Understand and minimize life's biggest expense—taxes.

TAX INSIGHT

For Tax Year 2013 and Beyond

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Introduction

Blackberries and Taxes: The Harvest Is Sweet

Picking wild blackberries is one of my family's favorite pastimes. In fact, blackberry season was at its peak in our area when I first had the inspiration for this book. One morning we were up early, picking to our hearts' content in a large blackberry patch near our home. As I was picking, I realized that the reason I love harvesting blackberries is very similar to the reason I love tax planning. Laugh if you will, but I think the same part of my brain is intrigued by both activities. For those who are not seasoned berry pickers, let me describe the experience.

Blackberry Picking

Wild blackberries are brambly, thorny plants. They emerge from long canes that reach in every direction and mesh together in a thorny maze. The thorns are sharp and curved, and they're particularly good at digging into your clothing and flesh as you try to pull away from them. In sharp contrast to the plant, however, the berries are heavenly. There is nothing more delicious than a ripe, juicy blackberry melting in your mouth.

The berries grow in clusters that are hidden throughout the blackberry bush. In fact, each bush conceals significantly more berries than those you see at first glance. Finding the hidden clusters of berries, without getting hurt by the thorns, is both challenging and rewarding. It is in that challenge that you find both the art and the intrigue of berry picking.

The casual berry picker often finds a few tasty treats easily within his reach on every berry bush. However, the taste of one sour berry, or a good jab from a thorn, is usually enough to deter the casual picker from making further efforts. He is not willing to deal with the thorns, the tearing of flesh and clothes, and other obstacles in the way of obtaining berries deeper in the bush. He is content to just get a little taste and then move on.

In contrast, the serious berry picker is not deterred by such obstacles. In fact, she develops a method through years of practice that inevitably yields larger, juicier fruits—as well as much greater quantities of berries. Here is how she does it.

She begins with a berry bush that has several nice-looking berries hanging right out on the edge of the plant. No berry picker would ever pass these up. As she picks all the ripe fruit from the clumps within reach, she begins to notice other clusters (better than the ones before) that are just out of reach. So, the serious picker presses into the thorny bush and reaches in as far as she can, careful to avoid the thorns. As she reaches in deep and picks the juicy delights, her arm brushes against other branches, which then reveal a treasure trove of once-hidden berries.

Seeing her efforts rewarded, she won't be stopped as she digs her way right into the middle of the bush. Thorns threaten at every move, but the reward is too great for these obstacles to deter her. She makes her way through the brambles and fills her baskets to overflowing. As she looks around for more berries, it appears that she has picked all of the ripe fruit. As she works her way back out of the bush she sees a berry she had missed and squats down to pick it up. From her new perspective she sees a dozen other clusters that she couldn't see before. She'll soon be back with more baskets to continue her harvest.

In this way the serious berry picker harvests the larger, sweeter berries, and in much greater quantity than the casual picker. The experienced picker knows that berries are hiding everywhere. Every bush must be explored from every angle—each thorny branch moved to reveal what lies beneath.

Taxberries

Picking berries is similar to preparing taxes. Certain "berries" (deductions and credits) are visible to nearly everyone. Many people take advantage of these and taste the sweet reward of saving a few tax dollars. However, most people are unwilling to trudge deeper into the thorny world of taxes to discover additional unseen yet juicy fruits. The confusing bramble of the tax code discourages them from entering. The ever-present, always looming thorns of IRS audits and penalties elicit too much fear of pain to justify reaching for the berries—especially among people who are inexperienced in avoiding those thorns. Even for those few who are willing to make the effort, many "clusters" of berries are certain to be missed, and thorns are certain to be felt, without the help of more experienced eyes.

The good news for casual pickers is that there are people who have a passion for "taxberry" picking. They are unafraid to trudge into the brambles to find every hidden berry. Better still, these passionate pickers are willing to be hired to pick your taxberry bush for you, or write how-to books like this one.

As you read this book, you will find me digging deep into the brambles of your taxberry bush, holding up the branches and showing you the fruit. I will also point out the thorns. I will teach you how to nurture and fertilize the plant. As you follow my lead you will reap the rewards of a plentiful harvest.

Disclaimer

This book contains numerous stories and examples that are based on real people and situations that the author has dealt with during his career. To protect the privacy of individuals, all names and other potentially identifying information, including numbers, have been changed. However, the nature of the descriptions remains true to the actual occurrences.

The tax code includes many quirks and nuances. This book offers general information for a variety of taxpayers and situations, is not all-inclusive, and might not apply to your specific situation. Tax laws and interpretations of those laws can change at any time. Any tax advice contained in this book is not intended or written to be used, and cannot be used, for the purpose of avoiding penalties under the Internal Revenue Code or for promoting, marketing, or recommending to another party any matters addressed herein. The information contained herein is not a substitute for legal, tax, investment, or other professional advice specific to your situation; nor should it be construed as advice or relied upon in such a manner. Always consult a Certified Public Accountant (CPA), attorney, or other professional tax advisor before implementing any tax strategy or making other significant financial decisions. The author shall not be liable for any loss or damages that may arise from reliance on information contained in this book and disclaims any accuracy of the text or misuse or misunderstanding on the part of any reader; nor is the author liable for the positions taken by the reader in particular situations.

PART I

The Foundation

The tax code is extremely complex. It is notoriously long and downright unpleasant to read. Most people would rather pretend it doesn't exist. Completely ignoring it or thwarting it, however, can lead to financial ruin. Even casual ignorance of it can lead to significantly fewer dollars in your bank account. It doesn't have to be that way.

The full focus and purpose of this book is to help you pull your head out of the sand and face the reality that taxes have a major impact on your life. More importantly, the goal of this book is to help you realize that *you can have a significant impact on your taxes*.

Part I is the essential foundation for achieving that goal. If you do nothing more with this book than read and understand the chapters of Part I, you will be so much further ahead in your efforts to minimize your taxes than the majority of the population.

I have made these foundational principles simple, straightforward, and easy to understand. If you study the five chapters of this first part you will never regret it. Then, as you move on to the rest of the book, you will be fully equipped to seize the valuable strategies it has to offer.

CHAPTER

1

The Tax Code Demystified

Knowledge Is Power

I often remember a conversation I had with an acquaintance. He was telling me about the "smart" things he had done to reduce his taxes. His business had been successful that year, so in December he purchased several pieces of equipment that he didn't really need in order to offset his income. With a mischievous grin, he said, "It's a deduction, right?"

Right—it is a deduction (although that too is questionable). But as I spoke with him, it became clear that he thought a deduction of $3,000 meant he would pay $3,000 less in taxes. He thought he had just stiffed the government and gotten that equipment for free (because he spent $3,000 but saved $3,000 in taxes by doing so). He didn't understand how a deduction actually works. In reality, he saved about $900 in taxes. But because he spent $3,000 on equipment he didn't need, he ended up wasting $2,100. Most people dislike paying taxes, but you have to *really* hate giving the government money in order to waste $2,100 just to keep them from getting $900!

In reality, this man did not intend to waste the $2,100; he just misunderstood the meaning of the word "deduction." I see this type of misunderstanding far too often; when people fail to grasp the true effects of a particular tax strategy on their return, they often end up making costly mistakes. This chapter will help solidify your understanding of the main components of your own tax return and the key terminology that is involved. That understanding will then help you recognize to what extent different strategies will (or won't) help you reduce your taxes—helping you avoid similarly costly mistakes.

The Tax Code—Boiled Down

In actuality, the tax code is nothing more than one gigantic algebraic formula. While that image may scare you, it is meant to give you comfort in knowing that there is really no mystery or secret involved in determining your taxes. Once you understand the formula and where each number in the formula comes from, determining the amount of taxes that you owe is simply a matter of putting those numbers into the formula and voilà, out comes the answer! It is as simple as that.

The real secret within the tax code (and the great news) is that *you* control the numbers that go into the formula. Even better, there are many opportunities for you to decide *where* you want to place the numbers into the formula. Taking control of the numbers in your tax return and consciously placing them in the most advantageous places within the formula give you genuine power over your taxes and are the key ingredients of great tax planning.

➯ **Example** In an algebraic formula, the placement of numbers can have a dramatic effect on the outcome of the formula. For example: (2 + 3 + 8) x 12 = 156, whereas (2 + 3) x 12 + 8 = 68. The placement of the + 8 in the first formula resulted in a solution more than two times greater than in the second one. There are many opportunities in the tax code to move the "eights" around in order to affect the final outcome of the taxes that you owe.

Tax Insight is devoted to unraveling the mystery in the tax code, teaching you the formula, and helping you understand where your opportunities for controlling that formula lie. Learning and understanding these opportunities is where you gain control of your tax destiny. To gain that control you must first understand the key pieces of the formula. In its simplest form the tax formula looks something like this:

➯ **The Tax Formula** {[Income – (Adjustments + Deductions + Exemptions)] x Tax Rates} – Credits + Additional Taxes – Payments = Taxes Due or Refund.

In this master formula, each of the terms is a category (for example, "Credits") made up of many subcategories (child care credit, foreign tax credit, earned income credit, and so on). The value for each category term in the master formula is calculated from a separate formula that combines the contributions of the subcategories. And each subcategory number is in turn derived from its own set of formulas and rules.

The plan of this book is to drill down from the level of the simple master formula to the deeper levels of the subcategory formulas. In the subsequent chapters of this section we explore each of the components of the master tax formula as it relates to your tax return. In subsequent sections, we dive into the nitty-gritty of each subcategory, again in relation to the appropriate parts of your tax return. Every part of this book aims to help you reap a more plentiful harvest from your tax planning efforts.

The Key Components of the Tax Formula

You have surely heard the lingo of the tax aficionado: AGI, deductions, credits, exemptions, brackets, marginal rates, effective rates, above-the-line, below-the-line, itemized, phase-outs, etc. You probably recognize these words and phrases, but do you understand what they mean? Do you know which of these are affecting you, how they are affecting you, or which can help you? Do you know how one component affects another? Is it possible to claim a deduction or credit and have it make no difference—or, worse, actually increase your taxes? These are important questions, and understanding the answers to them, can be critical in your tax planning efforts.

For tax planning purposes, the tax formula given above as a simple equation gets re-expressed as a sequence of arithmetic operations done on the key components of the formula (which include key subtotals such as AGI and AMT):

+	Income
–	Deductions (Adjustments to Income)
=	Adjusted Gross Income (AGI)
–	Deductions (Standard or Itemized)
–	Exemptions
=	Taxable Income
x	Tax Rates
=	Income Tax (or AMT)
–	Credits (non-refundable)
=	Cannot equal less than $0 at this point
+	Other Taxes
–	Credits (refundable)
–	Payments
=	Taxes Due or Refund

The first two pages of the federal tax return, called Form 1040, are an expanded version of this tax formula. All the other schedules and forms in a tax return are used to create the numbers that you plug into the first two pages of the return, which in turn are entered into the formula that determines your tax. In fact, when you look at Form 1040 (Figure 1-1), you will notice that the IRS has organized the lines of the return into successive sections that are divided and labeled in a way that resembles the formula above.

Form **1040** Department of the Treasury—Internal Revenue Service (99)
U.S. Individual Income Tax Return 20XX OMB No. 1545-0074 IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 20xx, or other tax year beginning , 20xx, ending , 20 See separate instructions.

Your first name and initial	Last name		**Your social security number**
If a joint return, spouse's first name and initial	Last name		**Spouse's social security number**
Home address (number and street). If you have a P.O. box, see instructions.		Apt. no.	▲ Make sure the SSN(s) above and on line 6c are correct.
City, town or post office, state, and ZIP code. If you have a foreign address, also complete spaces below (see instructions).			**Presidential Election Campaign** Check here if you, or your spouse if filing jointly, want $3 to go to this fund. Checking a box below will not change your tax or refund. ☐ You ☐ Spouse
Foreign country name	Foreign province/state/county	Foreign postal code	

Filing Status

Check only one box.

1 ☐ Single
2 ☐ Married filing jointly (even if only one had income)
3 ☐ Married filing separately. Enter spouse's SSN above and full name here. ▶
4 ☐ Head of household (with qualifying person). (See instructions.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶
5 ☐ Qualifying widow(er) with dependent child

Exemptions

6a ☐ **Yourself.** If someone can claim you as a dependent, **do not** check box 6a
b ☐ **Spouse**

Boxes checked on 6a and 6b

c **Dependents:**

(1) First name Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) ✓ if child under age 17 qualifying for child tax credit (see instructions)
			☐
			☐
			☐
			☐

No. of children on 6c who: • lived with you • did not live with you due to divorce or separation (see instructions)

Dependents on 6c not entered above

If more than four dependents, see instructions and check here ▶ ☐

d Total number of exemptions claimed

Add numbers on lines above ▶

Income

Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.

If you did not get a W-2, see instructions.

Enclose, but do not attach, any payment. Also, please use Form 1040-V.

7	Wages, salaries, tips, etc. Attach Form(s) W-2		7
8a	**Taxable** interest. Attach Schedule B if required		8a
b	**Tax-exempt** interest. **Do not** include on line 8a	8b	
9a	Ordinary dividends. Attach Schedule B if required		9a
b	Qualified dividends	9b	
10	Taxable refunds, credits, or offsets of state and local income taxes		10
11	Alimony received		11
12	Business income or (loss). Attach Schedule C or C-EZ		12
13	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐		13
14	Other gains or (losses). Attach Form 4797		14
15a	IRA distributions 15a	b Taxable amount	15b
16a	Pensions and annuities 16a	b Taxable amount	16b
17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E		17
18	Farm income or (loss). Attach Schedule F		18
19	Unemployment compensation		19
20a	Social security benefits 20a	b Taxable amount	20b
21	Other income. List type and amount		21
22	Combine the amounts in the far right column for lines 7 through 21. This is your **total income** ▶		22

Adjusted Gross Income

23	Reserved	23	
24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ	24	
25	Health savings account deduction. Attach Form 8889	25	
26	Moving expenses. Attach Form 3903	26	
27	Deductible part of self-employment tax. Attach Schedule SE	27	
28	Self-employed SEP, SIMPLE, and qualified plans	28	
29	Self-employed health insurance deduction	29	
30	Penalty on early withdrawal of savings	30	
31a	Alimony paid b Recipient's SSN ▶	31a	
32	IRA deduction	32	
33	Student loan interest deduction	33	
34	Reserved	34	
35	Domestic production activities deduction. Attach Form 8903	35	
36	Add lines 23 through 35		36
37	Subtract line 36 from line 22. This is your **adjusted gross income** ▶		37

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11320B Form **1040** (20xx)

Figure 1-1a. Form 1040 (first page)

Form 1040 (20xx) Page **2**

Tax and Credits

38	Amount from line 37 (adjusted gross income)			38
39a	Check if: ☐ **You** were born before January 2, 1948, ☐ Blind. ☐ **Spouse** was born before January 2, 1948, ☐ Blind. **Total boxes checked** ▶ **39a**			
b	If your spouse itemizes on a separate return or you were a dual-status alien, check here ▶ **39b** ☐			
40	**Itemized deductions** (from Schedule A) **or** your **standard deduction** (see left margin)			40
41	Subtract line 40 from line 38			41
42	**Exemptions.** Multiply $3,800 by the number on line 6d			42
43	**Taxable income.** Subtract line 42 from line 41. If line 42 is more than line 41, enter -0-			43
44	**Tax** (see instructions). Check if any from: **a** ☐ Form(s) 8814 **b** ☐ Form 4972 **c** ☐ 962 election			44
45	**Alternative minimum tax** (see instructions). Attach Form 6251			45
46	Add lines 44 and 45 ▶			46
47	Foreign tax credit. Attach Form 1116 if required	47		
48	Credit for child and dependent care expenses. Attach Form 2441	48		
49	Education credits from Form 8863, line 19	49		
50	Retirement savings contributions credit. Attach Form 8880	50		
51	Child tax credit. Attach Schedule 8812, if required	51		
52	Residential energy credit. Attach Form 5695	52		
53	Other credits from Form: **a** ☐ 3800 **b** ☐ 8801 **c** ☐	53		
54	Add lines 47 through 53. These are your **total credits**			54
55	Subtract line 54 from line 46. If line 54 is more than line 46, enter -0- ▶			55

Standard Deduction for—
- People who check any box on line 39a or 39b **or** who can be claimed as a dependent, see instructions.
- All others:

Single or Married filing separately, $5,950

Married filing jointly or Qualifying widow(er), $11,900

Head of household, $8,700

Other Taxes

56	Self-employment tax. Attach Schedule SE			56
57	Unreported social security and Medicare tax from Form: **a** ☐ 4137 **b** ☐ 8919			57
58	Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required			58
59a	Household employment taxes from Schedule H			59a
b	First-time homebuyer credit repayment. Attach Form 5405 if required			59b
60	Other taxes. Enter code(s) from instructions			60
61	Add lines 55 through 60. This is your **total tax** ▶			61

Payments

If you have a qualifying child, attach Schedule EIC.

62	Federal income tax withheld from Forms W-2 and 1099	62		
63	2012 estimated tax payments and amount applied from 2011 return	63		
64a	**Earned income credit (EIC)**	64a		
b	Nontaxable combat pay election **64b**			
65	Additional child tax credit. Attach Schedule 8812	65		
66	American opportunity credit from Form 8863, line 8	66		
67	Reserved	67		
68	Amount paid with request for extension to file	68		
69	Excess social security and tier 1 RRTA tax withheld	69		
70	Credit for federal tax on fuels. Attach Form 4136	70		
71	Credits from Form: **a** ☐ 2439 **b** ☐ Reserved **c** ☐ 8801 **d** ☐ 8885	71		
72	Add lines 62, 63, 64a, and 65 through 71. These are your **total payments** ▶			72

Refund

Direct deposit? See instructions.

73	If line 72 is more than line 61, subtract line 61 from line 72. This is the amount you **overpaid**			73
74a	Amount of line 73 you want **refunded to you.** If Form 8888 is attached, check here ▶ ☐			74a
▶ b	Routing number ▶ **c** Type: ☐ Checking ☐ Savings			
▶ d	Account number			
75	Amount of line 73 you want **applied to your 2013 estimated tax** ▶	75		

Amount You Owe

76	**Amount you owe.** Subtract line 72 from line 61. For details on how to pay, see instructions ▶			76
77	Estimated tax penalty (see instructions)	77		

Third Party Designee

Do you want to allow another person to discuss this return with the IRS (see instructions)? ☐ **Yes.** Complete below. ☐ No

Designee's name ▶ Phone no. ▶ Personal identification number (PIN) ▶

Sign Here

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Joint return? See instructions. Keep a copy for your records.

Your signature	Date	Your occupation	Daytime phone number
Spouse's signature. If a joint return, **both** must sign.	Date	Spouse's occupation	If the IRS sent you an Identity Protection PIN, enter it here (see inst.)

Paid Preparer Use Only

Print/Type preparer's name	Preparer's signature	Date	Check ☐ if self-employed	PTIN
Firm's name ▶		Firm's EIN ▶		
Firm's address ▶		Phone no.		

Form **1040** (20xx)

Figure 1-1b. Form 1040 (second page)

Next, we delve into a deeper understanding of the makeup of these key components. In doing so, you will begin to understand how each piece of the formula flows together and how the pieces affect one another. Once you have a solid understanding of each component and its effect on the formula, you will be better prepared to apply the strategies found in the other sections of this book.

CHAPTER

2

Key Components Defined

A Better Understanding

Now that you are familiar with the tax formula, it is important that you understand how each of the key components works, and how each will affect your tax. This chapter will give you a deeper understanding of the following components:

- Income
- Deductions (Adjustments to Income) and AGI
- Deductions (Standard or Itemized)
- Exemptions
- Taxable Income
- Income Tax, Tax Brackets, and Marginal Rates vs. Effective Rates
- The Alternative Minimum Tax (AMT)
- Credits (Non-Refundable)
- Other Taxes
- Credits (Refundable)

Income

My client, Jim, called me on the phone one day and said he would be making about $200,000 more that year than in the previous year. He wanted to know how much he should save for taxes. My answer was, "Somewhere between 0 and 50%." Now, in reading my response you might think that Jim needed another tax advisor. But what he really needed was to tell me how he was earning that extra income. The tax consequences really could have been anywhere in that range. Once I knew the source of that income, I was able to tell him how much to save.

Taxable income includes nearly all income, from whatever source it is derived. Other than a few types of income that are specifically excluded in the tax code, all other types of income are taxable. However, not all income is equal in the eyes of the law. Some types of income receive beneficial tax rates, some have punitive tax rates, some are not taxed, and some are taxed only in certain circumstances. This varying treatment of how different income sources are taxed is just one reason why a few people love tax planning and the rest avoid it like a plague. Nothing is simple or straightforward in the tax code . . . *nothing*.

Total gross income is the first key component of the tax formula. Nearly all sources of income (taxable and non-taxable) are reported on your tax return, and all of the taxable sources are added together to arrive at your total gross income. Here is a list of the categories of income sources, each of which has a unique method of taxation:

- Ordinary income
- Tax-exempt income (no tax)
- Preferred income (lower than normal tax rates)
- Deferred income (eventually taxed, but not currently)
- Potentially or partially taxed income (including Social Security)
- Penalized income (higher than normal tax rates)
- Earned and unearned income
- Passive income

Each of these types of income is analyzed in Chapter 3. For now, you should focus on three important points. First, nearly every source of income (or increase in wealth) is taxable. There are *very* few exceptions to this rule, and even those exceptions do not apply 100% of the time. The purpose of the tax code is to enable the government to take your money. Exceptions and exemptions are counterproductive to the very purpose of the code.

Second, the tax code is used to influence, punish, reward, and guide your decisions. This is the reason that there are so many different ways that income sources are taxed.

Third, it is to your advantage to learn how each type of income is taxed and then use that knowledge to adjust your income sources over time to reduce your taxes. Ultrawealthy individuals often pay taxes at a lower rate than middle-class individuals because they have shifted their sources of income to those that are taxed lightly or not taxed at all. Over time you can do the same.

Deductions (Adjustments to Income) and AGI

AGI is an incredibly important acronym. It stands for *Adjusted Gross Income*. You'll find it on the last line of the first page of Form 1040 (see Figure 1-1). It is arguably the most important line on your tax return. It can significantly affect the amount of tax you owe. It can also affect your ability to get loans, tuition assistance, and other types of financial support. Your AGI has a far-reaching effect on your financial life.

Remember where adjustments to income enter into the tax formula:

+ Income
– Deductions (Adjustments to Income)
= Adjusted Gross Income (AGI)

To understand AGI, you must first understand the meaning of the word "deduction." A deduction is an expense the government allows you to subtract from your income before you are taxed. It reduces your *taxable* income to an amount that is lower than your total income.

➪ **Example** Ted has a total income of $80,000 from taxable sources. However, he contributed $5,000 to his IRA account, paid $4,500 in alimony, and paid $500 in student loan interest. Because each of these expenses is considered deductible in the tax code, Ted has a total of $10,000 in deductions ($5,000 + 4,500 + 500 = $10,000). Thus Ted's taxable income will be $10,000 less than his actual income, or $70,000 ($80,000 – 10,000 = $70,000).

Deductions come in two varieties. They can be considered "**above-the-line**" or "**below-the-line**" deductions. "The line" refers to the bottom line of the first page of the tax return—your AGI. Above-the-line deductions (or adjustments to income) are subtracted from your total income, directly reducing that income when you arrive at AGI.

AGI is a very important number because it determines your eligibility to utilize below-the-line deductions and credits (discussed in the next section). The tax code limits the availability of many deductions and credits to those who have lower- or middle-income levels. (These limits are referred to as phase-outs.) If your AGI is too high, you can lose the ability to use a deduction or credit. For this reason, above-the-line deductions have a very important place in your tax planning. Some examples of above-the-line deductions include:

- Retirement plan contributions
- Student loan interest
- Tuition and fees
- Health savings account contributions
- Self-employed health insurance premiums
- Educator expenses
- Moving expenses
- Alimony
- Self-employment taxes
- Penalties from early withdrawals from savings

Understanding the portion of the tax formula that determines your AGI may be the most important thing that you can do to reduce your total tax liability.

Deductions (Standard or Itemized)

Once you have calculated your AGI it is time to turn to page 2 of your tax return (see Figure 1-1b) in order to complete the remaining items in the tax formula. The next piece of the tax return contains the below-the-line deductions. Here is the formula to this point:

\+ Income
– Deductions (Adjustments to Income)
= Adjusted Gross Income (AGI)
– Deductions (Standard or Itemized)

Just as with the above-the-line deductions, below-the-line deductions reduce your total taxable income. However, your ability to claim the below-the-line deductions may be limited or eliminated by your AGI.

When determining your below-the-line deductions you are given two options. The first option is to use the standard deduction. The standard deduction is a fixed dollar amount, adjusted for inflation by the IRS each year, that a taxpayer can claim regardless of his or her actual expenses. It is not based on any real deductible expenses incurred during the year. Rather, it is based on your filing status (single, married filing jointly, head of household, etc.). You can always choose to claim the standard deduction, regardless of what your true itemized deductions add up to (except for special rules applying to those who are married and filing separately).

As an alternative to the standard deduction, you may add together all of your *actual* deductible expenses, known as "itemized" deductions. If the sum of itemized deductions is higher than the standard deduction, you will usually achieve a better tax result by itemizing.

Expenses eligible to be claimed as itemized deductions are familiar to most taxpayers. Some of the more common ones are:

- Medical expenses
- Mortgage interest (and certain other interest)
- State income and sales taxes
- Property taxes
- Charitable contributions
- Employee expenses (not reimbursed)
- Investment expenses
- Tax preparation fees

Nearly all of the itemized deductions have limitations placed on them based on your AGI. For example, you only can deduct medical expenses that are greater than 10% of your AGI (or greater than 7.5% if you are over age 65 and not subject to the Alternative Minimum Tax). The list of reductions and limitations on itemized deductions is long, but each can serve to reduce or eliminate the benefit of the deductible expenses.

It is also important to understand that itemized deductions will do you no good if they do not add up to more than the Standard Deduction (after they have been reduced by the AGI limitations). It is not uncommon for a client to have a sudden increase in his itemized deductions, such as a large medical expense or a new mortgage, and then be confused because it did not make a difference in his taxes or even show up on his tax return. All of the deductions must be subjected to their AGI limitations *and then* still add up to more than the Standard Deduction in order to be of any benefit to your taxes. Don't be caught spending money on "deductible" expenses, only to realize that you won't be able to deduct them. (In contrast, the usefulness of above-the-line deductions is not affected by the standard deduction.)

Deductions cannot reduce your taxable income below zero. Put another way, if all of your deductions add up to more than your taxable income, any additional deductions will do you no good. The benefits of those deductions are lost when you have no corresponding taxable income to reduce.

Exemptions

Generally, each taxpayer is allowed to reduce his or her taxable income by an additional amount known as an exemption. An exemption is a fixed dollar amount, adjusted for inflation, that a taxpayer can claim as a reduction to his or her taxable income in addition to the standard or itemized deductions. Here is a look at the placement of exemptions in the tax formula:

+	Income
–	Deductions (Adjustments to Income)
=	Adjusted Gross Income (AGI)
–	Deductions (Standard or Itemized)
–	Exemptions

The theoretical reasoning for the exemption is to protect a minimal amount of income from taxes, approximately the amount that is needed to cover the most basic of life's necessities, such as food. In addition to claiming a personal exemption, each person is also allowed to claim an additional exemption for every individual who qualifies as a dependent, since the costs of those basic necessities increase with each dependent.

➯ **Example** Mike and Julie are married and have three young children who qualify as their dependents. Mike and Julie can claim five exemptions on their tax return (one for Mike, one for Julie, and one for each of their three dependent children). If the individual exemption amount happened to be $4,000 in a given year, Mike and Julie could claim $20,000 in exemptions as a reduction to their taxable income for that year (5 exemptions x $4,000 each = $20,000).

These exemptions help to reduce taxable income further. Beginning in 2013, exemptions are reduced or eliminated for taxpayers with a high AGI. The rules regarding personal and dependency exemptions and specific dollar amounts are discussed in detail in Chapter 4.

Taxable Income

Once you have determined the proper amounts to report for AGI, deductions, and exemptions, you are able to complete the most significant portion of the tax formula:

+	Income
–	Deductions (Adjustments to Income)
=	Adjusted Gross Income (AGI)
–	Deductions (Standard <u>or</u> Itemized)
–	Exemptions
=	Taxable Income

After reducing your total income by claiming all allowable adjustments, deductions, and exemptions, you arrive at your taxable income. Taxable income is the amount of your income that is actually subjected to the income tax. It is also the figure that determines your marginal tax bracket (the tax rate at which your next dollar of income is taxed).

Income Tax, Tax Brackets, and Marginal Rates vs. Effective Tax Rates

The next step in the tax formula is to determine your initial income tax liability, based on the rates in the income tax brackets:

+	Income
–	Deductions (Adjustments to Income)
=	Adjusted Gross Income (AGI)
–	Deductions (Standard <u>or</u> Itemized)
–	Exemptions
=	Taxable Income
×	Tax Rates
=	Income Tax (or AMT)

Our income tax system is progressive, which means that as your taxable income increases, the increased amounts are taxed at increasing rates. Your total income is broken into pieces and each group, or segment of that income, is taxed at a different rate. For the sake of simplicity, let's imagine that the tax bracket tables look like this:

Imaginary Tax Table	
Taxable Income	Tax rate
$1–$20,000	10%
$20,001–$50,000	20%
$50,001–$100,000	30%

In this scenario, if Mary had a *taxable* income of $60,000 during the year, she would have an income tax obligation of $11,000. This is so because the first $20,000 of her taxable income is taxed at a rate of 10%, or a $2,000 tax ($20,000 x 10% = $2,000). The next $30,000 of her taxable income (the income between $20,001 and $50,000) will be taxed at a 20% rate, or a $6,000 tax ($30,000 x 20% = $6,000). The remaining $10,000 of her taxable income (the amount over $50,000) will be taxed at a rate of 30%, or a $3,000 tax. Adding each of those taxes together ($2,000 + $6,000 + $3,000) brings us to a total tax of $11,000.

This illustration brings us to another important distinction: the difference between marginal and effective tax rates. When you hear a person say something like, "I am in the 25% tax bracket," what they are referring to is their *marginal* tax rate. Your marginal rate is the amount of tax that you pay on your last dollar earned. In the illustration above, Mary's marginal tax rate is 30%, because that is the rate that she paid on her last portion of income. Had she stopped earning money $10,000 sooner, she would have had a lower marginal rate (20%).

On the other hand, Mary's *effective* tax rate is 18.33% (as compared to her marginal tax rate of 30%). The effective tax rate is the average rate that you pay on *all* of your income combined. While Mary paid 30% on the last part of her income, she also paid 10% on a different portion of it and 20% on another part of it. When taken as a whole, her effective rate would be 18.33% ($11,000 tax/$60,000 taxable income = 18.33%).

Note There is one more way to look at the true tax rate that Mary paid. Marginal and effective tax rates are both based on *taxable* income. Mary actually had a *gross* income of $88,000, but $10,000 of that income came from non-taxable sources and she had $18,000 in deductions and exemptions ($88,000 gross income – $10,000 non-taxable income – $18,000 deductions and exemptions = $60,000 taxable income). If you look at the amount of tax that Mary paid as a percentage of her gross income, it would be only 12.5% ($11,000 tax $88,000 gross income = 12.5%). So, Mary's marginal tax rate is 30%, her effective tax rate is 18.33% and her tax as a percentage of her gross income is 12.5%.

I received a call from a client one day who was trying to decide whether to accept a promotion at work (and the increased income that would come with it). He knew from our previous conversations that he was on the cusp of entering the next tax bracket—a 10% jump from his current one. He was worried that earning extra money because of the promotion would suddenly push him into a new tax bracket and he would be stuck paying 10% more on *all* of his taxable income.

This, of course, was not the case. If it were, the increased taxes from the higher tax bracket would effectively cancel out his raise or possibly make him worse off than before. What he did not understand was that only the *new* income would be subject to the higher tax rates. I have found this to be a very common misconception.

The Alternative Minimum Tax (AMT)

Up to this point in the chapter, I imagine everything has been fairly straightforward. You have been able to follow and understand the terminology, principles, and formulas that determine how much tax you must pay. Don't get caught thinking anything in the tax code is straightforward, though! Remember, nothing is simple or straightforward in the tax code . . . *nothing*.

A prime example of complication in the tax code is the Alternative Minimum Tax (AMT). Once you have completed the first portion of the tax formula and have computed your total income tax, the government reserves the right to determine that the income tax you owe is not high enough. To ensure that your tax is at least as high as it "should" be, you may be required to recalculate your tax using a different (or alternative) formula. This alternative formula calculates the tax that you would owe if they were to take away some of your deductions, add in some of your tax-exempt income, and then calculate a tax based on a new (higher) set of tax brackets.

Once you have completed the second formula, you then compare your new tax figure with the original income tax. If the alternative tax is higher than the original tax, you must pay the additional amount. This new, higher tax is appropriately named the *Alternative Minimum* Tax. You see, there is a minimum amount you *should* pay, in their eyes, and so you are not allowed to use the standard rules if it results in a tax that is too low.

The AMT is becoming an increasingly important area of tax planning. It is affecting more and more people each year because the income levels that it applies to are not linked to inflation. Many people who are far from "rich" are finding out the hard way that the AMT is a part of their tax formula. It can have a significant financial impact on people with relatively modest incomes. You will find a more in-depth discussion of the AMT and the strategies available to reduce it in Part 7 of this book.

Credits (Non-Refundable)

Now we have arrived at the good stuff. Credits are the biggest, juiciest berries on the bush. If they are available to you (determined by your AGI), they can bring a lot of "bang for your buck." Here is how non-refundable credits fit into the tax formula:

+	Income
–	Deductions (Adjustments to Income)
=	Adjusted Gross Income (AGI)
–	Deductions (Standard <u>or</u> Itemized)
–	Exemptions
=	Taxable Income
×	Tax Rates
=	Income Tax (or AMT)
–	Credits (Non-Refundable)
=	Cannot equal less than $0 at this point

It is important to understand the difference between a *credit* and a *deduction*: they are not one and the same. In fact, they are dramatically different. Deductions reduce your *taxable income*. That means that your tax savings from a deduction is equal to your *marginal* tax rate multiplied by the amount of the deduction.

➫ **Example** If your marginal tax rate is 15%, you will pay $15 in taxes for every additional $100 you earn (until you reach the next tax bracket). Conversely, for every $100 you have in deductions, you will save $15 in taxes. Deductions reduce your taxes proportionate to your tax bracket—so the higher your tax bracket is, the more valuable deductions can be.

Credits, on the other hand, reduce your *taxes* (not taxable income) directly. For every $100 you have in credits, you will save $100 in taxes. Credits reduce your taxes *dollar for dollar,* whereas deductions reduce your taxes only by the percentage of your marginal tax rate. This gives credits a very important role in your tax formula.

The first credits available on the tax return are non-refundable. In other words, these credits can reduce your tax to $0, but no less (they can't create a refund greater than the amount of tax you have paid or withheld—hence the term *non-refundable*). Even though they cannot create a surplus refund, reducing your tax to $0 is still really good. Some of the more common non-refundable credits are:

- Child Tax Credit
- Child and Dependent Care Credit
- Education Credits
- Residential Energy Credits
- Elderly and Disabled Credits
- Foreign Tax Credit
- Retirement Savings Contribution Credit
- Adoption Credit
- Prior Year AMT Credit
- General Business Credits

Understanding which of these credits apply to your situation can make a significant difference in the taxes that you owe.

Other Taxes

In addition to the regular income tax and the Alternative Minimum Tax, there are a few other taxes that enter the picture in the next portion of the formula:

+	Income
–	Deductions (Adjustments to Income)
=	Adjusted Gross Income (AGI)
–	Deductions (Standard <u>or</u> Itemized)
–	Exemptions
=	Taxable Income
×	Tax Rates
=	Income Tax (or AMT)
–	Credits (Non-Refundable)
=	Cannot equal less than $0 at this point
+	Other Taxes

For some people the "other" group of taxes can be more significant than the income tax and AMT. Two factors contribute to this. The first is that these "other" taxes are determined without regard to adjustments, deductions, exemptions, or credits. Therefore, you can't reduce these additional taxes through traditional methods. Second, these additional taxes do not count toward minimum tax calculation to reduce the gap between the regular and minimum tax. The "other" taxes are in addition to the regular tax and the AMT.

A good illustration of this is in the tax return of a client I'll call Bob. Bob has an above-average income. He also has a lot of personal expenses that qualify as deductions. In fact, by the time you subtract all of his deductions from his income, Bob has *zero taxable income*—no tax!

Unfortunately for Bob, however, most of his income comes from owning a business. Even though he has no income tax liability, he is on the hook for an "other" tax—the self-employment tax. The self-employment tax is calculated separately from income taxes, without regard to personal adjustments, deductions, exemptions, or credits. It is a flat 15.3% tax of his net business income. As a result, he pays several thousand dollars in taxes each year that he wouldn't have owed if his income had come from another source, such as from investments.

Included in the group of "other" taxes are:

- Self-employment tax
- Penalties for early withdrawal of retirement funds
- Taxes on tips
- Taxes on household employees (such as a maid or nanny)
- Repayment of the homebuyer credit

Just when you think you have made it safely through the tax maze and are aware of what you owe, these other taxes can jump out and get you. This is an area of the tax return where careful planning can make a big difference for business owners.

Credits (Refundable)

In the world of taxes, it doesn't get any better than this. If the "other taxes" section of Form 1040 were to be named the "devil of the tax return," refundable credits would be the "guardian angel," ready to save you in the end. If you qualify for these special credits, they will be the best part of your tax return. Here they are, near the end of the calculation:

+	Income
–	Deductions (Adjustments to Income)
=	Adjusted Gross Income (AGI)
–	Deductions (Standard or Itemized)
–	Exemptions
=	Taxable Income
×	Tax Rates
=	Income Tax (or AMT)
–	Credits (Non-Refundable)
=	Cannot equal less than $0 at this point
+	Other Taxes
–	Credits (Refundable)

There are two reasons why the refundable credits play such an angelic role. First, these credits come after the "other taxes" section on the tax return. This means that, unlike the non-refundable credits, these credits can reduce your entire tax bill, *including* penalties and the self-employment tax. Second, these credits are refundable. What this really means is that even if your tax bill is zero, these credits can take your tax bill into negative territory. In other words, these credits can make the government owe *you* money. Even if you haven't paid one dime in taxes, you could get a "refund." These credits are treated the same as if they were "payments" that you had made.

➩ **Example** After taking into account all of Nancy's income, adjustments, deductions, exemptions, and non-refundable credits, her tax liability is $0. During the year she had $500 withheld from her paycheck. Nancy also qualifies for $1,000 of Earned Income Credit (a refundable credit). Under normal circumstances, if she owed no taxes she would get a refund of the $500 that was withheld from her paycheck. However, because the Earned Income Credit is refundable, she will also receive an additional $1,000 "refund" because of the credit, for a total refund of $1,500—even though she paid only $500 in taxes during the year!

I'm not sure that "refund" is the appropriate word for this scenario, but whatever you call it, this is a great tax break for those who qualify. The most common refundable credits are:

- Earned Income Credit
- Additional Child Tax Credit

- American Opportunity Credit
- Adoption Expenses
- Health Coverage Tax Credit

In addition to the credits listed above, there are a few other refundable credits available for taxes that you were required to pay but should not have been. These are:

- Excess Social Security Tax Withheld
- Tax on Fuels (for off-road use)
- Minimum Tax

The old adage of "save the best for last" definitely applies here. The best part of the tax formula comes at the end in the form of refundable credits.

The Calculation Is Complete

As you can see, each section of the tax return plays an integral part in the formula that determines your tax. Understanding each part is the foundation of successful tax planning. The final piece of the formula is to subtract any payments that you have made, which will give you the final determination of whether you owe the government money or they owe you. Here is one last look at the complete formula:

+	Income
–	Deductions (Adjustments to Income)
=	Adjusted Gross Income (AGI)
–	Deductions (Standard <u>or</u> Itemized)
–	Exemptions
=	Taxable Income
×	Tax Rates
=	Income Tax (or AMT)
–	Credits (Non-Refundable)
=	Cannot equal less than76.5 pt $0 at this point
+	Other Taxes
–	Credits (Refundable)
–	Payments
=	Taxes Due <u>or</u> Refund

No longer need you be confused by all of the lingo and jargon of the tax world. No longer should you be intimidated by the complexity of the code. With this solid foundation under your belt, you are more prepared to move forward and take control of one of the biggest and most complex expenses in your life.

Note Be sure to read the remaining chapters in Part 1 before going on to the rest of this book in order to gain a deeper understanding of the different types of income, the effects of filing status, the role of dependency exemptions, and some of ways that the tax code is rigged against you. Once you have a firm grasp of the information presented in Part 1, the remaining chapters and appendices of the book will help you discover strategies you can use within each section of the tax return, as well as recognize what value they may have in your individual circumstances. You will be ready to recognize and harvest the juiciest berries on your unique taxberry bush.

CHAPTER

3

Income

Not All Income Is Created Equal

It seems like politicians never tire of discussing whether the rich pay their fair share of taxes. In the 2012 election, there was much discussion in the political arena about the fact that Warren Buffett (one of the wealthiest people in the world) pays taxes at a lower marginal rate than his secretary. "How can a man who is worth billions and earns millions every year have a lower tax rate than his middle-class secretary?" they would say. "What tricks do his accountants and attorneys use to get his taxes so low? What secrets do they know?"

In reality, there is *no* secret involved in how he reduced his tax rates. The key to his tax prowess lay in the very open and obvious parts of the tax code that are related to income. Warren Buffett does not have lower tax rates because of complex schemes involving hidden deductions, credits, and offshore accounts. He has reduced his tax rate by shifting his *sources* of income to those given preferential treatment in the tax code.

The great news is that his "secrets" to lower tax rates are available to everyone. Even better, through conscious effort you too can shift your income to these preferred sources—lowering your overall tax rate every step of the way. To do so, you must first gain an understanding of each type of income and how each is taxed. Then you will be ready to carefully plan a way to get your effective tax rate as low as possible.

Here again is the list of the categories of income sources (from Chapter 2), each of which has a unique method of taxation:

- Ordinary income
- Tax-exempt income (no tax)
- Preferred income (lower than normal tax rates)