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How to Reduce Your Federal Income Taxes.

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Putting politics aside, let's actually focus on what is important: How to reduce your Federal income taxes.

Last week I was at a Bat Mitzvah talking to a doctor friend of mine. He started talking about how upset he was about the political risk, who the new Supreme Court Judges were, who would be in congress and much more.

He was upset about some of the State Amendments on the ballot. He went on for about 10 minutes and when he reached a breath, I looked at him and said 'how about taxes?' This stopped him cold.

He looked at me, took a deep breath and said now that's what I'm really upset about and he shared with me the following: Currently his Federal income tax rate is over 40%. That means he's at the highest Federal income tax rate. He lives in Florida and he works in Florida, so he is not subject to State income tax but he is subject to Federal income tax.

Here in Florida we have a high property tax rates, which makes up for the lack of State income tax. Our sales tax rate is not currently as high as other States but it potentially could go up. He asked me, how can I reduce my taxes?

Now we were at a social setting, so we didn't really talk too long about how he actually could reduce his taxes because I didn't want his personal information out there. If he was a client I would have normally invited him to my office for a conversation; however, I did share some basic understanding of how clients have been able to reduce Federal income taxes.

In order to make an improvement, you need to measure what your federal income tax rate is. You need to take a look at your IRS Form 1040 which is your Federal income tax return on page two.

Look at the amount of total taxes due which is about 2/3 of the way down on the second page (Line 63) of your tax return and divide it by the top line on page 2 (line 38) which is your adjusted gross income.

So for example if your total tax is 18,310 (line 63) and your adjusted gross income (line 38) if 100,000 then your tax rate is 18.31%. Once you figure out that rate, you know where you're starting from.

Then you have to ask yourself the following questions:

1. Do I itemize? Do I have enough expenses to itemize? If I do not have enough expenses to itemize, maybe I should not be paying those expenses now for this year and defer them to next year. For example, here in Florida we have a very high property tax amount. Traditionally you can deduct Property taxes for Federal income taxes as an itemized deduction. In Florida you can actually bunch your State property taxes or your property expenses in two years. Pay one early. That way you can have twice of a deduction and this might help

you itemize rather than just take the standard deduction.Another thing to look for itemized deductions is contributions to charities. Are you contributing enough to charity? Do you keep records of that amount? Have you given things to Goodwill? Did you keep receipts? What about expenses such as uniforms for work Can you deduct them?

2. Another thing to look for is to make sure that all your expenses that you pay for are deductible. For example, as a fiduciary I charge a fee. My fee is deductible. It is called an expense for money management. Mutual fund fees are not deductible. As the world turns away from mutual funds and the Department of Labor forces, the retail advisors move away from mutual funds, we'll find more and more people actually being able to finally deduct their expenses for their management fees.

3. Do you have a pension plan? Do you have a 401(k) plan? Are you max funding it? Always contribute up to the amount that the employer matches. This is essentially 'free money.' If you like the investment choices among the plan, contribute more. If you don't, then don't do it. Don't ever let the tax tail wag the investment dog. If you don't have good choices, you could actually lose more than you make up for the gain or deferring the taxes. Another thing to look for is if you own your own business, look to enhance your plan. Some of our clients have started to set up a Cash Balance Plan (also known as a Defined Benefit Plan). These types of plans allow you to deduct more than the normal amount into a 401(k) plan. Some clients place $100,000 per year into these plans. If your spouse is not working, he/she normally still could contribute to an IRA. Depending on his/her age he/she might be able to contribute more to an IRA.

4. The next item is mortgage expense. A lot of us try to get mortgages that have the least amount of interest rate. Sometimes it's good. Sometimes it's bad. Usually mortgage interest are deductible; however, sometimes because we have such high levels of income, our mortgage rate gets converted and gets taxed under a different federal income tax system called alternative minimum tax. This could reduce the amount of deduction for a mortgage interest. Even if you are reducing your mortgage rate it may not be meaningful because of the lack of deductibility. Before you make decisions of getting another mortgage, reducing a mortgage or refinancing a mortgage, figure out what the tax differential for each of the two mortgages are. Sometimes there's no advantage or very little advantage from moving from one mortgage to another.

Now these are some of the bigger items that we see for tax planning. Probably one of the most important and overlooked items are what we call tax loss harvesting.

Tax loss harvesting is a way of going through each of your accounts that are not retirement accounts, so these are either individually owned accounts, trust owned, or jointly owned accounts. Looking through each of the securities, bonds, mutual funds, ishares, or whatever they're invested in and finding each item that have a loss.

These are the securities, bonds, etc that have lost money, but have not yet been sold. Go through each one and see if it makes sense to sell them. That way before the end of the year, you can capture the loss and maybe it'll reduce your overall tax bite, by either reducing your long-term capital gains or offset some of your short-term capital gains.

Filing Taxes and Tax FormsRemember there's something called the wash sale rule. This requires that you are not allowed to buy back the same security within 31 days before or after you sell it otherwise you cannot get the capital loss. This trimming or selling of the losers every year has been found to increase your overall return on average 1% per year.

In low interest rate environments, 1% is a lot of money. When you sit down with your financial advisor and review your investments, ask the question what does it look every year when we review and we do the tax loss harvesting.

There's a lot of ways of saving money for taxes, unfortunately the Government is constantly trying to close the loop holes. It is our job as advocates for ourselves to make sure that we are paying the least amount legally of taxes working well within the rules to make it so that our overall financial status is constantly improved.

Remember, plan today… protect tomorrow.

Until Next Time,

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