WEALTH CARE KIT℠

Income Tax Planning

SmartAboutMoney.org

A website built by the National Endowment for Financial Education dedicated to your financial well-being.

As the joke goes, figuring out your taxes is pretty easy—

just add up how much money you made last year and mail it to the IRS.

If you feel you're paying more than your fair share of taxes, or you're frustrated by tax laws that seem to change as regularly as new fall fashions, you're certainly not alone. Tax planning can help you reduce or even eliminate some of that tax bite and confusion. Yet, most Americans don't take advantage of all their available tax deductions.

Why is tax planning so valuable?
• Taxes have a great impact on other aspects of our financial lives, from insurance to investments.
• Paying more in taxes than necessary siphons off money you could be saving, investing, or spending on other financial goals, such as retirement or college funding.
• Tax planning is a year-round, long term process. Many tax-saving strategies can't be implemented while you're hunched over your calculator on April 15.
• Changes in your personal life—marriage, divorce, loss of employment or a promotion, births and deaths—can alter your financial picture and affect your tax liabilities.
• Changes in the tax laws can affect your tax consequences.

HOLISTIC TAX PLANNING

One other point needs to be emphasized about tax planning: It is not merely about reducing taxes. Tax decisions always should be made in the context of your overall financial situation and goals.

It's easy to let the desire to avoid paying taxes drive all financial decisions. Yet, sometimes it's in your best interest not to save taxes. For example, the after-tax yield (how much you get to keep after taxes) of a taxable corporate bond might be higher than the tax-free yield of a municipal bond. That is, you might make more money investing in the corporate bond even after paying the taxes.

Also, investments should be chosen for their overall return, level of risk, and their appropriateness for your investment portfolio rather than for tax concerns alone.

> "TAX DECISIONS SHOULD ALWAYS BE MADE IN THE CONTEXT OF YOUR OVERALL FINANCIAL SITUATION AND GOALS."

Tax-driven financial decisions can have an adverse impact on other aspects of your financial planning. For instance, one strategy is to title more income-producing assets, such as stock that pays dividends, in an older child's (i.e., age 14 or over) name so that earnings are taxed at the child's lower rate. This strategy often is employed to help pay for the child's college education. Yet, this strategy can mean the loss of control of the assets, and it may reduce the amount of financial aid your child is eligible to receive.

HOW YOUR INCOME TAX LIABILITY IS CALCULATED

Whether doing your own tax planning or working with a tax expert, it's helpful to understand how one arrives at that final figure on the federal tax form. Nearly all tax-planning strategies grow out of one of the following four steps:

1. Determine total income. Add up wages, salaries, tips, taxable interest income, dividends, and capital gains (profits) and losses from investments, rents, royalties, and other taxable sources of income, such as unemployment benefits. Some sources of income, such as interest from certain municipal bonds, life insurance benefits received after the death of the insured, Social Security benefits below specified income levels, and child support, are excluded. However, alimony and separate maintenance payments received are taxable income. Other current sources of income, such as contributions to and earnings in qualified retirement plans, and the cash value built up in an insurance or annuity product, are tax deferred; that is, they won't be taxed until a later date.

2. Adjust gross income. You then deduct, or subtract, from your total gross income such items as qualifying contributions to an individual retirement account (IRA), Keogh plan (for the self-employed), or simplified employee pension plan (SEP); student loan interest; one-half of any self-employment tax liability; self-employed health insurance premiums; health savings account; tuition and fees; qualified moving expenses; and alimony paid.

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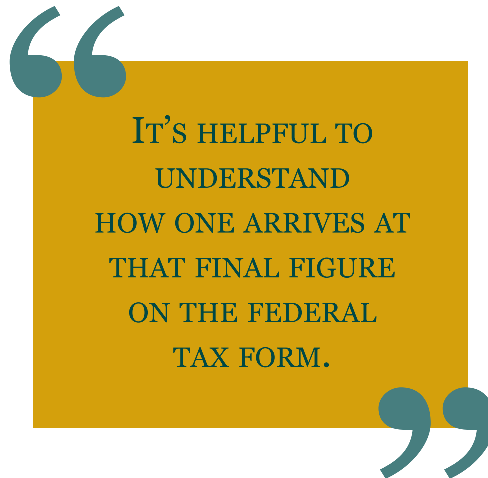
The resulting figure is known as your adjusted gross income (AGI).

3. Calculate taxable income. Starting with your AGI, subtract the amount of your personal exemptions and either a standard deduction (based on your filing status, e.g., single, married filing jointly, and so on) or itemized deductions, whichever is larger. Itemized deductions include state and local income taxes, real estate and personal property taxes, some medical expenses, qualified home mortgage interest, charitable contributions, and uninsured theft and casualty losses. Also included are certain miscellaneous deductions, such as unreimbursed employee business expenses. Tax provisions limit the tax benefits of personal exemptions and certain itemized deductions for higher-income taxpayers.

4. Arrive at total tax. Established tax rates are applied to the taxable income computed in Step 3. Additional taxes, such as self-employment tax, alternative minimum tax, and a variety of penalty taxes then may be added. Credits, such as for children and dependents, child care, retirement savings, higher education, and foreign taxes, reduce the total tax. The amount of tax you pay, or receive back as a refund, will be the difference between the total tax and the total tax payments made during the year, such as through withholding or estimated payments.

MARGINAL TAX RATES

One other explanation about the federal tax-calculation process may help you understand some of the strategies behind tax planning: the difference between marginal tax rates and the effective tax rate.



Marginal tax rates are the rates you see commonly referred to as a taxpayer's "tax bracket." For example, a taxpayer is in the 15 percent or the 35 percent tax bracket. The marginal tax rate is the rate you pay on the last dollar you make. Your first dollar through a set amount, depending on your filing status, is taxed beginning at the lowest tax rate, i.e., 10 percent. In 2005, if you're in the 25 percent tax bracket, you pay 25 percent on the last dollar you earned. But you don't pay that rate on all the dollars you earn. For example, a married taxpayer in the 25 percent tax bracket, filing jointly, paid only 10 percent on the first $14,600, 15 percent on the amount between $14,600 and $59,400, and 25 percent on income above $59,400 (tax brackets are indexed annually). The effective, or average, tax rate is the total amount of tax paid divided by the total amount of taxable income. In the above example, that rate would be somewhere between 15 and 27 percent.

Knowing your marginal tax rate is important because it helps you calculate how much a particular tax planning strategy is worth. For example, to determine whether to invest in a tax-free municipal bond or a comparable taxable corporate bond, you need to know your marginal tax rate so you can compare the effective yields of each bond.

A SAMPLE OF TAX STRATEGIES

Too many tax strategies exist to discuss them in any depth in this brief space. Tax advisors and tax guides can help you take full advantage of legal deductions. The general strategies offered below, however, illustrate the value of long-range tax planning.

- Keep good tax records. Record miscellaneous tax-deductible expenses, such as cash or non-cash contributions to charities, so you don't overlook legitimate deductions. Also, the Internal Revenue Service may demand those records as proof. If you sell shares in a mutual fund, you'll need adequate records to document the shares' cost basis (the initial purchase price of the shares).
- Maximize contributions to tax-deferred retirement accounts, such as your company's 401(k) or SIMPLE plan or, if you are self-employed, a SEP or Keogh plan. These offer some of the best tax shelters, especially for taxpayers in higher tax brackets. You're not escaping taxation, of course, only postponing it until you make retirement withdrawals. But you may be in a lower tax bracket by then, and—often more important—tax-deferred accounts can grow faster than comparable taxable investments.
- Consider funding a nondeductible Roth IRA if you cannot make a deductible IRA contribution. Roth IRA withdrawals are tax free (not just tax deferred) under the right conditions. If you expect to be in a

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higher tax bracket at retirement, a Roth IRA make sense.

• Take full advantage of fringe benefits your company may offer, such as flexible spending accounts. Many fringe benefits are not subject to tax, yet they contribute to your economic well being as much as your take-home pay.

• Consider investing in annuities or building up a cash-value life insurance policy. Contributions aren't tax deductible, but earnings on the contributions and growth are tax deferred. Like qualified retirement plans, annuities and cash-value life insurance should be treated as long-term investments.

• Bunch deductions. For example, you can't take deductions for medical expenses unless the total for the tax year exceeds 7.5 percent of your AGI (then only the excess can be deducted). By bunching expenses, such as for prescription drugs, into one year you might be able to exceed the 7.5 percent threshold.

• Reduce your total taxable income by shifting some of your taxable investments into tax-exempt investments like municipal bonds. But, as noted earlier, these investments must make economic sense as well as tax sense.

• Consider increasing your itemized deductions. By purchasing a home instead of renting, you may be able to deduct property taxes and home mortgage interest.

• Make charitable contributions of appreciated assets. Generally, if you donate stock you've held for at least one year, you can receive a deduction for the current market value of the stock, thereby avoiding any capital-gains tax on the profit.

• Take advantage of the long-term capital-gains rate. A realized capital gain occurs when a stock or

qualified asset is sold at a price higher than that for which it was bought. Assets held more than one year generally are taxed at a maximum rate of 15 percent. Consequently, if you're in the highest income tax brackets, you may want to consider producing more of your income through capital gains.

• If you own a small business or are self-employed, consider hiring your children to work part time for you (the work must provide a genuine service). You'll receive a tax deduction, while your child receives income (presumably taxed at a lower rate). In essence, you've shifted income to a lower tax bracket.

• State tax planning issues also play a significant role in your overall approach to tax planning. Contact a tax professional to discuss how your state tax liability may affect your overall tax liability and to take advantage of related planning opportunities.

Note: Most of these suggestions and similar tax-reduction strategies involve long-range, thoughtful planning.

ALTERNATE MINIMUM TAX

Beyond regular income tax strategies, you should be alert to the alternative minimum tax (AMT). This tax was designed to ensure that higher-income taxpayers do not escape paying regular income taxes through "excessive" deductions and credits. Certain deductions taken under income-tax calculations cannot be taken under AMT. Higher-income taxpayers need to calculate their regular income tax first and then recalculate their tax via the AMT method. They pay Uncle Sam whichever liability is higher. While most taxpayers are not subject to AMT, more and more are feeling its bite, and the 1993 tax act raised the AMT rates from 24 percent to a two-tiered structure of 26 and 28 percent. Again, careful long-range planning must be used to minimize vulnerability to the AMT.

SEEK PROFESSIONAL TAX ADVICE

If you have a modest income and a simple return, you may be able to do most of your own tax form preparation. But if you hate math, just don't have the time, or have a complicated return, consider hiring a professional tax expert. Also, tax laws change nearly every year. Keeping up with the changes is a challenge even for professionals. Working closely with a CFP® licensee or a professional authorized to use tax or accounting designations or licenses may be a wise strategy for your needs. You may save far more in taxes than what you pay for their fee.

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ESTIMATING TAX-SAVING POTENTIAL

Often, individuals can minimize their tax liability in three ways. First, they can reduce the amount of taxable income they are required to report. Second, they can increase the amount of deductions they are eligible to take. Finally, they can take advantage of available tax credits. How much tax savings can you expect as a result of each of these techniques? Consider the following examples on reducing the amount of taxable income and increasing the amount of deductions. After studying the examples, use the formulas and the table on page 5 to get an idea of your potential savings.

I. Investment Planning

Suppose that you have $10,000 invested in a security that generates a taxable yield of 5% per year. If you switch to another investment, such as a municipal bond with a tax-exempt yield of 4.0%, and you are in a 25% marginal tax bracket, would you benefit?

Taxable Security:

1. Amount of money invested	$10,000
2. Multiplied by taxable yield (5%2. 5%)	x .05
3. Equals pre-tax income	$ 500
4. Subtract tax liability (Line 3 times the marginal tax rate)	– 125
5. Equals after-tax income	$ 375

Tax-Exempt Security:

6. Amount of money invested	$10,000
7. Multiplied by tax-exempt yield (4.0%)	x .04
8. Equals tax-exempt income	$ 400

Subtract line 5 from line 8. This is the amount of additional after-tax income you can expect as a result of investing in tax-exempt securities. In our example, you would be $25 better off as a result of switching investments, even though the yield on the tax-exempt security is less than the yield on the taxable security. If line 5 is larger than line 8, you are better off sticking with the taxable securities.

II. Itemized Deductions

How much can you expect to save in taxes by increasing your itemized deductions? For example, what if you bought a home and paid deductible property taxes and interest? The answer depends on whether you currently have enough deductions to itemize or whether you are currently taking the standard deduction. Consider a situation where a single taxpayer in the 25% marginal tax bracket is considering buying a home and incurring $500 per month ($6,000 per year) in mortgage interest expense and property taxes. Because this individual already has itemized deductions (from state income taxes, for example) of $5,000 per year, and thus is able to itemize (since his or her itemized deductions already equal the standard deduction for a single individual — $5,000 in 2005), then the tax savings associated with paying the mortgage interest and property taxes are:

1. Additional itemized deductions the individual plans to incur	$ 6,000
2. Multiplied by the marginal tax rate	x .25
3. Equals tax savings from the additional deductions	$ 1,500

If you do not already have enough deductions to itemize, the computation of the tax savings is more complicated, since the additional deductions that bring you up to the amount of the standard deduction provide no tax benefit.

III. Tax Credits

How much tax can you expect to save as a result of a tax credit, such as the children and dependents credit, child care credit, earned income credit, credit for the elderly, or the low-income housing credit?

Tax credits reduce tax liability (rather than taxable income) dollar for dollar. Thus, a $500 tax credit saves $500 in taxes. Each tax credit is computed differently. To find out about credits that may affect your taxes, consult a professional tax advisor about the availability and computation of any credits you may be eligible to use.

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STAYING ORGANIZED THROUGHOUT THE YEAR FOR TAX TIME

Set up a manila folder for each of the following categories of common deductions and credits. By saving forms, receipts, and relevant paperwork throughout the year in an organized manner, you'll be ahead of the game when it's time to file your taxes next year.

Category	What to Keep	On Which Tax Form?
Medical & Dental Expenses	Receipts for co-pays, premiums paid for health and/or dental insurance, prescriptions, medical equipment requested by a doctor, vision expenses, hearing aid costs, etc.	Schedule A
Job Changes	Paperwork related to retirement plan distributions, moving expenses if any, relocation costs and documentation, etc.	Form 1040, page 1; Moving Expenses Form 3909
Charitable Contributions	Receipts for cash and/or donations of goods, mileage records, etc.	Schedule A
Real Estate	Property tax receipts, casualty losses due to weather or thefts, refinancing information, etc.	Schedule A
Education Expenses	Student loan payment information, tuition payment information, etc.	Form 1040, page 1; Form 8863 (Education Credits)
Childcare Expenses	Payments to providers, provider information (name, address, tax identification number)	Form 2441
Current-year Tax Forms	W-2s, W-4s, 1099s, etc.	Form 1040
Retirement Savings	Contribution records; Form 5498s	Form 1040, page 2; Form 8880

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TAX CALENDAR

To reduce income tax frustration, take the steps outlined below throughout the year:

JANUARY	Gather your tax records to review and organize them. Be sure to keep careful track of all tax documents, W-2s, 1099s, etc., as they come in.
FEBRUARY	Deliver your tax records to a qualified tax return preparer. If you want to prepare your own return, carefully study this year's forms and instructions, as well as other sources of information on return preparation, and begin your tax return.
MARCH	Review your completed tax forms before mailing them. If you expect to receive a refund, send your return immediately. If you owe taxes, wait to send in the form and the check until just before April 15. If you need to file an extension, do so now.
APRIL	Make a copy of your tax return and review it for ways that you can reduce your taxes in the future. What are the sources of your taxable income? What deductions and credits are you able to take?
MAY	Review your investments and other sources of income to see if you can reduce your taxable income without sacrificing economic yield. Consider purchasing municipal bonds. Investigate whether you can make additional contributions to an employer-sponsored retirement plan, thereby reducing this year's taxable income and deferring the tax on income generated by investment in the plan.
JUNE	Review your expenses to see if there is some way to increase your deductions without incurring unwarranted costs. For example, investigate the housing market, and determine whether it would make sense to buy rather than rent a home.
JULY	Investigate the opportunities to generate tax credits. Are you currently eligible for any tax credits that you were not aware of?
AUGUST	Review your tax record-keeping practices. Are you keeping adequate records to substantiate your income, deductions, and credits?
SEPTEMBER	Estimate your tax liability for the year and compare it with your withholding. Adjust your withholding, if necessary.
OCTOBER	Consult your tax advisor about any year-end tax planning savings.
NOVEMBER	Keep abreast of any changes in the tax law that may affect your tax picture.
DECEMBER	Follow up on the year-end details of tax planning to ensure they are completed by December 31.

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