DOLLARS & Sense

Family Financial Education Foundation

Edition 9, Volume 12

End of Year Tax Preparation and Considerations

There is not much in life more perplexing than taxes and ever-changing tax laws make filing taxes more daunting than necessary. The entire goal of tax preparation is to create a strategy that minimizes your taxable income and applies as many eligible credits as one can find, so that you pay the least amount of tax necessary.

When creating a profitable strategy, you should be equipped with knowledge, organization and a good tax professional. We recommend starting with a tax file.

Make a tax file.

A tax file is where you house all of your important tax documents, expenses, transactions and notes. It helps you stay organized and methodical in your tax plan. Your tax file can be electronic, such as a folder on your computer desktop, or a physical filing cabinet or bin. Be sure to keep a calendar in your tax file to note important dates and events, such as quarterly estimated tax payments

Some benefits of an electronic file, are that they take up little physical space and can be quickly delivered to your tax professional. They can also be filed and stored effortlessly in case of an audit. When keeping electronic data, be sure to make a backup of all your tax files in a separate place, such as an external hard drive, in case of computer failure. Ideally you should save your records for seven years.

Some documents to include in your tax file are W2, 1099, or K-1 Forms; documentation of property sales, receipts for property tax and vehicle registration fees, and deductible interest forms. Also, include all receipts for tax-deductible items. Don't forget acknowledgement letters or appraisals for donations made to nonprofit organizations. All documents and records that you need to file your taxes and prove your claims should go into your tax file.

Use adjustments to reduce your taxable income.

It's important to understand several terms when discussing taxes. The term "gross income" is the income you make from all sources during the calendar year. The term "adjusted gross income", AGI for short, is the income you make from all sources minus income adjustments. Essentially, income adjustments work like a deduction, except they do not need an itemization. The goal is to reduce your taxable wages in order to lower your tax bill. Two of the most potent ways to adjust your income are:

Funding your retirement

The simplest way to "adjust" or reduce your taxable income is to contribute to a retirement account. There are many different retirement accounts to choose from, but some of the most common ones are

Traditional 401(k): A traditional 401k is a retirement plan that is usually offered by an employer. You make defined contributions using "pretax" dollars, and those contributions are not taxable until withdrawal. Often, employers offer a contribution match, up to a certain percent. If there is a match offer to your contributions, you are essentially turning down free money by not participating. Traditional 401K accounts will give you immediate tax breaks but are subject to your standard taxed rate at withdrawal. There is an annual contribution limit of $17,500 as of 2014.

Traditional IRA: If you are self-employed, the easiest way to immediately lower your tax liability is to open up a

(Continued on page 2)

End of Year Tax Preparation

(Continued from page 1)

traditional IRA (individual retirement account). Because your contributions do not come from a paycheck, they are not technically “pretax” dollars, but they are tax deductible, so you still benefit by reducing your taxable income. There is an annual contribution limit of $5,500 ($6,500 if your 50 or older) as of 2014.

Roth 401(k) and Roth IRA: You do not see an immediate tax break with a Roth account because they are not tax deductible; however they are tax-free when withdrawn at retirement. Essentially, you are getting a tax break at the end instead of in the beginning.

All of these plans provide a tax benefit (immediate or eventual) and will earn compound interest while providing security in retirement. With the unpredictability that surrounds social security, a retirement plan will not only reduce your tax liability but also protect you during your retirement years. Please consult your banking institution or tax professional for more advice on what plan works best for your situation.

Flexible spending account

Flexible spending accounts (FSAs) are a great way to reduce your taxable income and help you prepare for unexpected health care bills. There are two types of flexible spending accounts offered by employers. The HCFSA for healthcare costs and the DCFSA for dependent care costs. With a flexible spending account, first decide the total annual amount you wish to deposit into your FSA account. The total amount is deducted from your paycheck in equal installments throughout the year, using pretax dollars, and deposited into your FSA account.

The advantage of a flexible spending account is that you spend pre-tax dollars, and so pay fewer taxes on your income, and your healthcare expenses are less. Also, the entire amount is immediately available, even before all funds have accrued. Deductibles, co-payments, eye exams, prescription drugs and hearing aids are just a few examples of costs covered under an HCFSA. The drawbacks are that there is a cap on the amount you can contribute as well as a “use it or lose it” policy. Money not used at the end of the year is not refunded. In some companies, you can now carry over up to $500 but the rules vary by employer. If you have an FSA, now is a great time to evaluate your previous years expenses and estimate what you will spend in the new year and adjust your withholding. Also, be sure to use the extra money left in your flexible spending account this year.

If you are self-employed, and have a high deductible health insurance plan that meets IRS guidelines, an HSA (Health Savings Account) is a good option. It is a tax deductible account like an FSA but works quite differently. An HSA is controlled and managed by you, not your employer. The money you deposit can roll over from year to year and earns interest (FSA does not). The drawbacks are that the funds are not immediately available because you cannot spend more than you accrue. If you have a large healthcare cost and not enough money to cover it in your account, it comes out of your pocket. Contact your financial institution of choice for more information on health savings accounts.

Increase your tax deductions

A tax deduction is a monetary amount that reduces taxable income thus reducing the amount a taxpayer owes. There are two types of deductions. The Standard Deduction is a predetermined amount that changes with your filing status and life circumstance. These circumstances include being married, or single and how many children or dependents you may have. For example, the standard 2014 deduction for married couples filing a joint return is $12,400. There are also additional standard deductions considered for age and blindness.

An Itemized Deduction reduces your taxable income like a standard deduction, but it is listed on a Schedule A (Form 1040). Itemizing deductions is particularly useful if you are self-employed or pay large amounts of deductible interest or costs. You cannot use both standard and itemized deductions, you must choose one. Some common itemized deductions are:

Medical and Dental Expenses

If the high cost of medical care has a silver lining, it is that you can use them to offset the taxes you have to pay. If medical and dental expenses paid for yourself, your spouse, and your dependents exceeds 10% of your AGI, you can deduct it from your taxable income. You cannot include amounts paid by a healthcare plan. You can only include expenses paid during the current tax year, regardless of when service was provided.

Eligible deductions can include services for diagnosis, cure, treatment and prevention, as well as medical supplies and transportation. There is an expansive list of eligible medical and dental deductibles available at www.irs.gov.

Other Taxes

Need a good reason not to begrudge your annual motor vehicle registration? Well, look no more. State and Local income tax, real estate tax and property tax are deductible! In order for these taxes to be deductible, they must be an imposed tax, and you must have paid them during the current tax year. Foreign income and real estate tax are also deductible in some cases. Not deductible however are, federal income taxes, social security taxes, homeowner’s association fees, estate and inheritance taxes, or service charges for water, sewer, or trash collection. These lists are not all-inclusive. Please visit www.irs.gov for a complete list.

Some Interests

Home mortgage interest: Any interest you pay on a loan secured by your home (or second home) is considered home mortgage interest. Examples include a mortgage, a second mortgage, and a home equity loan or line of credit. Only main homes and second homes are eligible. You cannot deduct rental payments or interest on rental properties under the home mortgage interest deductible. An acceptable way to increase your tax deduction amount is to prepay your new years mortgage in the current tax year.

Investment interest expenses: As an incentive to invest, federal tax code allows you to deduct investment interest expenses. That means any interest you pay on money borrowed to buy a property that will produce investment income such as, interest, dividends, annuities, or royalties, is tax deductible. Also, any property that will appreciate in value and can sell at a gain may qualify as an investment interest expense.

Charitable Donations: Giving to a qualified charitable organization is a great way to reduce your tax bill while doing some good. Contributions must be paid in cash or other properties before the close of your tax year to be deductible. You should price your donations of non-cash property at fair market value. You must have a bank record, payroll deduction, or a written acknowledgment of donations that equal $250 or more. You are required to get an appraisal when donation value equals $5000 or more. More information on what constitutes as a qualified organization is available in the IRS Publication 526.

Business expenses: When you are self-employed, business deductibles abound. Common write-offs include business use of your home and car as well as work related travel. Accelerating your expenses or delaying your income may be advantageous to you. Making large purchases in December that you need in the new year will move the write-off into the current year. Delaying the submittal of large end of year invoices until the new year can also be an effective technique in lowering your taxable income. There is no "one size fits all" plan. Calculating where you are financially this year, and where you expect to be next year is the only way to determine how to get your business into the lowest possible tax bracket.

Education Expenses: If you, your spouse or your dependent is a student that attends an eligible educational institution, you may qualify for the education expenses deduction. Eligible educational expenses include tuition, school fees and expenses related to enrollment or attendance. You must meet filing status, and income criteria in order to qualify. Contact your tax professional to find out if you qualify for the education expenses deductibles.

To find a complete list of the current standard and itemized deductions, please go to www.irs.gov

Take advantage of tax credits

A tax credit is a monetary amount deducted from the total amount a taxpayer owes. There are two tax credit categories, those for individuals and those for businesses. Some of the most effective and underutilized individual tax credits are:

Earned income tax credit: The EITC tax credit was created to help offset the burden of social security taxes and provide an incentive to work. You must meet certain filing status requirements and income limitations in order to qualify. The income limits often create reluctance to explore this credit, but are not as stringent as most people imagine. Depending on how much you make (up to $52,427) and how many qualifying children you have (up to three), you could be eligible for up to $6,143 in tax credits. The EITC is a refundable tax credit, which means after reducing your taxes to zero it can generate a refund.

Child and dependent care expense credit: If you are working or going to school full-time and pay for childcare for a dependent younger than 13 years old, you may qualify for this tax credit. The total expense that you can claim is $3000 for one qualified individual or $6000 for two. Do not confuse this with a similar sounding childcare tax credit that gives you up to $1000 per qualifying child. See IRS topic 602 for more details on the child and dependent care expense credit.

Savers credit: The Savers Credit is a great way to reduce your tax bill. In addition to the powerful tax benefits already discussed, the saver's tax credit will let you claim 50%, 20% or 10% of your first $2,000 contribution to an eligible retirement account. The percentage allowed depends on your AGI and tax filing status. For 2014, the maximum income for the Savers Tax Credit is $30,000 for single filers, $45,000 for heads of household with income, and $60,000 for those married and filing jointly. The saver's tax credit is a nonrefundable credit, which means it can reduce your taxes to $0, but cannot provide you with a refund.

Small businesses have a unique tax credit pool to help put money back in their pockets. There are tax credits that encourage employee care, environmental responsibility and community investment. Some examples are:

- Small Business Health Care Tax Credit
- Alternative Motor Vehicle Credit
- Credit for Employer-Provided Childcare Facilities and Services
- New Markets Tax Credit

All of these credit examples are just a drop in the bucket of possible credits that are available to you. We recommend you visit www.irs.gov and consult a good tax professional to help you find what credits work best in your situation.

Avoid Penalties

Obviously if we are diligently working to pay fewer taxes, we don't want to

(Continued on page 4)

ARTICLES

TIPS & TRICKS

End of Year Tax Preparation

(Continued from page 3)

lose our money through missed deadlines, penalties, or fees. It is important to protect your hard earned income. Let's look at some ways we can do that.

Make your quarterly tax payments.

If you are self-employed or earn income that does not withhold taxes,

you are expected to make quarterly estimated tax payments to the IRS. It is important to make these payments on time and as accurate as possible, or you may be hit with a penalty, even if you are due a refund when you file your tax return. Catching up on your payments in the fall is better than not paying because the sooner you send the money, the smaller the penalty.

How do you know if you have made enough income to pay quarterly estimated tax? Well, it all depends on how you are going to file. If you are filing as a sole proprietor, partner, S corporation shareholder or a self-employed individual, you should make estimated tax payments if you expect to owe $1,000 or more when filing your return. If you are filing as a corporation, you should make estimated tax payments if you expect to owe $500 or more when filing a return.

In order to figure your estimated tax payments, go to irs.gov and download Form 1040-ES. It would benefit you to have your prior years federal tax return for reference when filling out the form. You will want to estimate as accurately as possible to avoid penalties. When paying estimated taxes, the year is divided up into four payment periods (quarterly), and each period has a specific due date. Quarterly payment due dates are April 15th, June 16th, Sept. 15th and Jan. 15th of the next year.

Apply for a health insurance exemption.

If you did not purchase health insurance this year, you might be facing a tax penalty unless you qualify for an exemption. The types of exemption available will depend on your circumstances. We recommend you go to www.healthcare.gov to see if you are eligible for an exemption. If accepted, you will get an exemption number to use when completing your tax return.

If you are entitled to an Affordable Care Act Subsidy, now is the time to make sure you have not overestimated your income. Otherwise, you may have to pay it back. If your income was less than estimated, you might be entitled to a subsidy via your tax return. You can adjust your circumstances accordingly at the Health Insurance Marketplace.

Avoid early withdrawal from your retirement program.

It is never a good idea to withdraw your retirement fund early. The reasons are numerous; the first being that the money you withdraw becomes taxable income, possibly pushing you into a higher tax bracket. Also, the plan administrator is required to hold 20% of your distribution to pay the IRS and even though you never get that percentage, you still pay taxes on it. Quite often the 20% they keep isn't enough, and you end up paying more at tax time. You are also required to pay your state tax on the entire amount as well as suffering a ten percent early withdrawal penalty.

Taking into account the taxes and penalties of an early withdrawal, often the cost for using that money too soon is well over 50 percent. Yikes! In cases of an emergency, a good alternative would be to borrow against your retirement plan because you get a low-interest rate, and you pay yourself back. A personal loan is also a better solution, and although we don't recommend it, even credit card interest rates are lower than 50 percent.

Tax laws change rapidly, and last years knowledge can quickly turn to disappointment when counting on an expired credit or deduction. It is important to follow current tax law. Talking to your accountant or tax professional is a good idea this time of year, because tax season is not yet upon them. ■

Business Hours!

Monday-Friday: 7:00 a.m.-6:00 p.m.

Saturday: 8:00 a.m.-12:00 noon

Family Financial Education Foundation

ACCESS EDUCATION SYSTEMS
724 Front Street, Suite 340
Evanston, WY 82930
contact: (877) 789-4175
www.ffef.org | info@ffef.org

Disclaimer: The information contained in this newsletter does not constitute legal advice or tax advice. Legal rules and tax rules frequently change; therefore, we cannot guarantee that all information is accurate or up to date. The law varies widely from jurisdiction to jurisdiction, and it is subject to varying interpretation. Legal advice, including tax advice, must always be tailored to your circumstances, and nothing in this newsletter should be viewed as tax advice or used as a substitute for the advice of a legal tax professional.

If you know of someone who would benefit from this information, please pass this newsletter along.

This publication is the property of Family Financial Education Foundation. All rights are reserved. For more information about our services or how we can help you with your debt management program, please contact Family Financial Education Foundation at www.ffef.org.