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TAX REDUCTION STRATEGIES

Quick Guide

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Income tax planning is a fundamental part of financial planning. The less money you pay for income taxes, the more money you have working toward achieving other financial goals. Below is an overview of many of the techniques currently available that can be used to minimize your current and future taxes.

Deferring Income

Deferring income means reducing your current taxes by postponing the taxability of income until a future year. One easy way to defer income is by maximizing contributions to company retirement savings plans, such as a 401(k) plan, as well as by using other tax-advantaged savings vehicles, including IRAs, annuities, and cash value life insurance. Some contributions to retirement savings plans can be made on a pre-tax basis where you defer income tax on the monies going into the plan. In this case, your contributions won't be taxed until you make withdrawals in the future. The income you earn on these accounts accumulates tax-deferred, which means the earnings on your money are not taxed until you make a withdrawal. Roth IRAs present the opportunity to receive distributions tax-free.

Maximizing Itemized Deductions

Individuals should itemize deductions if their total itemized deductions exceed the federal standard deduction. Deductions reduce the amount of your income that is subject to tax. The following are categories of itemized deductions:

- **Medical and dental expenses:** This category should include the amount of unreimbursed medical and dental expenses (including prescriptions) not paid by insurance or reimbursed through a flexible spending account. Medical and dental expenses are deductible to the extent they exceed 10% (7.5% for age 65 or older) of your adjusted gross income. You can also include transportation costs when traveling for medical purposes, including mileage at 19 cents per mile in 2016 (23 cents in 2015), tolls, and the cost of public transportation.
- **State and local taxes:** The amount of state and local income taxes you paid in the current year may be deducted on your federal income tax return. This includes amounts withheld, estimated payments made in the current year, and any balance due on your prior year's state income tax return paid in the current year. Other deductible taxes include real estate taxes and certain personal property taxes.
- **Interest expense:** Deductible interest includes home mortgage interest, investment interest, qualified student loan interest, and trade or business interest. Certain restrictions apply.
- **Charitable contributions:** You may deduct contributions and gifts to qualified charities. Contributions may be in cash, property, or out-of pocket expenses (including mileage at 14 cents per mile in 2016, same in 2015) for volunteer work for qualified charities. No deduction is allowed for single contributions of $250 or more to any one organization unless you have a written receipt from the organization.
- **Miscellaneous deduction expenses:** Tax preparation fees, cost of safe deposit box, etc. are deductible to the extent they exceed 2% of your adjusted gross income.
- **Casualty and theft losses:** Nonbusiness casualty and theft losses are deductible to the extent they exceed $100 and then only to the extent they exceed 10% of your adjusted gross income. Business casualty and theft losses are fully deductible with certain limits applied.

Flexible Spending Accounts

Many companies provide employees with a variety of benefits such as medical and dental insurance, life insurance, long-term disability, and other health and welfare benefits. To obtain these benefits, employees usually have to pay some portion of the premiums. ***Flexible spending accounts*** allow you to pay for certain eligible benefits, such as health insurance, and pay for certain eligible expenses, such as unreimbursed medical expenses and daycare expenses, with pre-tax dollars. If you pay the premiums on a pre-tax basis, your cost is reduced since the money you pay is not subject to federal income tax or Social Security tax. At the end of the year, any unused balances are forfeited.

Health Savings Accounts

IMPORTANT NOTE: The Health Savings Account (HSA) permits eligible individuals who are not enrolled in Medicare to save for "qualified" medical health expenses on a tax-free basis. Note that over-the-counter (OTC) drugs unless prescribed are not a qualifying expense. These accounts may be offered through employers. However, any insurance company or bank can offer HSAs to eligible individuals as well.

These plans are only available to individuals with high-deductible health plans, i.e., plans with a deductible in 2016 of at least $1,300 (same in 2015) for individuals and $2,600 (same in 2015) for families. Contributions are limited to $3,350 in 2016 (same in 2015) for individuals and $6,750 in 2016 ($6,650 in 2015) for families, regardless of income, and additional "catch-up" contributions may be available to those age 55 or older. Contributions are tax-deductible, and distributions, when used for a qualified medical expense, are tax-free. If expenses are not qualified, then the distribution may be treated as taxable income, and a penalty may also apply.

However, when used as intended, HSAs can grow tax-free, and unused balances can roll over from year to year. These accounts are also portable, and may be used across different jobs. These are all potential advantages of using the Health Savings Account when compared with the Flexible Spending Account.

There are additional details and restrictions that must be considered. Check with your financial professional or account sponsor regarding your eligibility to use the HSA.

Tax Credits

Tax credits, unlike deductions, reduce tax liability dollar for dollar by the amount of the available credit. There are various tax credits benefiting many different types of taxpayers, including families with young children, the elderly, the disabled, and those with students attending college. Some examples are shown below. Consult your tax professional to determine which credits may be available to you.

- **Child and dependant care credit:** A credit is allowed for a portion of qualified child or dependant care expenses that are paid in order for the taxpayer to work. The maximum amount of child care expenses that can be considered is $3,000 for one child or dependant, or $6,000 for two or more. The credit ranges from 20% to 35% of eligible child care expenses.
- **Earned income credit:** A credit is available to certain low-income taxpayers who have earned income. The maximum credit in 2016 is up to $506 ($503 in 2015) for a taxpayer with no children and who has earned income less than $14,880 ($14,820 in 2015), and $3,373 ($3,359 in 2015) for a taxpayer with one child and earned income less than $39,296 ($39,131 in 2015). For a taxpayer with two children and earned income less than $44,648 ($44,454 in 2015), the maximum 2016 credit is $5,572 ($5,548 in 2015). For 3 or more children, higher limits apply.
- **Saver's Credit:** This credit is available to certain taxpayers who contribute to their employer's retirement plans and who have adjusted gross income levels under $61,500 in 2016 ($61,000 in 2015) for joint filing, $46,125 in 2016 ($45,750 in 2015) for head of household, or $30,750 ($30,500 in 2015) for all other filing (i.e. single, married filing separately, and qualifying widow(er)). The maximum credit available is $2,000 ($1,000 in 2015). For married couples, the maximum credit available in 2016 is $4,000 ($2,000 in 2015). By contributing to a retirement plan and claiming this credit, the taxpayer reduces the amount of tax due to the IRS.

Education Tax Incentives

Two income tax credits, the American Opportunity Credit (AOC) and the Lifetime Learning credit are provided to help defray qualified tuition and fees (not room and board).

The maximum amount of the American Opportunity Credit (AOC) is $2,500 per student. For 2016 the credit is phased out if your modified adjusted gross income (MAGI) is between $80,000 and $90,000 for single filers ($160,000 and $180,000, if you file a joint return). The phase-out is the same in 2015.

The credit can be claimed for the first four years of post-secondary education.

Generally, 40% of the AOC is now a refundable credit for most taxpayers, which means that you can receive up to $1,000 even if you owe no taxes

The term "qualified tuition and related expenses" includes expenditures for "course materials". For this purpose, the term "course materials" means books, supplies, and equipment needed for a course of study whether or not the materials must be purchased from the educational institution as a condition of enrollment or attendance. The Lifetime Learning credit equals 20% of the first $10,000 of qualified education expense. The Lifetime Learning credit is calculated on a per-family (taxpayer and his or her dependants) rather than a per-student basis, making the maximum 2016 family credit $2,000 (same in 2015). In 2016, the credit is phased out for joint filers with modified AGI between $104,000 and $124,000; and $52,000 and $62,000 for single filers. In 2015, the credit is phased out for joint filers with modified AGI between $110,000 and $130,000; and $55,000 and $65,000 for all other filers. These income amounts will be annually adjusted for inflation.

The Lifetime Learning credit is available for any course work at a qualified education institution that improves job skills. Eligible taxpayers may elect to exclude from income amounts withdrawn from an Education Savings Account that are used to pay qualified education expenses for a student. American Opportunity and Lifetime Learning tax credits can be claimed in the same year as Education Savings Account distributions, as long as the ESA distribution is not used to pay for the same costs used to claim the education credit.

Taxpayers may also exclude from income amounts withdrawn from a Qualified Tuition Plan, or QTP (e.g., a "529" plan) that are used to pay for qualified higher education expenses for a student. American Opportunity and Lifetime Learning tax credits can be claimed in the same year as QTP distributions, as long as the QTP distribution is not used to pay for the same costs used to claim the education credit. Individuals can contribute to both QTPs and ESAs on behalf of the same beneficiary.

Tax-Exempt Investing

In constructing the income-generating portion of your portfolio, investing in tax-exempt vehicles (such as municipal bonds) can be used as a tax-saving strategy. When evaluating investments, you should compare the after-tax yields you are earning. You must look at a taxable investment on an after-tax basis in order to compare it with a tax-exempt obligation. You may also need to factor in state taxes when making your investment decisions.

If you decide to utilize tax-exempt investments, keep the following points in mind:

- Due to lower yields, you generally have to be in one of the higher marginal federal income tax brackets for municipals to make sense.
- Don't invest in tax-exempt municipals within a tax-deferred retirement plan. The money in your retirement account is already tax-advantaged.
- Occasionally, municipal funds declare a capital gain, which will be taxable.

Income Shifting

Shifting assets into a child's name often minimizes your overall household tax burden. However, for children under age 18, the amount of unearned income which may be taxed at the child's federal income tax rate is limited. In 2016, the limit is $2,100 per child (same in 2015). (This dollar threshold is adjusted periodically for inflation.) The first $1,050 is offset by the dependant standard deduction. The next $1,050 is taxed at the child's rate. Earnings in excess of this amount are taxed at the parents' marginal federal income tax rate. (This is often referred to as the "kiddie tax."). Between the ages of 18 to 24, kiddie tax still applies depending on the earned income and status of the child. Keep in mind that assets shifted into your child's name to reduce your income taxes may be subject to gift taxes, and often later reduce the amount of financial aid for which you are eligible.

Business Owner Tax Considerations

Self-employed individuals may establish tax-advantaged retirement plans with contributions based on net earnings from self-employment. Tax-advantaged plans include Keogh plans, Simplified Employee Pensions (SEPs), and Savings Incentive Match Plan for Employees—SIMPLE Plans. See your tax professional for information on retirement plans and other tax-savings retirement vehicles.

Self-employed individuals are currently entitled to deduct up to 100% of the amount paid for health insurance coverage for themselves, their spouses, and dependants during the tax year. The deduction is limited to the net earnings from the trade or business for which the insurance coverage was established, minus the deduction for one-half of the self-employment tax and any Keogh, SIMPLE, and SEP deductions.

IMPORTANT NOTE: You cannot take a self-employed health insurance deduction for any month or part of a month that you were eligible to participate in an employer-sponsored health plan.

Other tax issues to keep in mind for a self-employed individual include:

- If your net earnings from self-employment exceed $400, you will be liable for self-employment taxes. If you make estimated income tax payments, be sure to consider the self-employment tax.*
- If you have employees, you must obtain a separate federal tax identification number and fulfill employment tax responsibilities.
- A deduction may be available for certain expenses incurred in maintaining a portion of your home as an office. You must meet certain restrictive tests for your home office to qualify for deductions.

** The self-employment tax is a Social Security and Medicare tax. It is similar to the Social Security and Medicare taxes that are withheld from the pay of most wage earners. For 2016, the tax rate is 15.3% (same in 2015) on the first $118,500 (same in 2015) of combined wages, tips, and net earnings, and 2.9% on earnings above this limit.*

Consult your tax professional for tax issues relating to self-employed business owners.

Withholding and Estimated Taxes

Paying too much or too little in taxes during the year can make budgeting difficult. If you received a large tax refund last year, this money could have been invested instead, helping you achieve your financial goals during the year. Project how much tax you expect to owe and be sure to have at least 90% of that amount withheld during the year. Another option is to consider using one of the safe harbor methods of making estimated federal income tax payments. You should consult with a financial professional to determine which tax payment methods are most advantageous to you, and to consider any state requirements that may apply.

IMPORTANT NOTE: Overpayments of tax are basically interest-free loans to the government.

Capital Gains and Losses

To adequately plan for the tax impact of your investments, you need to understand how capital gains and losses and dividends are taxed. Figuring out the taxes on mutual funds outside of retirement plans can be tricky. And you should be aware of certain deductible investment expenses, which can reduce the amount of tax you need to pay.

When you have an active portfolio of investments outside a tax-deferred retirement account, consider some of the following planning tips to minimize the amount of income tax you will pay on capital gains generated during the year. Keep in mind that you should not base a buy or sell investment decision solely on tax minimization; make sure it makes economic sense and is part of your overall investing strategy.

If you have **recognized** short-term capital gains and you were considering selling an asset that will generate a capital loss, you can use the loss to offset the gain by selling the asset. This can eliminate the short-term capital gain that would have been subject to tax at ordinary rates.

If you have a capital loss or a capital loss carryforward and you were considering selling an asset that will generate a short-term capital gain, you can use the loss to offset the gain by selling the asset. This may eliminate the short-term gain that would have been subject to tax at ordinary rates. Keep in mind the capital gains tax rates and the related holding periods when doing your tax planning.

> Capital gains are defined as an increase in value of a capital asset, such as an investment or real estate, resulting in being valued at higher than the price at which it was purchased. The gain is realized when the asset is sold, and it must be claimed on income taxes. Conversely, a capital loss occurs when a capital asset's value decreases to below its purchase price.

Loss carryforward is an accounting technique that applies the losses from one year to the profits for one of the seven following years to reduce tax liability.

What Happens if I Sell an Investment at a Loss?

As mentioned above, if you've sold investments, some at capital gains and some at capital losses, you can offset them against each other. But if you end up with a net realized capital loss, you can only deduct up to $3,000 on your tax return against other taxable income, including salaries, interest, and dividends. If there's any left over (loss carryforward), you can carry it forward to future years until you use it all up. You're allowed to deduct up to $3,000 of realized losses per year even if you don't have any realized capital gains in that year.♦