could be entitled to claim the child as your dependent. High-income parents, however, should think twice before doing so. “By not treating the child as a dependent, the parents can help the child qualify for a Hope Scholarship or Lifetime Learning credit for which the parents are ineligible. And the exemption for dependents may produce little or no savings for the parents,” says Scharin.

Sample strategy: Your child can get tax credit for tuition you paid: You are entitled to a \$3,300 exemption for each of your dependents in 2006. Dependency exemptions phase out at higher income levels—in the \$225,750 to \$348,250 adjusted gross income range for joint return filers in 2006. Thus, high-income individuals may derive no tax savings from claiming their children as dependents. At this income level, you would also be ineligible for the Hope Scholarship or Lifetime Learning credits; they phase out at incomes in the \$90,000 to \$110,000 range for joint return filers (\$45,000 to \$55,000 for singles). However, your college-student child may have the right income to benefit from these tuition credits, but he or she cannot claim a credit if claimed as a dependent on your return. “If you take a pass on claiming the child as a dependent, he or she can reap the tuition tax credit,” Scharin explains. “In calculating the credit, your child can count the tuition payments *you* made for him or her.”

Shift exemption to working child. High-income parents who cannot get a tax benefit from claiming a child as a dependent can reduce their family’s aggregate tax payments by passing up on claiming a younger child as a dependent so that their older child can get the exemption for his or her younger sibling. This can work if both children live in your home (e.g., the older child is out of school and working, but still living at home). Under the current rules for

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claiming exemptions, the older sibling does not need to be “supporting” the younger one; as long as the younger one is not providing more than half of his or her own support (and after all, you—the parents—are footing the bills), the older brother or sister who shares the same residence for more than half of the year can reap the exemption.

Warning. When one sibling claims another as a dependent, there may be implications with respect to health insurance and college financial aid, so you should consult your tax and financial advisors before implementing the strategy.

Joint returns. Married couples will generally pay the same or less tax by filing a joint return rather than filing separately. In fact, some tax benefits (e.g., the Hope Scholarship and Lifetime Learning credits) are *not* available to couples who file separately. Consider however that in certain situations, couples pay less tax with separate returns.

Prime example: Sometimes both spouses would be in the same tax bracket if they file separately or jointly. Suppose that is the situation and one spouse has significant medical expenses or miscellaneous itemized deductions (e.g., unreimbursed employee business expenses). These types of expenses are deductible only to the extent they exceed certain percentages of the taxpayer’s adjusted gross income (i.e., 7.5% for medical expenses, and 2% for miscellaneous deductions). “If a couple files a joint return, the deduction floors are based on the couple’s combined, joint income. In contrast, if they file separate returns, only the income of the spouse who is claiming the deduction is counted, so the deduction will be larger,” Scharin explains.

Home-sale exclusion. Home sellers may generally exclude up to \$250,000 (\$500,000 for joint return filers) of gain from the sale of their residences. An eligibility requirement is that you’ve used the home as your principal residence for at least two of the last five years. The “two out of five year” rule means that you could own two homes, either of whose sale would qualify for the exclusion. If you are planning to sell both of them within a two-year period, you may want to pass up on claiming the exclusion for the first sale. Scharin’s advice is to estimate what the taxable gain would be on each before using the exclusion for the first one sold.

Example. Helene and Paul have lived in their Connecticut home for many years. They purchased a small condo in Florida a few years ago. They originally intended to stay there during the winter months, but made it their principal residence in October 2004. The couple soon felt cramped from spending so much time in the unit and sold it in November 2006 at a \$50,000 gain, moving into a larger home nearby.

In February 2007, the Helene and Paul sold the Connecticut residence to reduce their household expenses. Thus, the Connecticut home was their principal residence for more than two years of the five-year period prior to sale (i.e., from February 2002 to October 2004.) That sale produced a \$400,000 gain.

If they claim the exclusion for the Florida home sale on their 2006 return, Helene and Paul will not be eligible to exclude the \$400,000 gain on their Connecticut home on their 2007 income tax return. By paying tax on the \$50,000 gain for 2006, they will avoid owing tax on the much larger 2007 gain.

IRA deduction. Even if you are eligible to contribute to a deductible IRA, you may be better off in the long run putting your retirement dollars in a Roth IRA. While you will not receive an upfront deduction, you won't owe tax on distributions you receive (which include investment growth) down the road. "This is a particularly good strategy for someone who plans to be in a higher tax bracket during retirement than he or she is in for 2006," Scharin points out. "That is likely to include recent graduates who are starting their careers, someone who has had a 'bad year' in business in 2006, or someone who has unusually high deductions this year (e.g., a large casualty loss)."

Itemized deductions. Itemize your deductions if they exceed your standard deduction—right? That is a sound general rule, but not necessarily always the best move.

Example. Suppose your itemized deductions do exceed your standard deduction, but only because you erroneously overpaid your state income tax. The overpayment occurred because you started 2006 in great financial shape, but then your earnings declined and your income for 2006 was lower than usual. (Ex: you work on commission and were unable to work for a few months for health reasons.) Next year, you expect to bounce back to your usual level of earnings.

If you itemize your deductions for 2006, you will need to include as income the large state tax refund you will be receiving in 2007—and it will be taxed in your higher 2007 tax bracket. On the other hand, if you claim the standard deduction in 2006, you will get a smaller deduction when your tax bracket is lower, but the refund will be tax free in 2007.

"In the elaborate world of tax return preparation, forgoing a tax break can sometimes be the wisest move. The tough task is recognizing when to make this move," Scharin concludes.

-30-

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