Planning With Your Tax Return

By Claire E. Toth, JD, MLT, CFP™
Vice President and Chief Operating Officer
Point View Wealth Management, Inc.
http://www.ptview.com

Taxes are too high. They're too complicated. The rich don't pay enough. You and I pay too much. Expect the anti-tax rhetoric to heat up along with the presidential race. In the meantime, take out your most recent tax return. It can help you determine why you pay the high taxes you do and what—if any—steps you can take now to minimize that number for 2016. For those who have been on Medicare for more than a few years, reducing Adjusted Gross Income (AGI) may also reduce the growth rate of your future Part B premiums.

Most of the action takes place on page one of your 1040. The key number is your AGI—line 37, at the bottom of the page. That number determines whether you'll pay the Medicare surtax on unearned income ($250,000 for married filing jointly and $200,000 for singles—not subject to inflation) and whether your itemized deductions and personal exemptions will be cut back ($311,300 for married filing jointly and $259,400 for singles—adjusted annually for inflation). Particularly for anyone subject to that cut back, your AGI is key in determining your ultimate tax rate.

Note that AGI is determined without regard to your itemized deductions or your exemptions. Those play an ever-decreasing role in determining your ultimate tax bill. Much of what is on page one applies to specifically targeted groups; this discussion focuses on the more generally applicable portions.

Start with line 7, your W-2 income. The number shown is after your contributions to your 401(k) plan and Flexible Spending Account. The more you contribute to those plans, the more you reduce your taxable income. This year, you can contribute up to $18,000 to your 401(k) ($24,000 if you are at least age 50). You can contribute $2,550 to an FSA. The more you save for yourself, the more you save in taxes.

Next is taxable interest, and this line should be zero. Put taxable fixed income in your retirement accounts, to shield the interest from tax. If you do hold fixed income in a taxable account, it should be tax-exempt bonds.

Most dividends are qualified. Those are taxed at 15 percent (20 percent if you're in the highest tax bracket). Because of the favored tax rate, taxable investment accounts should be tilted toward stocks. Just be aware that significant dividend income can increase the tax rate on other, ordinary income.

If you have recurring tax refunds (line 10), decrease your withholding and direct the increased funds into some savings vehicle. There is no excuse for making interest-free loans to the government.

If you are self-employed, either as your main profession or on the side, you have significant control over your business income (line 12). That number is after expenses, so deduct what you are entitled to. Just be aware that showing multiple loss years can trigger an IRS inquiry into whether the business is real or merely a hobby.

Line 13 is capital gains and losses; ideally that number should be a loss of $3,000. You can balance capital gains each year with capital losses. If you recognize more losses than gains, you can use up to $3,000 of those losses against ordinary income and carry the balance forward indefinitely. Another way to keep gains off line 13 is to make charitable gifts with significantly appreciated stock—you avoid paying capital gains tax on the profits but get to deduct the entire value of your gift. If you do have net capital gains, those are taxed at a maximum rate of 15 percent (20 percent if you are in the highest bracket).

You can also make charitable gifts with IRA distributions (line 15). For those at least aged 70-1/2, you can direct that up to $100,000 of required minimum distribution go directly to a qualified charity. Doing so keeps the distribution off your tax return entirely. That's usually better and never worse than taking the funds into income and reporting a charitable deduction. Check with your tax advisor to see if you're best off making gifts from your IRA or with appreciated securities.

You may or may not be able to control the items on line 17—income flowing through from real estate, partnerships, LLCs, trusts, S corporations, and the like. To the extent you manage any of those entities, you may be able depress taxable income (ideally, without depressing cash flow).

Most investors who receive Social Security benefits are taxed on 85 percent of them. That's the case if your other income (including tax free interest and half of your Social Security benefits) exceeds $44,000 ($34,000 for single taxpayers).

This pretty much gets you to "total income." There are a few—a very few—adjustments that can reduce total income to reach Adjusted Gross Income. After all, not many of us are directly involved in energy production or are performing artists or in the military reserves.

Employees may be able to take advantage of Health Savings Accounts—you can save and deduct as much as $6,750 in an HSA. If you are self-employed, you can deduct half your payroll taxes plus your retirement savings.

That brings us to Adjusted Gross Income. Personal exemptions and itemized deductions key off of that, and as noted above, are reduced if your AGI exceeds the threshold of $311,300 for married filing jointly and $259,400 for singles.

For 2016, the personal exemption is $4,050. For every $2,500 your income exceeds that $311,300 (or $259,400) floor, your exemptions are reduced by two percent. It goes away entirely at $433,800 for married taxpayers and $381,900 for singles.

The most common itemized deductions (home mortgage interest, state taxes, charitable gifts) are also cut back. For every dollar above that AGI threshold, deductions are reduced by three percent of the excess. They are not reduced by more than 80 percent total.

An example may be useful here. Assume a couple with an AGI of $750,000 ($438,700 above the threshold) and itemized deductions of $80,000. Three percent of $438,700 is $13,161, so their deductions are reduced by that amount, to $66,839. Their deductions would never be reduced below $16,000 (an 80 percent maximum reduction).

This cutback does not apply to investment interest expenses (though those can be reduced in other ways), or to medical, gambling, and casualty losses. Those last have very high income thresholds to take in the first place.

Finally, if you are in the top bracket ($466,951 of taxable income for married couples and $415,051 for singles), that 15 percent tax rate on dividends and long-term capital gains is boosted to 20 percent.

The moral of all this? It is difficult to reduce your tax bill, but the biggest steps you can take are those on the front page of your tax return.