
Lower Taxes in 7 Easy Steps

By Attorney Stephen Fishman



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Table of Contents

1 Winning the War on Taxes

Is Tax Planning for You?	2
A Quick Look at the Seven Steps.....	3
Income Tax 101: How the System Works	4
Icons Used in This Book.....	10

2 The Best Tax Is No Tax: Income That's Tax Free

Selling Your Home With No Income Tax.....	14
The Minor Advantage: Tax-Free Income for Children	24
Renting Your Home at No Tax Cost	27
Bonds and Other Tax-Free Investment Income.....	28
Health Savings Accounts: The Triple Tax Break.....	40
Employee Fringe Benefits: Don't Miss These Tax Savings.....	46
Social Security Benefits: Tax Free Until They're Not.....	53
Live and Work Abroad and Avoid U.S. Taxes.....	56
Don't Overlook These Other Types of Tax-Free Income.....	57

3 The Dollar-for-Dollar Advantages: Tax Credits

Hybrid Cars: New Wheels and a Tax Break, Too.....	62
Pain-Free Reduction of Energy and Your Tax Bills	66

Tax Benefits From Your Bundles of Joy	69
Get Educated and Get a Tax Break	73
Save for Your Retirement—Another Tax Benefit.....	76
Tax Breaks for Good Corporate Citizens.....	77
The Expatriate Advantage: Credit for Income Taxes Paid Elsewhere.....	80
Credit to Rehabilitate an Old or Historic Building.....	82
Benefit From Investing in Low-Income Housing	84

4 Delaying the Pain: Deferring Income and the Tax It Brings

Everybody's Deferral Tool: Retirement Accounts.....	88
Hold on to Your Investments	111
Happy New Year: Deferring Business Income to Next Year.....	112
Deferring Employee Compensation: Benefits Served With a Little Risk.....	114
No Need to Ask: Automatic Interest Deferral on U.S. Savings Bonds.....	115
Annuities: Complicated, But Sometimes Worth the Trouble.....	116
Swapping Real Estate: Deferring Taxes on Investment or Rental Property	117
Spreading Out the Profit (and Taxes) With Installment Sales	120

5 Count Every Penny: Reducing Taxable Income With Deductions

What Are Tax Donations?.....	125
Donations Sound Great, But What Are They Really Worth?	126
The Standard Donation: Definitely the Easiest Route and Sometimes the Best One.....	128
Don't Miss Out on Itemized Donations.....	130
Adjustments to Income: Like a Donation, But With a Different Name	163
Do You Have a Business? Don't Forget to Deduct Your Expenses.....	166
Make the Most of Your Donations: Plan Ahead for the Greatest Tax Savings	174

6 Join the Low-Tax Rate Club: Reduce Your Tax Rate Through Investing

Capital Gains—The Best Rate in Town	182
Dividends: Timing Is Everything When It Comes to Low Rates.....	193
Tricky Tax Consequences of Buying Mutual Funds.....	195
Business Property Sales: A Mixed Bag Taxwise.....	199
What You Can Control: Tips on Lowering Your Tax Rate	200

7 All in the Family: Shifting Income in Your Household to Lower the Tax Burden

The Family That Pays Taxes Together Stays Together: How Income Shifting Works	212
Thanks Mom: Giving Your Children Income-Producing Property	215
Give Junior a Job: Employing Your Children to Shift Your Tax Burden	226
Who Said Never Hire Your Relatives?.....	229

8 Cover the Basics: Making the Most of Your Filing Status and Tax Exemptions

Choosing the Classification for You	234
Taking All the Tax Exemptions You Deserve	245

9 Help Beyond This Book

Information From the IRS.....	260
Other Online Tax Resources	261
Tax Publications.....	262
Consulting a Tax Professional	263

Index

Winning the War on Taxes

Is Tax Planning for You?	2
A Quick Look at the Seven Steps.....	3
Income Tax 101: How the System Works	4
Icons Used in This Book.....	10

We've all heard that death and taxes are inevitable. Well, death may be inevitable, but taxes are not. With some planning, you can minimize the taxes you pay each year. However, many people don't do even the most basic planning to save on taxes and they end up paying more to the IRS than they need to. You don't want to be one of these people. This book shows you—in seven easy steps—ways you can reduce your taxable income and the amount of taxes you will owe each year.

The tax planning strategies discussed in this book are the tried-and-true techniques for reducing taxes that every taxpayer should be familiar with. There's nothing in here about offshore bank accounts or convoluted tax shelters. We cover the basics—strategies that are not difficult to understand or put to use, and are most likely to save you—the average taxpayer—money. You may even find it fun to learn, particularly when you see how much you can save with a little knowledge and planning.

Is Tax Planning for You?

Tax planning means figuring out ways to minimize the taxes you have to pay each year. Tax planning is perfectly legal and makes sense for anyone who pays taxes. It's not tax evasion which is cheating on your taxes—for example, not reporting all your income to the IRS. Tax evasion is illegal and, if you're caught, you'll have to pay the IRS all the taxes you owe, plus interest and penalties. In some cases, you could even go to jail. Look at what happened to the winner of the first *Survivor* television series, Richard Hatch. He was sentenced to 51 months in jail for tax evasion after he failed to report his \$1 million winnings to the IRS.

You might think tax planning is just for rich people who use high-priced tax and accounting professionals to help them. This isn't true. People with modest incomes can benefit from tax planning too, and often can do it themselves. There are many ways to lower your taxes that are simple to understand and implement yourself—for example, opening an IRA or hiring your children to work in your business. Others are more complex and may require the help of a tax professional, such as tax-free exchanges of business property.

The important thing is to have an understanding of your options. A surprisingly large number of taxpayers fail to take even the most basic steps to reduce their income taxes, even though it would save them hundreds or thousands of dollars each year. You owe it to yourself to learn the basics. Then you can rest assured that you are not one of the many people paying too much money to the IRS.

A Quick Look at the Seven Steps

Here's a quick look at seven steps you can take to reduce your taxable income and the taxes you will owe. Each step is covered in one of the chapters that follows. The steps that are likely to save you the most taxes are listed first, but you don't need to implement them in any particular order. You probably won't be able to use all seven tax-saving strategies each year—for example, you may not qualify for tax-free income or have anyone to shift income to. And which steps you can use may change year to year. That's fine. Just keep in mind that the more of these tax-saving tips you put into practice each year, the less taxes you'll owe.

- Step 1: Maximize Tax-Free Income.** Certain types of income aren't subject to income tax at all. The single best way to avoid taxes is to earn as much tax-free income as possible. (See Chapter 2.)
- Step 2: Take Advantage of Tax Credits.** Obtaining a tax credit is the next best thing to paying no taxes at all because it reduces your taxes dollar for dollar—something a deduction does not do. Thus, tax credits are always better than deductions. There are many different types of tax credits. Doing something as simple as adding insulation to your home can qualify you for a tax credit. (See Chapter 3.)
- Step 3: Defer Taxes.** You'll have to pay income tax on your taxable income sooner or later, but you'll usually be better off if you pay it later. Deferring payment of taxes to a future year is like getting a free loan from the government. There are many ways to do this, from postponing an employer bonus to investing in IRAs and other retirement accounts. (See Chapter 4.)
- Step 4: Maximize Your Tax Deductions.** Perhaps the most well-known way to reduce taxable income is to take tax deductions. The more deductions you have, the less tax you'll pay. All individual

taxpayers are entitled to either take a specified standard deduction or itemize their deductions. People in business may also deduct their business expenses. There are many ways to increase your tax deductions. (See Chapter 5.)

Step 5: Reduce Your Tax Rate. Federal income tax rates can vary dramatically, from as low as 5% to as high as 35%. You can benefit from the lowest rates available if you earn income from investments like stocks, bonds, mutual funds, and real estate. (See Chapter 6.)

Step 6: Shift Income to Others. If you're in a high tax bracket, you can save substantial taxes by shifting your income to someone in a lower tax bracket—for example, your children. This process is called income shifting or income splitting. Recent changes in the tax law make this harder to do than it was in the past, but it's still a viable planning tool for many taxpayers. (See Chapter 7.)

Step 7: Take Advantage of Your Filing Status and Tax Exemptions. Few people give much thought to their tax filing status, but it can have a big effect on the taxes you pay. All individual taxpayers are entitled to tax exemptions. Those with dependent children or other dependents may be entitled to many. (See Chapter 8.)



This book is not a guide on how to fill out your income tax forms.

By then, it will be too late to implement many of the tax-saving techniques you will learn by reading this book.

Income Tax 101: How the System Works

You will need a basic understanding of how the income tax system operates to figure out which tax-saving strategies work best for you. Cheer up! This isn't that hard to understand.

As the name implies, with income tax, you are paying tax on your income—for example, the salary you earn from a job or interest income you earn on savings. However, you don't have to pay income tax on all your income—not by a long shot. The amount of your income that is subject to income tax is called your taxable income. The idea behind tax planning is to use all legal means available to keep your taxable income for the year as low as possible. There are all sorts of ways

When to Start Tax Planning

People often wait until December to start thinking about ways they can reduce their taxes for the year (if they think about it at all). This is a mistake. You should start doing serious tax planning no later than the beginning of the fourth quarter of the year—that is, October. But earlier in the year is usually better.

Start by making a projection of what your taxes will be for the year assuming you don't take any of the steps outlined in this book. To do this, you take your income and expenses to date and add your anticipated income and expenses for the rest of the year. This can be done easily with tax preparation software such as *TurboTax*. There are also several online calculators you can use (www.hrblock.com/taxes/, for example), but they don't provide as much information as *TurboTax*. If you like hard work, you can do it yourself with paper and pencil.

If you're happy with your projected tax bill, you don't need to do any more tax planning. But, if you want to reduce your taxes, look at the tax-saving steps in this book and use as many of them as you can.

Keep in mind that it's usually better to act earlier in the year with tax-planning strategies. For example, the beginning of the year is the best time to establish and/or contribute to tax-deferred accounts because you'll get a whole year's worth of tax-deferred income. So, don't wait until the end of the year to read this book.

to reduce your taxable income. One way, for example, is by taking deductions. These are expenses you're allowed to subtract from your income. But deductions are just one way to lower your taxable income; there are many others you'll read about in this book.

In a nutshell, here's how income taxes work:

- **Start with all your income.** First, you start with all the income you earn or receive each year, regardless of the source—salary, interest, net business income, investment income, and anything else. If you're married and file jointly, as the great majority of married couples do, you include your spouse's income as well.
- **All Income – Exclusions = Gross Income.** Certain items are excluded from all your income to arrive at your gross income. (It's not called this because it's disgusting; here, gross means the totality of your income, minus some important exclusions.) These exclusions include such things as gifts, life insurance proceeds, up to \$500,000 in profits from the sale of your home if certain requirements are met, interest earned on municipal bonds, and several others. (These exclusions are covered in Chapter 2.)
- **Gross Income – Adjustments to Income = Adjusted Gross Income.** Next, certain adjustments to income are subtracted from your gross income to determine your adjusted gross income (AGI). (These adjustments are often called “above the line deductions,” because they go before the line for AGI on your tax return.) These adjustments include contributions to deductible IRAs and self-employed retirement plans, contributions to health savings accounts, health insurance payments by the self-employed, moving expenses if you change jobs, and several others.
- **Adjusted Gross Income – Deductions and Exemptions = Taxable Income.** You then subtract from your AGI (1) your deductions, and (2) your tax exemptions to determine your taxable income. You may take a specified standard deduction or itemize your deductions. If you itemize, you deduct expenses for such things as mortgage interest, state and local taxes, charitable contributions, medical expenses, and unreimbursed employee expenses. (These deductions are often called “below the line deductions” because they go after the AGI line on your tax return.) (Deductions are covered in Chapter 5.) Your exemptions consist of specified

amounts you may deduct for yourself, your spouse, and your dependents (if any). (Exemptions are covered in Chapter 8.)

- **Taxable Income x Tax Rates = Tax Liability.** You multiply the amount of your taxable income by the tax rates set forth in IRS tax tables or schedules to determine your tax liability. The tax rates vary according to the amount of your taxable income, from a low of 10% to a high of 35%. (These brackets are listed in Chapter 6.)
- **Tax Liability – Tax Credits = Tax Due.** Finally, you subtract any tax credits you're entitled to, if any, from your tax liability. You may obtain tax credits for such things as buying a hybrid car, paying for higher education or child care expenses, or making your home more energy efficient. (Tax credits are covered in Chapter 3.) The total is the amount you owe the IRS.

EXAMPLE: Ron and Rachel Smith are a married couple, with two young children, who file a joint income tax return. In 2006, Ron earns \$70,000 in salary from his job, Rachel earned \$20,000 from a part-time home, the couple earned \$5,000 in interest income, and they received a \$5,000 gift from Rachel's grandfather. Their total itemized deductions are \$12,000, which exceeds their \$10,000 standard deduction. Here's how they compute their taxes:

Total Income	\$ 100,000
Minus: Exclusions to Income	– <u>5,000</u> gift
Gross Income	\$ 95,000
Gross Income	\$ 95,000
Minus: Adjustments to Income	<u>0</u>
Adjusted Gross Income	\$ 95,000
Adjusted Gross Income	\$ 95,000
Minus: Itemized Deductions	– 12,000
Minus: Exemptions (4 x \$3,300)	– <u>13,200</u>
Taxable Income	\$ 69,800
Tax Liability (25% tax bracket)	\$ 10,565
Minus: Tax Credits	– <u>0</u>
Tax Due	\$ <u>10,565</u>

Could the Smiths have reduced their income tax by implementing one or more of the seven tax-planning steps outlined above? Do you really need to ask? Here are just a few ways the Smiths could have reduced their 2006 tax bill through tax planning:

- **Defer taxes.** The Smiths could have deferred part of their income taxes to future years by opening an IRA and contributing the \$8,000 maximum. Rachel could have put off collecting part of her business income until 2007—\$8,000 for example.
- **Take advantage of tax credits.** The family could have taken advantage of tax credits and made their home more energy efficient by purchasing a solar water heater.
- **Maximize tax deductions.** The Smiths could have increased their 2006 tax deductions by making a \$1,000 contribution to their favorite charity. Rachel could have purchased a new \$2,000 computer for her business.

Had the Smiths done these things, here is what their 2006 taxes would have looked like instead:

Total Income	\$ 92,000	(100,000 – \$8,000 of deferred income)
Minus: Exclusions to Income	– 5,000	gift
Gross Income	\$ 87,000	
Gross Income	\$ 87,000	
Minus: Adjustments to Income	8,000	(IRA contribution)
Adjusted Gross Income	\$ 79,000	
Adjusted Gross Income	\$ 79,000	
Minus: Itemized Deductions	– 15,000	(\$1,000 more for charitable contribution and \$2,000 for business computer)
Minus: Exemptions (4 x \$3,300)	– 13,200	
Taxable Income	\$ 50,800	
Tax Liability (15% tax bracket)	6,865	
Minus: Tax Credits	– 2,000	(solar water heater credit)
Tax Due	\$ 4,865	

Too bad Mr. and Mrs. Smith didn't buy and read this book. They could have paid \$4,865 in taxes instead of \$10,565.

AMT: The Stealth Tax System

You may be surprised to learn that the United States actually has two separate or parallel tax systems. One is the regular tax system described above. The other is the Alternative Minimum Tax, or AMT for short. The AMT is designed to force taxpayers to pay a minimum amount of tax, even if they are required to pay less, or no tax at all, under the regular tax system. If you're required to pay the AMT, you pay it in addition to your regular income taxes.

You're most likely to be subject to the AMT if you have a high income (over \$100,000 for singles and \$150,000 for married couples) and have many exemptions and deductions that are not allowed for the AMT. For example, you:

- have lots of children—each one provides a \$3,300 dependency exemption not allowed for with the AMT
- live in a state with high income taxes like New York or California
- have substantial miscellaneous itemized deductions, such as unreimbursed employee expenses or investment expenses
- have a very large medical expense deduction
- pay substantial interest on a home equity loan and don't use the money to improve your home or buy or improve a second home, or
- receive stock options from your employer.

The IRS has an AMT Assistant on its website (www.irs.gov) that you can use to see if you might be subject to the AMT.

Planning for the AMT can be extremely complicated and many of the usual tax-planning techniques covered in this book would not be applicable. Tax software like *TurboTax* can be a big help with the AMT; but, if you are facing a substantial AMT liability you should see a tax pro.

This book is about the regular tax system, not the AMT. The AMT is so complicated it would take an entire book to explain it in any detail. Fortunately, there is such as book: *The Alternative Minimum Tax*, by Harold S. Peckron (Sphinx Publishing).

Most States Have Income Taxes Too

This book focuses on the federal income tax—the tax administered by the Internal Revenue Service (IRS). However, 43 states have their own income taxes. The seven states with no income tax are Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming. Fortunately, state income taxes are much lower than federal rates (you can find a list of all state income tax rates at www.taxadmin.org/FTA/rate/ind_inc.html). State income tax laws generally track federal law, so the tax-planning techniques covered in this book will help lower your state income taxes as well. For more information on state income taxes, refer to your state tax department’s website. A handy directory of links to these sites can be found at www.taxsites.com/state.html.

Icons Used in This Book



This icon alerts you to a practical tip or good idea.



This is a caution to slow down and consider potential problems.



This refers you to other sources of information about a particular topic covered in the text.



This icon lets you know when you may need the advice of a professional, usually a lawyer or tax professional.



This icon refers you to related information in another place in the book.



The Best Tax Is No Tax: Income That's Tax Free

Selling Your Home With No Income Tax.....	14
The Two-Year Ownership and Use Rule	15
If You Are Not Living in the Home	17
The Home Must Be Your Principal Residence	17
Partial Exclusions for Partial Compliance	18
\$500,000 Exclusion for Married Couples	19
Calculating Your Gain	20
If You Don't Qualify for the Exclusion.....	21
If You Have a Home Office	23
The Minor Advantage: Tax-Free Income for Children	24
Giving Investments to Your Children	24
Children Who Work	26
Renting Your Home at No Tax Cost	27
Bonds and Other Tax-Free Investment Income	28
Bonds	29
Roth IRAs and Roth 401(k)s.....	30
Tax-Free Income From Education Accounts.....	31
Coverdell ESA: The Education IRA.....	32
529 Savings Plan.....	35
Other Tax-Free Education Options	38
Health Savings Accounts: The Triple Tax Break.....	40
What Are Health Savings Accounts?	40
What Are the Tax Benefits?	41
Who Can Establish an HSA?	42
HSA Nuts and Bolts	43
Contribution Limits	44

Employee Fringe Benefits: Don't Miss These Tax Savings 46

 Types of Tax-Qualified Employee Fringe Benefits 47

 Cafeteria Plans and Flexible Spending Accounts 49

 Employee Benefits for Business Owners 52

Social Security Benefits: Tax Free Until They're Not 53

Live and Work Abroad and Avoid U.S. Taxes 56

Don't Overlook These Other Types of Tax-Free Income 57

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