

Smart Tax Planning

For most people, taxes are something they only think about on April 14th. Just kidding – you probably have your tax return done before then. However, do you think about taxes outside of filing your return? Smart tax planning is not just claiming all of the deductions and credits you are entitled to so that you can get a bigger refund. It also involves thinking about and engaging in methods to legally lower your tax burden throughout the year. This program will cover:

- Retirement Plans
- Education Plans
- Flexible Spending Accounts and Transportation Savings Accounts
- Investing
- Tax Fraud

Chapter 1: Retirement Plans

Employer-Sponsored Retirement Plans

There are two basic types of employer-sponsored retirement plans: the defined benefit plan, where a certain level of benefits is promised and it is the employer's responsibility to fund it, and the defined contribution plan, where the employee makes defined contributions and there is no guaranteed payout. The value of the plan is dependent on how much is put in and how well your investments perform. Most employers let employees determine how much they want to contribute per paycheck, and some even match all or part of their employees' contributions. Today, defined contribution plans are much more common than defined benefit plans. An example of a defined contribution plan is the 401(k). (The 403(b) is the equivalent for employees of non-profits.)

The money that you contribute to a defined contribution plan is deducted from your paycheck pre-tax, meaning you don't have to pay state or federal income taxes on it. While your money is invested in the plan, you don't have to pay taxes on the earnings either. You only have to pay taxes on the withdrawals you make. The example below shows the benefits of contributing to a tax-deferred account like a defined contribution plan.

Let's say you can save \$200 pre-tax a month for retirement and expect you can earn a return of 4% annually. You have a state and federal marginal tax rate (the rate at which the last dollar earned is taxed) of 30%. If you use a defined contribution plan, the full \$200 a month is invested. By the end of the year, you will have a total of \$2,455 in your account and earned \$44 in interest, which you do not have to pay taxes on. If you use a regular, non-tax deferred account, only \$140 a month will be invested, with the other \$60 being taken by taxes. By the end of the year, you will have a total of \$1,711 in your account and earned \$31 in interest, but these amounts drop to \$1702 and \$22 once you factor in the taxes you have to pay. By the end of year 30, you will have a total of \$138,810 in the defined contribution plan (\$97,167 after withdrawal). In contrast, you will have only \$78,846 in the regular account.

Individual Retirement Accounts (IRAs)

- **Traditional IRAs**

Like with defined contribution plans, you do not have to pay taxes on the contributions made to or earnings on a Traditional IRA, only the withdrawals. However, IRAs are not tied to your employer; you can open one at a variety of financial institutions, such as credit unions, banks, and mutual fund companies. In order to contribute to an IRA, you or your spouse must have earned income.

One of the downsides of defined contributions plans is that the investment options are typically limited. For example, your company may only let you select between five mutual funds offered by the ABC Investment Corp. However, with an IRA, you can invest in what you want. You also do not have to worry about what to do with your IRA when you leave your job. On the other hand, you don't have the benefit of automatic payroll deduction (or matching funds if your employer provides that), and the contribution limits are higher for defined contribution plans than IRAs. You can contribute to both at the same time, but contributions to a Traditional IRA are not deductible if you are covered by a retirement plan at work and your income is above a certain amount.

- **Roth IRAs**

Unlike with defined contribution plans and Traditional IRAs, you do have to pay taxes on the contributions you make to a Roth IRA. However, earnings grow tax-free in the account, and you do not have to pay taxes on qualified withdrawals. Many financial experts prefer Roth IRAs to Traditional IRAs, but which one is more beneficial is largely dependent on your tax bracket now versus your tax bracket in retirement.

Plans for the Self-Employed

If you are self-employed, you can still take contribute to a Traditional or Roth IRA. There are also retirement plans specifically for the self-employed, such as the Keogh plan, simplified employee pension plan (SEP IRA), and savings incentive match plan for employees (SIMPLE IRA). All allow you to make pre-tax contributions, and the earnings grow tax free. The SEP IRA and SIMPLE IRA generally have lower administrative costs and are easier to set up, but the Keogh plan may allow larger contributions.

Chapter 2: Education Plans

Do you have children or are you planning to go back to school? Why not take advantage of a plan that allows you to save for education costs and gives you a break on taxes at the same time?

Coverdell Education Savings Accounts (Coverdell ESAs)

The Coverdell ESA works just like a Roth IRA; contributions aren't tax deductible, but the investment earnings accumulate tax-free, and qualified distributions are exempt from income tax. It can be used to pay for such expenses as tuition, fees, books, and equipment for primary, secondary, and postsecondary education (kindergarten – graduate school). Contributions can only be made until the beneficiary turns 18 and must be used by the time he or she is 30. Coverdell ESAs can be opened at many financial institutions, and unlike with 529 plans (discussed more below) your investment options are virtually unlimited. As the plan's owner, you choose what stocks, bonds, mutual funds, or other opportunities to invest in.

529 Plans

529 plans are tax-advantaged savings vehicles that can be used for college and graduate school expenses. They come in two basic varieties: the college savings plan and the prepaid tuition plan.

College savings plans are offered by individual states; almost every state has at least one. Do you have to invest in your state's plan? No, you can open a plan in any state and use the funds to pay for expenses at any accredited college or university. In fact, because each plan offers different investment choices, it's possible that another state's plan may best meet your financial needs. That is why it is a good idea to do research and compare plans before investing.

Prepaid tuition plans allow you to buy all or part of a future public in-state education at today's prices. Unlike with college savings plans, you can generally only invest in your state's plan (if they have one). It may be possible to use the plan at a private or out-of-state public school, but the coverage will likely be less. For example, if you purchase a year's worth of tuition, it may only cover a half a year at a private school.

With both college savings and prepaid tuition plans, you don't have to pay federal and, in most cases, state income tax on the earnings or withdrawals as long as you use the funds for qualified education expenses. For the savings plans, qualified expenses include tuition, books, supplies, and room and board if the student is enrolled at least half time. In contrast, the prepaid plans typically cover just tuition and sometimes room and board. Contributions are not deductible on your federal income tax return, but they may be deductible on your state return if you use your state's plan.

Unlike with Coverdell ESAs, there are no age restrictions on who can use a 529 plan. If you plan to go back to school, you can set up a 529 plan for yourself. Another plus: the amount that you can contribute to a 529 plan is generally much higher than what you are allowed to contribute to a Coverdell ESA. To learn more about what each state is offering and compare and contrast plans, visit the College Savings Plans Network's website: www.collegesavings.org. Many financial institutions also offer information and advice about 529 plans.

Chapter 3: Flexible Spending Accounts and Transportation Savings Accounts

Retirement and education plans offer you tax breaks for saving for expenses you will typically incur far in the future. However, you may also be able to get tax breaks on expenses you have today.

Medical Expense Flexible Spending Account

Offered through employers, a medical expense flexible spending account is a savings plan that allows you to contribute earnings pre-tax and withdraw the funds to pay for qualified unreimbursed medical and dental costs, such as co-pays and over-the-counter medication. You can even use it to purchase Band-Aids! Unlike with retirement plans, you do not have to pay taxes on the withdrawals. The example below shows the benefits of contributing to a flexible spending account.

Let's say you have a marginal state and federal income tax rate of 30% and your unreimbursed health costs average \$2,000 a year. You decide to set aside \$1,600 a year in a medical expense flexible spending account. This will save you \$480.

You can sign up for a flexible spending account during your employer's open enrollment period. At that time, you must choose how much you want deducted from each paycheck. Your first instinct may

be to contribute as much as possible to take full advantage of the tax break, but keep in mind that flexible spending plans operate under a “use it or lose it” rule – any money not spent by the end of the year is forfeited. Many financial experts recommend that you set your contributions at 80% of your anticipated health care costs.

If you have a high deductible health care plan, you may qualify as for a health savings account. It works the same way as a flexible spending account, and an added bonus is that you don't lose unspent balances at the end of the year. You can sign up with your employer, if you have insurance through them, or, if you pay for your insurance on your own, at many financial institutions.

Dependent Care Flexible Spending Account

While the medical expense flexible spending account allows you to use pre-tax dollars to pay for medical expenses, the dependent care flexible spending account allows you to use pre-tax dollars to pay for – what else? – dependent care. In order to take advantage of this account, you and your spouse (if applicable) must work, and the funds can only be used to pay for dependent care expenses while you are working. You can't use it to pay the babysitter when you go to the movies! However, you may be able to use it to pay for summer day camp. The dependent does not have to be a minor child; it can also be a parent who is incapable of caring for him or herself. If you are interested in opening up a dependent care flexible spending account, talk to your human resources department.

Expenses paid through a dependent care flexible spending account cannot be used to claim the child and dependent care credit. You may want to talk to a qualified tax advisor about what would provide the biggest tax benefit in your situation.

Transportation Savings Account

A transportation savings account is a benefit offered by many employers that allows you to use your pre-tax dollars to pay for qualified transportation expenses. Qualified expenses include parking (near your place of work or commute site, not near your home), public transportation, and vanpooling (vehicle must seat at least six, and at least 80% of usage must be for transporting employees to and from work). If you drive yourself to work, you cannot use a transportation savings account to purchase gasoline.

Chapter 4: Investing

Not only do you have to pay taxes on your income, but also on the interest and other profits that you receive from investments. You may be tempted to spend all your money – why invest if the IRS is just going to take a chunk of it? – but remember, you will always have more by saving instead of spending, even if you have to pay taxes on it. Plus, there are many tax-lowering strategies you can engage in.

Bonds

A bond is a loan to a company or the government, with you, the bondholder, as the lender. Organizations issue bonds when they want to raise funds. Typically, you receive the principal at the maturity of the bond and the interest periodically (usually twice a year) while you are holding the bond. In most cases, you have to pay taxes on the interest you receive. However, this is not true for all bonds.

Municipal bonds are issued by cities, counties, states, and other non-federal government agencies to fund public projects. In general, the interest received on municipal bonds is exempt from federal income tax, as well as state tax if you live in the state you purchased the bond from. If you purchase a municipal bond with a yield (total return) of 5%, you receive the full 5%. In contrast, if you purchase a corporate bond with a yield of 7% and have a marginal tax rate of 30%, you are essentially getting only 4.9% due to the taxes you have to pay.

In the U.S., the biggest issuer of bonds is the federal government. Most federal bonds are issued by the Department of the Treasury. Typically, you do not have to pay state taxes on interest received from federal bonds. However, you do have to pay federal taxes. (One exception: you do not have to pay federal taxes on U.S. Series EE or I savings bonds if the funds are used to pay for college tuition or fees.) A nice feature of federal bonds is that you do not need a fortune to purchase them: most types can be bought for as little as \$25-\$100.

Treasury bonds can be purchased online at www.treasurydirect.gov. You may be able to purchase municipal bonds directly from the government or agency offering them. Bonds can also be purchased from investment firms, bond brokers, and many credit unions and banks.

Keep in mind that tax-free bonds don't always provide the best deal. If the yield on the corporate bond mentioned above was 8% instead of 7%, it would provide an after-tax yield of 5.6%, a better deal than a municipal bond at 5%. Generally, the higher your income, the more advantageous tax-free bonds are. You may want to consult with a financial advisor about what would be best for you.

Stocks

There are no tax-exempt stocks, but you can lower your tax burden by making sure you do not sell your stocks too quickly. Profits made from stocks held less than a year are considered short-term gains and are taxed at the regular rate that your income is taxed at. Profits made from stocks held more than a year are considered long-term gains and are taxed at the capital gains tax rate (on the federal level). For people in the 10% and 15% tax bracket, the capital gains tax rate is 0%. For people in the 25% tax bracket and above, the capital gains tax rate is 15%, a difference of at least 10 percentage points.

Homeownership

If you are currently renting, have you thought about buying a home? A house is not just a place to live but also an investment. Over the long term, the values of most houses increase. You can deduct several expenses associated with homeownership on your tax return, such as mortgage interest and property taxes. Furthermore, when you sell the house, you are exempt from paying taxes on up to \$250,000 (\$500,000 for married couples filing jointly) of the profits from the sale, as long as the home had been your primary residence for at least two of the five years prior to the sale. So if you buy a house today for \$200,000, live there, and sell it five years from now for \$300,000, your \$100,000 in profit would be completely tax free! Of course, purchasing a \$200,000 house is a much bigger commitment than purchasing a \$50 bond and is something that should only be done if you can afford the mortgage payments and other responsibilities of homeownership.

Most tax-advantaged vehicles have restrictions on how much you can contribute/purchase annually, and you may not qualify if your income is above a certain amount. Visit the IRS's website at www.irs.gov for more information or consult with a qualified tax advisor.

Chapter 5: Tax Fraud

Remember, smart tax planning involves engaging in legal methods to lower your tax burden. Engaging in illegal methods to lower your tax burden is tax fraud. Unless you want to risk legal action, including fines and jail, you should always do the following:

Report All Income

If you work for a company, they automatically report your income to the IRS. But what if you are self-employed or earning money on the side? It is tempting to underreport your income or just leave it off your tax return, but you should resist the temptation. If you are audited, the IRS may look at your checking and saving account statements and ask you to account for all of your deposits. Why risk getting caught to save a few dollars? This doesn't mean you have to report the \$10 your elderly neighbor gave you for shoveling her driveway, but don't hide the \$200 a month you earn tutoring. If you are not sure if certain income has to be reported, check the IRS's website (www.irs.gov) or consult with a qualified tax professional.

Claim Appropriate Number of Exemptions and Amount for Deductions and Credits

Many people joke about claiming their pet as a dependent. Few actually try, but some do inflate the amount they spent on such things as medical expenses and charitable donations to increase their deductions or credits. Remember, if you get audited, you will have to provide receipts to prove your expenses are what you said they were. Even if you legitimately had an expense and aren't making it up, you want to make sure you have proof. Take the time throughout the year to collect and save receipts for all of your tax-related expenses.

File a Tax Return (If Required to Do So)

The IRS does not require everyone to file a tax return, but if you are required to file, it is a crime not to do so. There are some so-called tax experts that claim there is no law that requires you to file and pay income taxes. Don't listen to them. Individuals using this argument have continuously lost in court. What if you owe taxes but don't have the funds to pay them? You should still file and contact the IRS (1-800-829-1040) to see if you can work out a payment agreement.

As the old saying goes, there are two things certain in life: death and taxes. You may not be able to avoid taxes, but there are certainly many things you can do to lower the amount you have to pay.