THE TRUTH ABOUT

PAYING FEWER TAXES

"Save hundreds of thousands of dollars over your lifetime..."

S. Kay Bell

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Introduction

Every year, more than 130 million Americans face one of life's most dreaded tasks: filing their federal income tax returns.

But the truth about taxes is that they are much more than a once-a-year ordeal. They are constant, albeit uninvited, companions in our lives.

Taxes and their real-life effects began on day one, when our delivery room cries signaled a new tax break for our parents. And taxes continue to share our lives as we get and change jobs, start our families, increase our assets, and make plans to help ensure the financial future of our heirs.

At every one of these major milestones, the tax opportunities and pitfalls are myriad and their financial implications are huge. Yet most of us try to deal with taxes as little as possible. Typically, we put off the intimidating and maddening task of tax filing until the last minute. Worse, we put off tax planning completely. The trouble with this all-too-prevalent attitude is that the cost is often literal and large.

But it doesn't have to be that way.

Although our tax laws require that you pay what you owe, they don't demand that you overpay. In fact, the Internal Revenue Code is full of ways to trim your eventual IRS bill. This book will help you realize just how these laws can be used to your maximum tax-saving advantage.

Over the years, I've dealt with taxes from a variety of perspectives. As a taxpayer, I encounter the same frustrations you do each filing season. As a Congressional staff member, I witnessed firsthand the creation of some of these aggravating tax laws. And as a writer who has focused on tax issues on an almost-daily basis for the last decade, I've learned that most of us simply want an understandable way to meet our tax responsibilities.

That's where *The Truth About Paying Fewer Taxes* comes in. This is not a line-by-line, how-to-file-your-return book. Neither is it an all-inclusive look at the Internal Revenue Code. That's a nearly impossible task, because our tax laws now fill around 68,000 pages.

Rather, it's an overview of key tax laws that affect the lives of most of us and the truth about how to make them work in our favor. When you finish reading, you'll be ready to tackle your taxes or discuss them more confidently with your tax adviser, with a solid grasp of what to expect, avoid, and make the most of.

The core of the book is organized around the major life stages that offer many tax obstacles and opportunities: how taxes and tax breaks apply to your family, your career, your home, your investments, and your eventual retirement.

Sandwiching those high points in your life are some universal tax considerations, starting with a look at general filing issues, tips, and ways to reduce your taxable income, and closing with some compliance concerns and a discussion of special tax circumstances.

Regardless of where you are in your personal and tax-paying life, you'll find a chapter or two or more that affects you. Perhaps only one section applies to you now; perhaps you can make use of several. Each section, indeed each of the 52 chapters, is self-contained, so read this book at your own pace, picking and choosing chapters as your circumstances demand.

But don't be afraid to check out those areas in which taxes aren't yet a concern to you. Eventually, they probably will be. And by taking a sneak peek, you'll be prepared when you do embark on a new phase of your life and its tax consequences.

More importantly, with your newfound grasp on the many tax implications at each stage of your life, you'll be able to maximize your tax savings or at least minimize your tax burden.

TRUTH 1

Not everyone has to file

*"I like to pay taxes.
With them I buy civilization."
—Supreme Court Justice
Oliver Wendell Holmes, Jr.*

Taxes are truly one of the most egalitarian of institutions. Young and old, rich and poor, living in the United States or abroad, most Americans must deal with paying what has been described as the price of a civilized society.

But the U.S. tax code's reach, while long, is not absolute. In fact, for some folks, April 15 is just another day because they don't have to worry about filing a return.

How do these lucky individuals get off the tax hook? They don't meet the filing requirements. But arriving at that fortunate tax place requires assessment of three different factors.

Generally, whether the IRS requires a 1040 from you is determined by the following:

1. Your income
2. Your filing status
3. Your age

Income—The primary consideration is how much you make. It is, after all, called an income tax. And after you make a certain amount in a tax year, the IRS wants to know about it via a Form 1040 (or 1040A or 1040EZ).

There is, however, no set dollar amount that initiates the filing requirement. There are several threshold amounts, and the IRS adjusts them each year to account for inflation. That way, you won't find yourself automatically bumped up into a higher tax bracket just because you got a raise. The annual filing requirement amounts are published each year in each of the instruction booklets for Forms 1040, 1040A, and 1040EZ or are available online at IRS.gov.

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But it's not just your salary that counts toward determining the income filing trigger. There are various types of income that, if the total is large enough, trigger the filing requirement.

Gross income is all the compensation you receive. It can be as money, goods, property, and even services. Income from sources outside the United States also must be counted when considering whether you make enough to require a 1040 submission.

Self-employment income, either as your full-time job or a weekend enterprise, also is part of the equation. The trigger for filing in this case is $400. If you are married and live in a community property state, half of any income your state law deems community earnings may be considered yours. This amount affects your federal filing requirement, even if you and your spouse do not file a joint return.

Filing status—In addition to inflation, the income amounts that determine whether you must file also vary depending upon your filing status. You can choose from single, married filing jointly, married filing separately, head of household, and widow or widower with a qualifying child.

In most instances, the required income amount for a single taxpayer is half that of a couple who sends in a joint return.

However, if a husband and wife decide to file separate returns, the income threshold for each is substantially lower. Why isn't it the same as single filers? In part, the tax laws want to reward joint filings because it makes the processing easier. Some tax benefits are not available to "married but separate filers," which makes things more complicated for taxpayers and IRS examiners alike.

A head of household taxpayer is one who is supporting others. Because of that, the income trigger amount for this status is a bit more than for single taxpayers. Similarly, a widow or widow raising at least one dependent child is allowed to earn even a bit more before he or she must submit a return.

Age—Finally, your age can affect whether you must file a return.

Youngsters are not automatically off the tax hook. When a child earns money, he or she must face the same tax consequences as other taxpayers. However, when a child is also the dependent of another taxpayer—that is, he or she can be claimed on another person's tax return for that person to obtain some additional tax benefits—different filing requirements apply.

A dependent filer must take into account both money earned from a job, as well as income from investments. How much income from each of those two sources determines whether the dependent must file his or her own tax return.

While dependents typically are children, a dependent could be an adult relative. And that dependent, regardless of age, much use the formula for determining whether he or she must file.

Older taxpayers, however, do receive some other special consideration when it comes to determining whether they must file. If you are 65 or older, you are able to collect more gross income than other taxpayers before you must file.

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Vision issues also can bump up the amount of money necessary to require filing. This extra income amount is calculated separately and could make a difference as to whether you must file, regardless of your age.

Other considerations—The general tax-filing requirements apply not only to U.S. citizens, whether living in America or abroad, but also to residents of Puerto Rico and resident aliens—that is, persons whose permanent residence is in the United States but who are not citizens.

Even if you don’t have to file, sometimes it literally pays to do so. If you’re due any refund amount or you’re eligible for certain tax credits, submitting the proper paperwork to the IRS is the only way to get that money.

TRUTH 2

Figuring out your filing status

Every taxpayer's situation is unique. But the Internal Revenue Service gives us just five categories, or filing statuses, to choose from when we prepare our returns. They are single, married filling jointly, married filing separately, head of household, or qualifying widow or widower with a dependent child.

Given such limited choices, you would think picking the appropriate one would be a snap. It can be. But some of us need to take a little more time to ensure that we select the appropriate, and most tax-advantageous, status.

Your filing status is based on your marital status on the last day of the tax year. But, as is often the case when it comes to taxes, it's not that cut and dried. Some folks are able to file a couple of ways. Married couples can send in one 1040 or two. And the wrong choice could be quite costly.

Filing status, along with your income and age, helps determine whether you need to file a return at all. It's also a factor in your ability to claim certain tax breaks and determines just how much of a standard deduction you can claim.

Single—Single filing status is available to unmarried individuals. This is taxpayers who have never been married, are divorced, or are legally separated under a divorce or separate maintenance decree.

Remember, the last day of the tax year is the determinant. If you were married from Jan. 1 through Dec. 30, but your divorce is final on Dec. 31, you are considered unmarried for the full year.

Married filing jointly—Similarly, if your wedding was Dec. 31, you are considered married for that tax year and are able to file jointly. But you don't necessarily need a marriage certificate to qualify for this status. In addition to having a formal marriage certificate, the IRS also considers you married for tax purposes if, on the last day of the tax year, you are

Filing status, along with your income and age, helps determine whether you need to file a return at all.

- Living together in a common law marriage recognized by the state in which you live or by the state where the common law marriage began
- Married and living apart, but are not legally separated under your state's law
- Separated under an interlocutory—that is, not final—decree of divorce

In some cases, a marriage certificate is no good when it comes to filing jointly. Although same-sex marriages and civil unions are recognized by some states, federal law explicitly states that for IRS purposes, a marriage means only a legal union between a man and a woman as husband and wife.

If your spouse died before the end of the tax year and you did not remarry, you can still file a joint return for that year. Don't be confused by the qualifying widow/widower status; you'll find more on it in a few paragraphs.

Joint filing is the choice of most couples. Not only is it convenient for both you and your spouse, as well as the IRS, which then has to examine only one return for two people, you could lose some tax breaks if you file a separate return.

A joint return, however, does have some potential drawbacks.

When you and your spouse combine all your personal financial information on one form, you each are responsible for any tax that results, as well as for any possible tax penalty that might come from the combined filing. This shared tax liability applies even if only one spouse earned income.

Married filing separately—Because of potential tax troubles, some couples file separate returns. This is common when marriages are on the rocks or when one spouse suspects the other of using overly aggressive tax techniques.

But there are other, less sinister and potentially tax-cutting reasons to file two 1040s. For example, some tax breaks have limits that are easier for one, rather than two, taxpayers to meet.

Take medical deductions. To be claimed as an itemized deduction, medical expenditures must exceed 7.5 percent of a filer's adjusted gross income. If a couple makes a combined $100,000, this means they must have eligible health-related costs of more than $7,500 to get any tax break. But if the medical costs were primarily for the wife and her income alone was $40,000, her expenses over $3,000 would be deductible.

The goal is to use the filing status that produces the lowest combined tax.

Head of household—This filing status is a great benefit for single people with dependents.

When you provide more than half the cost of keeping up a home for yourself and a qualifying person who lived with you for more than six months, head of household status will get you a larger standard deduction. Your tax rate also will likely be lower than the rates for single or married filing separately taxpayers. In some cases, married persons living apart might qualify for this status.

Qualifying widow/widower—After you have lost a spouse and no longer are able to file a joint return as discussed earlier, if you still have children at home, look into this filing status. It essentially gives you the basic filing advantages (for example, larger standard deduction) of married joint filers.

The qualifying widow or widower status can be used for two years following the year a spouse passes away as long as the surviving spouse cares for a dependent child. The child must live in your home for the full tax year, and you must pay for more than half the cost of keeping up that home.

When a surviving spouse no longer qualifies for this status, he or she would file as a head of household if the kids are still living at home or, with no dependents to claim, as a single taxpayer.

TRUTH 3

Filling out the right form

1040. It's the most feared number in America, especially when April 15 is fast approaching.

Form 1040 is *the* tax document, the one millions of us complete to report our income and figure any associated federal taxes or refunds due.

There are, however, three 1040 versions. Picking the appropriate one could save you money.

Form 1040EZ—Because tax filing is a dreaded task, the allure of an official form labeled EZ is understandable. And for many people, this simplest of the three 1040 versions is the perfect filing answer.

But there are some restrictions. The main one is income, both the amount and type. You must make less than $100,000 to file the EZ. Even if you meet the income limit, if your earnings include interest of $1,500 or more, you cannot use the form. Neither is it available if you're living off of retirement account distributions.

Other 1040EZ prerequisites include the following:

- You be a single taxpayer or couple filing jointly.
- You have no dependents.
- You are younger than age 65. If you file a joint return, your spouse also must meet the age requirement. Be careful if you or your spouse were born on Jan. 1. In this case, for filing purposes the IRS considers you to have turned 65 the prior year, meaning you can't file the EZ form.

One thing that catches the eyes of many taxpayers is the 1040EZ's standard deduction amounts; they're larger than the amounts shown on the other two 1040s. Don't let that alone entice you to use the form; in reality, the standard deduction amounts are the same regardless of which 1040 version you use. The form simply combines the standard deduction and exemption amounts.

That's a nifty shortcut, but this form offers only one additional tax break, the earned income tax credit (EITC) that is designed for lower-income workers.

Form 1040A—Form 1040A is twice as long as 1040EZ, but it offers many more opportunities to save on taxes. It also can be used by taxpayers who file using any of the five filing statuses (single, married filing jointly, married filing separately, head of household, or qualifying widow/widower).

Form 1040A is twice as long as 1040EZ, but it offers many more opportunities to save on taxes.

It does, however, have a few limitations. Your income must be less than $100,000. But you are allowed to report more interest and dividend income. When it comes to capital gains, though, only capital gains distributions, not profits or losses from the sale of assets, are allowed on this form.

Older taxpayers will find the 1040A more amenable. Pension and other retirement income can be reported on this form. Even better, the 1040A allows age 65 or older and visually impaired filers to claim a larger standard deduction. Elderly and disabled individuals also can claim a special credit on 1040A.

In addition, 1040A offers four income adjustments, also commonly called above-the-line deductions because they are found on page 1 of the form, just above where you enter your adjusted gross income, or AGI.

The 1040A above-the-line deductions that help reduce your taxable income are educator expenses, traditional IRA contributions, student loan interest, and higher education tuition and fees.

More tax-cutting options are available through seven credits found on Form 1040A. In addition to the EITC found on the EZ and the previously mentioned elderly or disabled credit, Form 1040A allows you to claim the child, additional child, education, dependent care, excess Social Security withholdings, and retirement savings credits.

Form 1040—If you want the most tax-saving chances, use the long Form 1040, the granddaddy of tax forms. It first appeared in 1913 just after ratification of the 16th Amendment, which gave Congress the authority to enact an income tax. Today's Form 1040 is packed with ways to report, and reduce, more types of income.

Form 1040 can be filed by a taxpayer using any filing status. It's required if your earnings are larger, you itemize deductions, or you have a variety of investment and other income, such as self-employment earnings, to report.

Form 1040 also is closely associated with another well-known piece of filing paperwork, Schedule A. This is the document used to itemize tax-deductible expenses, such as medical costs; home-related expenses (mortgage interest and property taxes); other taxes (state income or sales taxes); and charitable donations.

Some of these deductions are limited to certain percentages of your adjusted gross income. Your overall itemized deductions also might be reduced if you earn over a certain amount. But if you have enough allowable expenses to exceed the standard deduction amount available for your filing status, you should itemize. And that requires you to file the long Form 1040.

This longest form also offers more than a dozen above-the-line deductions. As with the 1040A, these tax breaks, officially called "adjustments to income," allow you to subtract certain amounts from your gross income. And although most people file Form 1040 because they itemize, you can claim above-the-line deductions regardless of whether you also file Schedule A.

In addition to the educator expenses, IRA contributions, student loan interest, and tuition and fees deductions found on the 1040A, the bottom of Form 1040's first page offers deductions for alimony payments, moving expenses, a portion of self-employment taxes, and contributions to certain self-employment retirement and various health savings accounts. Several specialized deductions also are found only on Form 1040. Details on each of the above-the-line deductions are found in the form's instruction book.

When you flip over the Form 1040, you'll find the tax-saving opportunities afforded by various credits. In addition to those found on the other two returns, Form 1040 offers the foreign tax credit and half a dozen specialty credits, such as breaks for electric and other alternative-fuel vehicles, prior-year minimum tax paid, and several business credits.

Of course, the additional tax-saving possibilities of the longer Form 1040A and Form 1040 require more time and extra schedules. But that price usually is more than offset by a reduction in your tax bill.

TRUTH

4

Meeting filing deadlines

The Internal Revenue Service is all about numbers, and that includes dates on calendars. If you don't file your return on time and if you owe tax, you'll face penalties and interest.

Everyone knows about April 15, the day tax returns are due. But as countless procrastinators can attest, it's when your return must be en route to the IRS, not when the agency actually has to have your 1040 in hand.

The IRS considers a paper return filed on time if it is mailed in a properly addressed envelope, has enough postage, and is postmarked by the due date. The official term, per Section 7502 of the Internal Revenue Code, is "timely filed." The tax code also notes that the date on a U.S. Postal Service receipt for certified or registered mail also qualifies.

As long as the tax mailing has the appropriate USPS cancellations showing it was mailed on or before the due date, the return is considered on time no matter when the IRS actually receives it.

Private delivery accepted—What if you're more comfortable using a private delivery service? That's okay with the IRS and has been since 1997.

In these cases, the IRS considers a timely-filed postmark to be the date a private delivery service records in its database that it accepted the tax document or marks that date on the mailing label.

The IRS has designated three companies as authorized private delivery services: DHL Express, Federal Express, and United Parcel Service. If you choose to use one of them, check with its local office as to the company's requirements and pick-up deadlines, as well as the specific private delivery services the IRS accepts.

Filing on time electronically—Electronic filing is popular in part because it enables you to send your 1040 from a personal computer with a simple push of the Enter button.

E-filing also provides an almost immediate acknowledgment that the return is on its way to Uncle Sam. This notification from tax software companies and other electronic return originators is your official electronic postmark.

Technically, an e-filed return is not considered filed until the IRS acknowledges that it has been received and accepted for processing.

However, if the electronic transmission is successful and completed on or shortly before the due date, the IRS considers it as timely filed.

Technically, an e-filed return is not considered filed until the IRS acknowledges that it has been received and accepted for processing.

But don't wait until 11:59 p.m. on April 15 to e-file. Although such a last-minute electronic timestamp is acceptable to the IRS, you run the risk that your online connection might be bogged down by other late e-filers. Worse, your PC could crash, not only causing you to miss the filing deadline, but also destroying your entire return.

Pushing the deadline—Sometimes April 15 comes and goes without any tax consequence. That's the case when it falls on a weekend or federal holiday. In these instances, the next business day becomes the official tax-filing deadline.

The IRS also allows you, if you file the proper paperwork, six more months to complete your Form 1040. Submit Form 4868 by the regular April due date, and your filing deadline becomes October 15, or if that date falls on a weekend or federal holiday, the next business day.

Although an extension can be a welcome tax respite, keep in mind that it only gives you more time to file your return. It is not an extension of time to pay any tax you owe. Failure to pay will cause penalty and interest assessments to start accumulating.

There are three ways to file Form 4868:

1. Mail in the paper form, which can be downloaded from www.IRS.gov.
2. File it electronically. The form is included in most tax software packages, or eligible taxpayers can find it at the IRS's Free File site. Go to www.IRS.gov and type "Free File" in the search box at the top of the page.
3. Pay part or all of your tax bill by credit card via an authorized, private-sector service provider.

The IRS has authorized two companies to process credit cards payments:

- Link2Gov Corporation
  www.PAY1040.com
  1-888-729-1040
- Official Payments Corporation
  www.officialpayments.com
  1-800-272-9829

Both companies charge a convenience fee of 2.5 percent of the payment amount. And if you do not pay your full tax due, penalties and interest will accrue on the unpaid balance.

More filing deadlines for some—April 15, or the following business day if the 15th falls on a weekend or federal holiday, is a double deadline for some taxpayers. The mid-April date also is the due date for the year's first estimated tax payment.

U.S. taxes are collected on a pay-as-you-earn system, with the bulk of them paid by payroll withholding from employee wages. But when you are self-employed or have income, such as investment earnings, from which no taxes are withheld, you must make the payments yourself as estimated payments. If you do not pay enough throughout the year, either via withholding, estimated payments, or a combination of both, you could face an underpayment penalty.

To avoid this, Form 1040-ES, which includes instructions and payment vouchers, helps you calculate your untaxed income and figure your bill. The IRS prefers you take that total estimated amount, divide it by four, and send in equal payments on April 15, June 15, September 15 and January 15 of the following year. Again, holidays or weekends will push these deadlines to the next business day.

You can make each payment by sending the appropriate paper 1040-ES voucher, downloadable from www.IRS.gov; paying by credit card; having the funds electronically withdrawn from your bank account; or paying via the IRS's Electronic Federal Payment System, or EFTPS, at www.EFTPS.gov.

Figure your estimated payments carefully, since underpayment penalties also are assessed on each payment period if too little is remitted. If your income that is not subject to withholding is unequal throughout the year, you can avoid such penalties by using the annualized method. Using Form 2210, figure each 1040-ES payment period separately and pay the appropriate tax for each. This is particularly useful if your job is one where you earn most of your income in one period, such as a lawn service with key earnings during the summer, because you then will have the cash to pay the taxes.