Strategies for Reducing Your Taxes©

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Income Taxes

Over and over again the Courts have said that there is nothing sinister in so arranging affairs as to keep taxes as low as possible. Everyone does it, rich and poor alike and all do right, for nobody owes any public duty to pay more than the law demands: Taxes are enforced exactions, not voluntary contributions.

-- Learned Hand, US Appeals Court Judge

Income Taxes

Irony

In the last four years, the Federal government's Food Stamp program enrollment has risen from 31 million to 47 million Americans.

The US National Park Service warns:

"Please Do Not Feed the Animals."

Their stated reason for the policy: "The animals will grow dependent on handouts and will not learn to take care of themselves."

Income Tax Rates

"The top marginal income tax rate was 70% in 1981, and the average actual (effective) tax rate of top earners was 30.4%.

By 2004 the top rate was cut in half, to 35%, but the average effective rate of top earners was barely changed, at 30.1%. "

-- Morgan Housel, Motley Fool, 10/31/2013

Deductions, exemptions, credits, phase-outs/ins, and exclusions are just as important as tax rates.

Some Definitions

- Total Income
- Deductions – “above the line”
  - IRA contributions
  - Certain college education and health care expenses
  - Alimony
- Adjusted Gross Income (AGI)
- Deductions – “below the line”
  - Standard Deduction or Itemized Deductions
- Personal Exemptions
- Taxable Income
- Credits
  - Directly reduces the tax due
  - Non-refundable
  - Refundable
  - Withholding and estimated tax payments
- Tax Due or Refund

Income Tax *Rates* are <u>not</u> the only Danger

Additional income cannot only put you in a higher tax bracket, but can:

- Increase your Social Security taxes
- Increase your Medicare premiums
- Reduce your Itemized deductions
    - Medical expenses
    - Mortgage interest & points
    - Tax deductions: State tax, real estate tax, DMV
    - Charitable contributions
    - Miscellaneous deductions
    - Casualty losses
- Phase-out rental real estate deductions
- Phase-out IRA contributions
- Reduce Child Care Credit
- Reduce Earned Income Credit
- Reduce Hope Credit
- Increase Alternative Minimum Tax

Medicare Part B Premium Surcharge

- 2014 premium based on 2012 MAGI (AGI plus "tax-exempt" income)
- Medicare monthly premiums for 2014:

Single Taxpayer:	Married Taxpayer:	Mo. Premium:
MAGI under $85,001	MAGI under $170,001	$ 104.90
$ 85,001- $107,000	$ 170,001-214,000	$ 146.90
$ 107,001- $160,000	$ 214,001-$320,000	$ 209.80
$ 160,001- $214,000	$ 320,001-$428,000	$ 272.70
$ 214,000+	$ 428,000+	$ 335.70

- You can appeal surcharge if "Life Changing Event"
  - Marriage, Divorce, Death of Spouse, Stopping Work
  - Involuntary loss of income (natural disaster, insolvent pension)
  - High income due to sale of property is not a LCE

"American Taxpayer Relief Act of 2012"
(Actually passed January 2, 2013)

The lower "Bush Tax Cut" rates

- Made permanent, except for:
  - "High earners", top rate increases from 35% to 39.6%
  - "High earners" = AGI $400,000+ single, $450,000+ MFJ

The AMT exemption

- Made permanent and indexed for inflation
- 2013 exemption: Single $51,900; MFJ $80,800

Capital gains and qualified dividend rates

- Remain at 15%, except:
- "High earners", whose rate will increase to 20%

2% payroll tax holiday

- Not extended, rate to 6.2% from 4.2%

American Taxpayer Relief Act of 2012

Personal Exemption

- $3900 for 2013
- Phase-out for "High earners" begins:
  - AGI $250,000 single, $300,000 MFJ
  - Phase-out: 2% for each $2500 over AGI limit

Standard Deduction:

- Single: $12,200 for 2013
- MFJ: $6,100 for 2013
- Phase-out for "High earners" begins:
  - AGI $250,000 single, $300,000 MFJ
  - Phase-out: 3% of excess AGI, not more than 80% phased out

American Taxpayer Relief Act of 2012

IRA Qualified Charitable Distributions (QCD)

- Extended through 2013
- Must be at least age 70-1/2
- Distribution must be transferred directly from IRA to charity
- Satisfies age 70-1/2 required mandatory distribution
- QCD amount is <u>not</u> a taxable distribution
  - Therefore, does not increase your AGI
- QCD amount is <u>not</u> deductible

- Will they extend this provision for 2014 ?

An IRA owner can exclude from gross income up to $100,000 of a QCD made for a year, and a QCD can be used to satisfy any IRA required minimum distributions (RMDs) for the year. Also, the amount of a QCD excluded from gross income is not taken into account in determining any deduction for charitable contributions. (See Notice 2007-7, Section IX, for additional information on QCDs.)

Obamacare Taxes

Itemized Deduction disallowance:

- Medical Itemized Deduction disallowance
- 2012 and before: 7.5%
- 2013 and after: 10%
  - If 65+ then 7.5% still applies – until 2017
  - Tax planning: if turning 65 next year, defer paying medical bills until 65

New investment tax

- 3.8% rate on top of capital gains & dividends tax
- Applies to AGI $200,000+ single, $250,000+ MFJ

Medicare Payroll Tax increase

- 2012 and before: 1.45%
- 2013 and after: 2.35%
- Applies to AGI $200,000+ single, MJF $250,000+ MFJ

Obamacare Taxes

Flexible Spending Accounts

- Previously no cap, now capped at $2500

10% excise tax on indoor tanning services

2.3% excise tax on medical devices

- How does this make healthcare more affordable ?

Tax Tips & Tricks

Withholding & Estimated Tax Payments

- New, higher tax rates and elimination of some deductions may increase your tax due, even without an increase in income
- General rule: you must pay an amount equal to 100%* of last year's tax, or be subject to a penalty and interest
- Review your annual income late in year and make up for any underpayment
  - Using estimated tax payment (1040-ES) may not be enough
  - Use withholding from your paycheck or IRA, allocated throughout year

* 110% of last year's tax if AGI over $150,000, or 90% of current year's tax.

Tax Tips & Tricks

Delaying Income Tax (time is money)

- **Deferring income from late in year 1 to early in year 2**
  - IRAs: if you can, defer December withdrawal until January
  - Self-employment work in November/December: Bill in January
  - Year end bonus from employer: can you defer to January?
- **Accelerate Itemized Deductions**
  - Prepay:
    - First installment of next year's property taxes in December
    - January/February DMV fee in December
    - State income tax estimate installment
    - January medical premium in December
    - January mortgage payment in December
    - Charitable contributions
    - Tax preparer retainer !
- **Defers payment of federal and state income taxes**
- **For self-employed, defers Social Security and Medicare taxes**
- **But consider year-to-year income changes**

Tax Tips & Tricks

Mutual Funds – in a non-IRA / 401(k) account

- **Mutual funds provide simplified investing, but they are tax traps**
  - Capital gains within a mutual fund are distributed at year-end and you must include these on <u>your</u> tax return
  - Investment gains may have accrued over many years, but are realized when the mutual fund sells the stock or bond
    - You have no control over when stocks are sold in the mutual fund
  - Avoid buying mutual funds in November or December
    - You can end up being allocated taxable capital gains that you didn't really get
    - Example: a stock was sold with a large gain in July, so mutual fund price went up. You bought in November at the higher price, but you will be allocated the capital gain even though you got no benefit
- **A drop in the stock market can create mutual fund redemptions, causing the mutual fund to sell stocks that have built-in gains**
  - Those gains will go onto <u>your</u> tax return, even though you didn't sell
  - Even if you sell your mutual fund shares at a loss, you could be allocated some of the fund's capital gains !
  - Nothing worse than being taxed on gains your didn't get !
- **Consider individual stocks or ETFs instead**

Tax Tips & Tricks

Harvesting Losses

- "When you have lemons, make lemonade"
- Did you sell some assets and realize some capital gains?
- Are some of your investments worth less than you paid for them?
    - Selling them can create capital losses that can offset capital gains
    - Up to $3000 in capital losses can be used to offset other income
    - Wash Rule: don't rebuy the stock/asset within 30 days or loss is disallowed

Tax Tips & Tricks

Tax-free exchanges

Real Estate: 1031 exchange

- Exchange “like-for-like” property
  - e.g. Investment property for investment property
  - Generally, any investment real estate
- New property is equal or greater in value
- Immediate or deferred exchange
  - Deferred: usually within 6 months

Insurance Annuity: 1035 exchange

- You can generally rollover your current annuity into a new annuity tax-free

Tax Tips & Tricks

Bunching

- Due to phase ins/phase outs, and standard deduction levels:
  - Deferring payment of late year medical/dental bills to next year
  - Delaying routine medical or dental visits to next January
    - Because 10% of AGI disallowed starting in 2013 (Obamacare)
    - Exception: age 65+: 7.5% until 2017
  - To the extent possible, making Charitable Contributions every other year
- Avoid triggering too many realized gains on investments in same year
  - Can you reasonably delay sale of appreciated asset to next year?
  - If you have some stocks, mutual funds, or other investments that have gone down in value, can you sell those to realize a loss to offset gains this year?

Tax Tips & Tricks

Types of Accounts

Taxable Accounts

- Bank accounts
- Brokerage accounts

Tax-deferred accounts

- Traditional IRAs
- Insurance annuities
- 401(k) plans
- 403(b) & 457 plans

Tax-free accounts

- Roth IRAs
- Tax-free municipal bonds

Where to Hold Your Investments

Taxable Accounts (especially if AGI under $400,000 - $450,000)

- Stocks, Mutual Funds, ETFs
  - LT Capital Gains receive 0-15% tax rate
  - Qualified Dividends receive 0-15% tax rate
  - Capital Losses can offset other income
  - If these investments are in an IRA: ordinary tax rates (up to 35%)
- Tax-free Municipal Bonds
  - Can avoid both Federal and California income taxation
  - Private activity bonds are subject to AMT
- Insurance Annuities
  - No taxation until amounts withdrawn
    - Distributions partially tax-free until all contributions recovered
- REITs and MLPs
  - Most have partial tax deferral/tax credit features
  - If held in IRA, there may be Unrelated Business Tax

Where to Hold Your Investments

Tax-deferred Accounts: Traditional IRAs, 401(k)s

- Bonds, Money Markets, CDs, ETNs
  - Earnings within these accounts are tax-deferred
  - Put your “income” (interest) investment allocation here
  - Upon withdrawal, all income is taxed at ordinary tax rates (up to 35%)
- Partnerships and Sub-chapter S ownership
  - Holding a partnership interest in an IRA can create UBTI
  - Holding a sub-chapter S interest in an IRA will create UBTI
  - UBTI in an IRA results in <u>current</u> taxation !
- Stocks, Mutual Funds, ETFs

Tax Tips & Tricks

Tax-free Accounts

Roth IRA s

- One time, upfront incursion of taxes
- Long term tax savings
- Distributions to you <u>and your heirs</u> are tax-free (aka “stretch IRA”)
- Careful long term planning is essential

Roth Conversions

1. “Beginning of the Year” strategy
2. Multiple conversions strategy, with recharacterization
3. Larger conversions
   - If current year is a low income year, or
   - If you have loss carryovers

Re-characterization (unwind a conversion)

- If you had a current year loss in Roth account
- If multiple conversions, only retain best performing conversion
- Until extended due date of tax return (October 15 of next year)

Estate Taxes

Pre-2010

- Exemptions ranged from $600,000 - $3,500,000
- Estate tax rate up to 55%
- Basis of assets received by inheritance
  - Fair market value on date of death

2011 -2012

- $5 million exemption
- Married couple: $10,000,000 exemption available
- Up to 35% estate tax rate on amounts over exemption

Estate Tax Changes
Tax Relief Act of 2012

2013 & after

- $5 million exemption
  - Adjusted annually for inflation !
  - 2014 amount is $5,340,000
  - Unlimited transfer amounts to surviving spouse
  - Unused deceased spouse's exemption can go to survivor
    - $5,340,000 x 2 = $10,680,000
    - File Form 706 to elect
    - 2011, 2012, 2013 deaths have until 12/31/2014 to elect
- Maximum 40% estate tax rate
- Basis of assets received by inheritance:
  - Fair market value on date of death

California does <u>not</u> have an estate or gift tax

  - Don't tell Jerry Brown !

Gifts and Gift Taxes

2013 - 2014

Annual exclusion: $14,000

- $14,000 allowed per recipient
- Husband & wife can give $28,000 to one person
- Does <u>not</u> count against lifetime exclusion amount
- Does <u>not</u> require a gift tax return
- If annual gift over $14,000: a gift tax return (Form 706) <u>is required</u>
- IRS has a current campaign to find gifts over $14,000
- IRS is making inquiries to State of California about real estate transfers to family members

Lifetime exclusion: 2014: $5.34 million ($5.25 million in 2013)

- Amounts now indexed to inflation
- Married couple can exclude up to $10.68 million
- Gifts over $14,000 count against lifetime exclusion

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