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TAX REDUCTION STRATEGIES

Quick Guide

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Table of Contents

Deferring Income.. 1
Maximizing Itemized Deductions... 1
Flexible Spending Accounts 1
Tax Credits... 1
Earned Income Credit ………………………………………………….. 2
Saver's Credit ………………………………………………………… 2
Education Tax Incentives... 3
American Opportunity Tax Credit (AOTC)………………………...…… 3
Lifetime Learning Credit (LLC) …………………………………………… 3
Tax-Exempt Investing.. 3
Business Owner Tax Considerations 4
Withholding and Estimated Taxes.. 4
Capital Gains and Losses... 4

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 17 cents per mile in 2017 (19 cents in 2016), 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 2017 same in 2016) 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.

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:** The Earned Income Tax Credit (EIC or EITC) is a refundable tax credit for low- and moderate-income workers. The amount depends on income and number of children. People without kids can qualify. For 2020, the earned income credit ranges from $538 to $6,660.
- Here are some quick facts about the Earned Income Tax Credit (EITC or EIC):
- For the 2020 tax year, the earned income credit ranges from $538 to $6,660 depending on your filing status and how many children you have.
- You don't have to have a child in order to claim the earned income credit.
- The earned income tax credit doesn't just cut the amount of tax you owe — the EIC could also score you a refund, and in some cases a refund that's more than what you actually paid in taxes.

2020 Earned Income Tax Credit
(for taxes due in April 2021)

Number of children	Maximum earned income tax credit	Max earnings, single or head of household filers	Max earnings, joint filers
0	$538	$15,820	$21,710
1	$3,584	$41,756	$47,646
2	$5,920	$47,440	$53,330
3 or more	$6,660	$50,954	$56,844

2019 Earned Income Tax Credit

Number of children	Maximum earned income tax credit	Max earnings, single or head of household filers	Max earnings, joint filers
0	$529	$15,570	$21,370
1	$3,526	$41,094	$46,884
2	$5,828	$46,703	$52,493
3 or more	$6,557	$50,162	$55,952

Both your earned income and your adjusted gross income each have to be below the levels in the table. In general, the less you earn, the larger the earned income credit.
Your earned income usually includes job wages, salary, tips and other taxable pay you get from your employer. Your adjusted gross income is your earned income minus certain deductions.

- **Saver's Credit:** The federal government created the Saver's Credit (originally the Retirement Savings Contributions Credit) in the early 2000s. It's already possible to deduct contributions that you make to a traditional IRA, but this credit provides even greater incentive. In particular, it is designed to help low- and moderate-income individuals save for retirement.
- You're eligible for the saver's credit if you are 18 or older, not a full-time student and not claimed as a dependent on another person's tax return.
- You must also make a retirement plan or IRA account contribution, and fall under maximum adjusted gross income caps the IRS sets each year.
- If your adjusted gross income is above any of these thresholds in 2019, you aren't eligible for the saver's credit:
- • $64,000 as a married joint filer
- • $48,000 as a head of household filer
- • $32,000 as any other filing status
- The income thresholds for the credit change each year to keep pace with inflation. You can find the income limits for the current tax year in the table below.

2020 SAVER'S CREDIT INCOME LIMITS			
Credit Amount	Single	Head of Household	Joint Filers
50% of contribution	AGI of $19,500 or less	AGI of $29,250 or less	AGI of $39,000 or less
20% of contribution	$19,501 – $21,250	$29,251 – $31,875	$39,001 – $42,500
10% of contribution	$21,251 – $32,500	$31,876 – $48,750	$42,501 – $65,000
0% of contribution	more than $32,500	more than $48,750	more than $65,000

Calculating the value of the saver's credit

Unlike many IRS rules, the math here is fairly simple: The credit is worth 50%, 20% or 10% of a maximum contribution of $2,000 (or a total of $4,000 if you're married filing jointly).

Let's say you earn $19,000 as a single filer, and you contribute $1,000 to an eligible account. The value of your saver's credit would be $500. If you managed to contribute $5,000 to an eligible account, your credit would be worth $1,000, due to the cap.

If your contribution was made to a traditional IRA, 401(k) or other account that offers a tax deduction for contributions, your taxable income would also be reduced by the amount of your contribution

Education Tax Incentives

If you paid for education expenses in the last year, you may be able to save money on your taxes by claiming the American Opportunity Tax Credit (AOTC) or Lifetime Learning Credit (LLC). The American opportunity credit is generally the most valuable, if you qualify.

You can claim these education tax credits and deductions even if you paid with a student loan. Parents can take advantage, too, so long as they don't choose a married filing separately status. Here's what to know about each option.

American Opportunity Tax Credit (AOTC)

The American Opportunity Tax Credit (AOTC) allows taxpayers to save money on their taxes if they paid higher education expenses for themselves, a spouse, or a dependent. The credit is worth up to $2,500 per student but only for their first four years of higher education. If you paid education expenses for multiple people, such as for two dependents, you can deduct up to $2,500 for each person. Your exact credit amount is calculated as the 100% of your first $2,000 of qualified expenses, and then 25% of your next $2,000 of eligible expenses. You need to have at least $4,000 of expenses per person in order to qualify for the maximum credit.

Qualifying expenses include tuition, fees you are required to pay in order to enroll in a course or program, books and classroom supplies and equipment.

Only a student's first four years of higher education are eligible for the AOTC. This is typically just enough for an undergraduate degree and so graduate students don't qualify unless their undergraduate degree took fewer than four years to complete. You don't need to complete all four years consecutively, but a taxpayer can only claim the credit on four separate income tax returns. (The four-year limit includes any years you claimed the Hope credit, a previous version of the AOTC)

2020 AOTC income limits

FILING STATUS	MAXIMUM INCOME FOR FULL CREDIT	MAXIMUM INCOME FOR PARTIAL CREDIT
Single	$80,000	$90,000
Head of household	$80,000	$90,000
Married, filing jointly	$160,000	$180,000
Married, filing separately	$80,000	$90,000
Qualified widow(er)	$80,000	$90,000

Lifetime Learning Credit (LLC)
The lifetime learning credit, or LLC, is a tax break for taxpayers with education expenses during the year. This mostly covers tuition but includes other fees and costs you have to pay in order to enroll in a class or program, as long as you pay those costs directly to the school or program administrator.
Unlike other education tax credits, the LLC covers the cost of classes that help you to improve your job skills or learn new job skills. You do not need to be in a degree program to claim the LLC. However, most accredited postsecondary institutions do qualify. The lifetime learning credit also **covers your expenses** for career development classes and other classes to learn or improve your job skills.
The lifetime learning credit is worth a maximum of $2,000 per tax return but you need to have at least $10,000 of expenses to be eligible for the full deduction ($20,000 if you file a joint tax return). You also need to fall within the income limits to claim this credit. For 2020, your income must be $69,000 or less ($138,000 for joint filers) to claim even a partial credit, up from $68,000 ($136,000 for joint filers) in 2019.
Qualifying expenses include tuition and fees you are required to pay in order to enroll in a course or program.
Your exact credit is calculated as 20% of your first $10,000 of qualified education expenses, which means you need to spend at least $10,000 ($20,000 for joint filers) on eligible expenses in order to get the full LLC.
The lifetime learning credit is not a refundable tax credit. So if the credit brings the amount of tax you owe for the year below $0, you will not get a refund for the excess credit. For example, if you owe $1,000 of income tax for the year and then you qualify for a $1,500 credit, you simply owe nothing and will not get a refund for the extra $500**.**

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:

1. Due to lower yields, you generally have to be in one of the higher marginal federal income tax brackets for municipals to make sense.

2. Don't invest in tax-exempt municipals within a tax-deferred retirement plan. The money in your retirement account is already tax-advantaged.

3. Occasionally, municipal funds declare a capital gain, which will be taxable.

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 dependents during the tax year if they choose to itemize deductions. 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 2020, the tax rate is 15.3% (same in 2019) on the first $137,700 ($132,900 in 2019) of combined wages, tips, and net earnings, and 2.9% on earnings above this limit.*

Since you're paying both portions (for employer and employee) of Social Security and Medicare, the rate breaks down as follows:
• The employee's portion of the Social Security tax, which is 6.2% of the first $137,700 of net income
• The employer's portion of the Social Security tax, which is 6.2% of the first $137,700 of net income
• The employee's portion of the Medicare tax, which is 1.45% of all net income (no cap or limit on net income)
• The employer's portion of the Medicare tax, which is 1.45% of all net income (no cap or limit on net income)

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 carry-forward 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 carry-forward 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 carry-forward), 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.