TAXES

Tax Saving Strategies: Frequently Asked Questions

Table of Contents

What's the best way to borrow to make consumer purchases?

For tax years 2018 through 2025 interest on home equity loans is only deductible when the loan is used to buy, build or substantially improve the taxpayer's home that secures the loan. Prior to 2018, many homeowners took out home equity loans. Unlike other consumer-related interest expenses (e.g., car loans and credit cards) interest on a home equity loan was deductible on your tax return.

What special deductions can I get if I'm self-employed?

You may be able to take an immediate Section 179 expense deduction of up to $1,080,000 for 2022 ($1,050,000 in 2021), for equipment purchased for use in your business, instead of writing it off over many years. There is a phaseout limit of $2,700,000 in 2022 ($2,620,000 in 2021). Additionally, self-employed individuals can deduct 100 percent of their health insurance premiums. You may also be able to establish a Keogh, SEP, or SIMPLE IRA plan and deduct your contributions (investments).

Can I ever save tax by filing a separate return instead of jointly with my spouse?

You sometimes may benefit from filing separately instead of jointly. Consider filing separately if you meet the following criteria:

- One spouse has large medical expenses, miscellaneous itemized deductions, or casualty losses.
- The spouses' incomes are about equal.

Separate filing may benefit such couples because the adjusted gross income "floors" for taking the listed deductions will be computed separately.

Why should I participate in my employer's cafeteria plan or FSA?

Medical and dental expenses are deductible to the extent they exceed 7.5 percent of your adjusted gross income or AGI. If your employer offers a Flexible Spending Account (FSA), Health Savings Account, or cafeteria plan, these plans permit you to redirect a portion of your salary to pay these types of expenses with pretax dollars.

What's the best way to give to charity?

If you're planning to make a charitable gift, it generally makes more sense to give appreciated long-term capital assets to the charity, instead of selling the assets and giving the charity the after-tax proceeds. Donating the assets instead of the cash avoids capital gains tax on the sale, and you can obtain a tax deduction for the full fair-market value of the property.

I have a large capital gain this year. What should I do?

If you also have an investment on which you have an accumulated loss, it may be advantageous to sell it prior to year-end. Capital gains losses are deductible up to the amount of your capital gains plus $3,00 ($1,500 for married filing separately). If you are planning on selling an investment on which you have an accumulated gain, it may be best to wait until after the end of the year to defer payment of the taxes for another year (subject to estimated tax requirements).

What other tax-favored investments should I consider?

For growth stocks you hold for the long term, you pay no tax on the appreciation until you sell them. No capital gains tax is imposed on appreciation at your death.

Interest on state or local bonds ("municipals") is generally exempt from federal income tax and from tax by the issuing state or locality. For that reason, interest paid on such bonds is somewhat less than that paid on commercial bonds of comparable quality. However, for individuals in higher brackets, the interest from municipals will often be greater than from higher paying commercial bonds after reduction for taxes.

For high-income taxpayers, who live in high-income-tax states, investing in Treasury bills, bonds, and notes can pay off in tax savings. The interest on Treasuries is exempt from state and local income tax.

What tax-deferred investments are possible if I'm self-employed?

Consider setting up and contributing as much as possible to a retirement plan. These are allowed even for a sideline or moonlighting business. Several types of plans are available: an individual or self-employment 401(k) plan, a SEP (Simplified Employee Pension), and the SIMPLE IRA plan.

How can I make tax-deferred investments?

Through the use of tax-deferred retirement accounts you can invest some of the money you would have otherwise paid in taxes to increase the amount of your retirement fund. Many employers offer plans where you can elect to defer a portion of your salary and contribute it to a tax-deferred retirement account. For most companies, these are referred to as 401(k) plans. For many other employers, such as universities, a similar plan called a 403(b) is available.

Some employers match a portion of employee contributions to such plans. If this is available, you should structure your contributions to receive the maximum employer matching contribution.

What can I do to defer income?

If you are due a bonus at year-end, you may be able to defer receipt of these funds until January. This can defer the payment of taxes (other than the portion withheld) for another year. If you're self-employed, defer sending invoices or bills to clients or customers until after the new year begins. Here, too, you can defer some of the tax, subject to estimated tax requirements.

You can achieve the same effect of short-term income deferral by accelerating deductions, for example, paying a state estimated tax installment in December instead of at the following January due date.

Why should I defer income to a later year?

Most individuals are in a higher tax bracket in their working years than during retirement. Deferring income until retirement may result in paying taxes on that income at a lower rate. Deferral can also work in the short term if you expect to be in a lower bracket in the following year or if you can take advantage of lower long-term capital gains rates by holding an asset a little longer.

Recordkeeping For Your Taxes: Frequently Asked Questions

Table of Contents

- How long should I keep these records?
- Should I keep my old tax returns? If so, for how long?
- What other types of tax records should I keep?
- Are there any non-tax records I should keep?
- What kind of recordkeeping system do I need?

What pieces of paper do I need to keep in order to do my taxes?

Keep detailed records of your income, expenses, and other information you report on your tax return. A good set of records can help you save money when you do your taxes and will be your trusty ally in case you are audited.

There are several types of records that you should keep. Most experts believe it's wise to keep most types of records for at least seven years, and some you should keep indefinitely.

What type of records do I need to keep?

Keep records of all your current year income and deductible expenses. These are the records that an auditor will ask for if the IRS selects you for an audit.

Here's a list of the kinds of tax records and receipts to keep that relate to your current year income and deductions:

- Income (wages, interest/dividends, etc.)
- Exemptions (cost of support)
- Medical expenses
- Taxes
- Interest
- Charitable contributions
- Child care
- Business expenses
- Professional and union dues
- Uniforms and job supplies
- Education, if it is deductible for income taxes
- Automobile, if you use your automobile for deductible activities, such as business or charity
- Travel, if you travel for business and are able to deduct the costs on your tax return

While you're storing your current year's income and expense records, be sure to keep your bank account and loan records too, even though you don't report them on your tax return. If the IRS believes you've underreported your taxable income because your lifestyle appears to be more comfortable than your taxable income would allow, having these loan and bank records may be just the thing to save you.

How long should I keep these records?

Keep the records of your current year's income and expenses for as long as you may be called upon to prove the income or deduction if you're audited.

For federal tax purposes, this is generally three years from the date you file your return (or the date it's due, if that's later), or two years from the date you actually pay the tax that's due, if the date you pay the tax is later than the due date. IRS requirements for record keeping are as follows:

- You owe additional tax and situations (2), (3), and (4), below, do not apply to you; keep records for 3 years.
- You do not report income that you should report, and it is more than 25 percent of the gross income shown on your return; keep records for 6 years.
- You file a fraudulent return; keep records indefinitely.
- You do not file a return; keep records indefinitely.
- You file a claim for credit or refund* after you file your return; keep records for 3 years from the date you filed your original return or 2 years from the date you paid the tax, whichever is later.
- You file a claim for a loss from worthless securities or bad debt deduction; keep records for 7 years.
- Keep all employment tax records for at least 4 years after the date that the tax becomes due or is paid, whichever is later.

Should I keep my old tax returns? If so, for how long?

Yes, keep your old tax returns.

One of the benefits of keeping your tax returns from year to year is that you can look at last year's return while preparing this year's. It's a handy reference and reminds you of deductions you may have forgotten.

Another reason to keep your old tax returns is that there may be information in an old return that you need later.

Audits and your old tax returns

Here's a reason to keep your old returns that may surprise you. If the IRS calls you in for an audit, the examiner will more than likely ask you to bring your tax returns for the last few years. You'd think the IRS would have them handy, but that's not the way it works. More than likely, your old returns are stored in a computer, in a storage area, or on microfilm somewhere. Usually, your IRS auditor has just a report detailing the reason the computer picked your return for the audit. So having your old returns allows you to easily comply with your auditor's request.

How long should I keep my old tax returns?

You may want to keep your old returns forever, especially if they contain information such as the tax basis of your house. Probably, though, keeping them for the previous three or four years is sufficient.

If you throw out an old return that you find you need, you can get a copy of your most recent returns (usually the last six years) from the IRS. Ask the IRS to send you Form 4506, Request for Copy or Transcript of Tax Form. When you complete the form, send it, with the required small fee, to the IRS Service Center where you filed your return.

What other types of tax records should I keep?

You need to keep some other types of tax records and receipts because they tell you how much you paid for something that you may later sell.

Keep the following types of records:

- Records of capital assets, such as coin and antique collections, jewelry, stocks, and bonds.
- Records regarding the purchase and improvements to your home.
- Records regarding the purchase, maintenance, and improvements to your rental or investment property.

How long should I keep these records? You need to keep these records as long as you own the item so you can prove the cost you use to figure your gain or loss when you sell the item.

Are there any non-tax records I should keep?

There are other records you should keep, even though they don't appear to have any use for your tax returns. Here are a few examples:

- Insurance policies, to show whether you were to be reimbursed in case you suffer a casualty or theft loss, have medical expenses, or have certain business losses.
- Records of major purchases, in case you suffer a casualty or theft loss, contribute something of value to a charity or sell it.
- Family records, such as marriage licenses, birth certificates, adoption papers, divorce agreements, in case you need to prove change in filing status or dependency exemption claims.
- Certain records that give a history of your health and any medical procedures, in case you need to prove that a certain medical expense was necessary.
- These categories are the most universal and should cover most of your recordkeeping needs. Everyone's needs are unique, however, and there may be other records that are important to you. Skimming through our Tax Library Index might highlight other categories that apply to you.

What kind of recordkeeping system do I need?

Unless you own or operate your own business, partnership, or S corporation, recordkeeping does not have to be fancy.

Your recordkeeping system can be as casual as storing receipts in a box until the end of the year, then transferring the records, along with a copy of the tax return you file, to an envelope or file folder for longer storage.

To make it easy on yourself, you might want to separate your records and receipts into categories, and file them in labeled envelopes or folders. It's also helpful to keep each year's records separate and clearly labeled.

If you have your own business, or if you're a partner in a partnership or an S corporation shareholder, you might find it valuable to hire a bookkeeper or accountant.

Do you contribute to charity?

If you donate to a charity, you must have receipts to prove your donation.

Starting in 2007, contributions in cash or by check aren't deductible at all unless substantiated by one of the following:

1. A bank record that shows the name of the qualified organization, the date of the contribution, and the amount of the contribution. Bank records may include: a canceled check, a bank or credit union statement or a credit card statement.
2. A receipt (or letter or other written communication) from the qualified organization showing the name of the organization, the date of the contribution, and the amount of the contribution.
3. Payroll deduction records. The payroll records must include a pay stub, Form W-2 or other document furnished by the employer that shows the date and the amount of the contribution, and a pledge card or other document prepared by or for the qualified organization that shows the name of the organization.

Besides deducting your cash and non-cash charitable donations, you can also deduct your mileage to and from charity work. If you deduct mileage for your charitable efforts, keep detailed records of how you figured your deduction.

Are you employed by someone else?

If you work for someone else and spend your own money on company business, keep good records of your business expense receipts. You will need these records to either get a reimbursement from your employer or to prove business-related deductions that you take on your taxes.

Do you have income from tips?

If you make tips from your job, the hand of the IRS reaches here too, and if you are ever audited, the IRS will be interested in records of how much you made in tips.

Do you own property?

If you own property, be particularly careful to keep receipts or some other proof of all your expenses, especially for repairs and improvements.

Do you hire domestic workers?

It's important to keep accurate information about who works for you, including nannies and housekeepers, when and where they worked for you, and how much you paid them for the work.

Do you have a business?

If you have a business, you must keep very careful records of all your business expenses, including vehicle mileage, entertainment expenses, and travel expenses.

If you have a business, just because you have cash in your pocket doesn't mean you're in the black on the books. Keeping up-to-date records of all transactions and costs will not only help you tax wise, it will tell you if your business is actually profitable.

Do you travel for your business?

If you travel for business, keep good receipts and logs of all your travel expenses, including those for meals and entertainment. You will need this information whether you work for yourself or for someone else.

Tax Benefits of Higher Education: Frequently Asked Questions

Table of Contents

- What tax benefits are available for continuing/adult education for a hobby or a sideline?
- Can I deduct student loan interest?
- If I take a home equity loan to pay education expenses, can I deduct the interest?
- What tax treatment applies if my student loan debt is canceled?
- What's the tax relief for education savings bonds?
- Must I pay tax on my employer's payment or reimbursement of my education expenses?
- Can I take tax deductions from education I pay for that helps me in my work?

What Types of Tax Relief are Available for Costs of my Children's Higher Education?

A wide variety of tax relief is available, but you'll need to choose which credit or deduction to claim or which savings plan to use based on your individual tax situation. You also can't use two different kinds of relief for the same item. For instance, you can't take the higher education credit and tuition fees deduction for the same student for the same year. You also can't take the American Opportunity Tax Credit and the Lifetime Learning Credit for the same student for the same year. There may also be limits based on adjusted gross income.

What is the Education Tax Credit?

Two tax credits are available for education costs - the American Opportunity Tax Credit and the Lifetime Learning Credit. These credits are available only to taxpayers with adjusted gross income below specified amounts, see Income Phase-Outs, below. Both credits were made permanent by the Protecting Americans from Tax Hikes Act of 2015 (PATH).

How Do These Credits Work?

The amount of the credit you can claim is either, $0, $2,000, or $4,000 and depends on (1) how much you pay for qualified tuition and other expenses for students and (2) your adjusted gross income (AGI) for the year.

You must report on Form 8863 the eligible student's name and Social Security number on your return to claim the credit. You subtract the credits from your federal income tax. If the credit reduces your tax below zero, you cannot receive the excess as a refund. If you receive a refund of education costs for which you claimed a credit in a later year, you may have to repay ("recapture") the credit.

> If you file married-filing separately, you cannot claim these credits.

Which costs are eligible? Qualifying tuition and related expenses refer to tuition and fees, and course materials required for enrollment or attendance at an eligible education institution. They now include books, supplies, and equipment needed for a course of study whether or not the materials must be purchased from the educational institution as a condition of enrollment or attendance.

"Related" expenses do not include room and board, student activities, athletics (other than courses that are part of a degree program), insurance, equipment, transportation, or any personal, living, or family expenses. Student-activity fees are included in qualified education expenses only if the fees must be paid to the institution as a condition of enrollment or attendance. For expenses paid with borrowed funds, count the expenses when they are paid, not when borrowings are repaid.

> If you pay qualified expenses for a school semester that begins in the first three months of the following year, you can use the prepaid amount in figuring your credit.
>
> You pay $6,500 of tuition in December 2022 for the winter 2022-2023 semester, which begins in January 2023. You can use the $6,500 in figuring your 2022 credit. If you paid in January instead, you would take the credit on your 2023 return.
>
> As future year-end tax planning, this rule gives you a choice of the year to take the credit for academic periods beginning in the first 3 months of the year; pay by December and take the credit this year; pay in January or later and take the credit next year.

Eligible students. You, your spouse, or an eligible dependent (someone for whom you can claim a dependency exemption, including children under age 24 who are full-time students) can be an eligible student for whom the credit can apply. If you claim the student as a dependent, qualifying expenses paid by the student are treated as paid by you, and for your credit purposes are added to expenses you paid. A person claimed as another person's dependent can't claim the credit. The student must be enrolled at an eligible education institution (any accredited public, non-profit or private post-secondary institution eligible to participate in student Department of Education aid programs) for at least one academic period (semester, trimester, etc.) during the year.

No "double-dipping." The tax law says that you can't claim both a credit and a deduction for the same higher education costs. It also says that if you pay education costs with a tax-free scholarship, Pell grant, or employer-provided educational assistance, you cannot claim a credit for those amounts.

Income limits. To claim the American Opportunity Tax Credit, for example, your modified adjusted gross income (MAGI) must not exceed $90,000 ($180,000 for joint filers). To claim the Lifetime Learning Credit, MAGI must not exceed $69,000 ($138,000 for joint filers). "Modified AGI" generally means your adjusted gross income. The "modifications" only come into play if you have income earned abroad.

The American Opportunity Tax Credit

The American Opportunity Tax Credit (AOTC) was made permanent starting with tax-year 2015. The maximum credit, available only for the first four years of post-secondary education, is $2,500. You can claim the credit for each eligible student you have for which the credit requirements are met.

Special qualification rules. In addition to being an eligible student, he or she:

- Must be enrolled in a program leading to a degree, certificate, or other recognized credential;
- Must be taking at least half of a normal full-time load of courses, for at least one semester or trimester beginning in the year for which the credit is claimed; and
- May not have any drug-related felony convictions.

Amount of credit. The maximum amount of the AOTC is $2,500. Generally, 40 percent of the AOTC is now a refundable credit for most taxpayers, which means that you can receive up to $1,000 even if you owe no taxes.

The Lifetime Learning Credit

You may be able to claim a Lifetime Learning Credit of up to $2,000 (20 percent of the first $10,000 of qualified expense) for eligible students (subject to reduction based on your AGI). Only one Lifetime Learning Credit can be taken per tax return, regardless of the number of students in the family.

- The credit can help pay for undergraduate, graduate and professional degree courses, including courses to improve job skills.
- For courses taken to acquire or improve job skills, there are no requirements as to course loads, so that even one or two courses can qualify.
- The number of years for which this credit can be claimed is not limited.

Choosing the Credit. You can't claim both credits for the same person in the same year. But you can claim one credit for one or more family members and the other credit for expenses for one or more others in the same year - for example, an American Opportunity Tax Credit for your child and a Lifetime Learning Credit for yourself.

Electing Not to Take the Credit. There are situations in which the credit is not allowed, or not fully available, if some other education tax benefit is claimed - where the higher education expense deduction is claimed for the same student, see below, or where credit and tax exemption (under a Section 529 or 530 program) are claimed for the same expense. In that case, the taxpayer - or, more likely, the taxpayer's tax adviser - will determine which tax rule offers the greater benefit and if it's not the credit, elect not to take the credit.

Do any tax planning considerations apply to the education tax credit?

For an academic period (quarter, semester, etc.) beginning in the first 3 months of a calendar year, you can pick which year to pay the expense and take the credit. That is, pay in December 2022 and take the credit in 2022 or pay in, say, February 2023 and take the credit in 2023.

Your family may be able to save tax by foregoing the education credit and taking an available exemption for program distributions instead.

Do living expenses while in school qualify for tax relief?

Sometimes. Examples are for relief provided for Coverdell Education Savings Accounts (Section 530 programs), for Qualified Tuition Programs (Section 529), for withdrawals from traditional and Roth IRAs, and for student loans.

How does a Coverdell (Section 530) Education Savings Account work?

An education IRA differs from other IRAs in the following ways:

- No more than $2,000 a year can be contributed to any beneficiary of a single 530 account in any year and contributors are subject to income limits. Modified AGI cannot exceed $110,000 ($220,000 joint filers).
- Contributions aren't deductible and excess contributions are subject to penalty.
- Withdrawals are tax-free to the extent used for qualified education expenses.
- Contributions can't be made after the student reaches age 18, and the account generally must distribute all funds by the student's age 30.

A 530 account may be used for primary and secondary education, including paying for room and board of children in private schools, and for computers and related materials whether or not away from home.

How can my family make best use of a Coverdell (Section 530) program?

There can be a number of Section 530 accounts for any student. Various family members, such as grandparents, aunts, and uncles, and siblings--and persons outside the family--can contribute to separate accounts for a student.

The original student beneficiary for the Section 530 account can be changed to another family member, such as a sibling - for example, where the original beneficiary wins a scholarship or drops out.

Funds can be rolled over tax-free from one family member's Section 530 account to another's for example, to avoid distribution when the first family member reaches age 30.

The education tax credit (where applicable) can be waived in favor of tax-free treatment for Section 530 account distributions.

What are Qualified Tuition Programs (QTPs)?

Also called Section 529 plans, these college savings plans have been established by almost every state and some private colleges. You invest now to cover future college or vocational school expenses, by contributing to a savings account or buying tuition credits redeemable in the future. Investments grow tax-free, and distributions to pay college expenses can also be tax-free. You may choose any state's plan, regardless of where you live. Starting in 2018, funds from 529 plans can be used for up to $10,000 of qualified expenses related to K-12 education as well.

Even if a QTP is used to finance a student's education, the student or the student's parents still may be eligible to claim the American Opportunity Tax Credit or the Lifetime Learning Credit.

How do Coverdell Education Savings Accounts (Section 530) and Qualified Tuition Plans (Section 529) differ?

Section 530 plans limit investment to $2,000 a year per student; 529 plans allow a much larger investment. Section 530 plans allow a wide choice of investments; 529 investment choices are limited and conservative. Section 530 is a single nationwide program, whereas each 529 program is different. Both are available for higher education as well as primary and secondary education.

Can my traditional IRA be used for education?

Yes. The 10 percent penalty on withdrawal under age 59-1/2 won't apply, but ordinary income tax will apply to at least some of the withdrawal.

Can a Roth IRA be used for education?

Yes, generally under the same terms as traditional IRAs. Also, ordinary income tax is somewhat less likely or may be smaller in amount, than with traditional IRAs.

What tax deductions are available for college education?

You can choose to take a tax deduction rather than the college tuition tax credits noted above. A tax deduction is usually taken if income is too high for the tax credits. The tax deduction reduces your amount of income. The tax credits reduce the amount of tax you pay.

A $4,000 above the line deduction for qualified tuition expenses was extended through tax-year 2020, but repealed for 2021 and beyond under the Consolidated Appropriations

Act (CAA). In 2020, the deduction was allowed if taxpayer's (modified) adjusted gross income is $80,000 or less ($160,000 or less on a joint return).

A business expense deduction is also allowed without dollar limit, for education that serves the taxpayer's business, including employment. The deduction is also allowed for student loan interest; however, a taxpayer may not take more than one deduction for the same item.

What tax benefits are available for continuing/adult education for a sideline hobby?

If it's not part of a degree or certificate program, and not work-related, the limited deduction (up to $4,000 for qualified tuition and fees) was your only option; however, please note that this deduction expired at the end of 2020 and was repealed for tax years 2021 and beyond. It is possible that in some instances, a sideline interest might qualify for exclusion if paid for under an employer-provided education assistance program.

Can I deduct student loan interest?

Since personal interest is generally non-deductible, deductions must meet several tests:

1. You must be the person liable on the debt and the loan must be for education only (not an open line of credit).
2. Your income can't exceed $170,000 on a joint return or $85,000 for single filers. Married couples filing separately cannot take the deduction.
3. You can't deduct if you're claimed as a dependent.
4. Deduction ceiling is $2,500 (starting in tax year 2013).

If I take a home equity loan to pay education expenses, can I deduct the interest?

For tax years prior to 2018, you could deduct interest form a home equity loan used to pay educational and other non-home improvement-related expenses, not as student loan interest. In this case, there was no income ceiling on your deduction, and certain other student loan limits didn't apply. However, for tax years 2018 through 2025, taxpayers are no longer able to deduct interest on home equity loans taken out for non-home-related purposes.

What tax treatment applies if my student loan debt is canceled?

Usually you're taxed on the unpaid loan balance, but the tax can be waived if the debt is canceled if you worked:

- For a certain period of time,
- In certain professions, and
- For any broad class of employers.

Tax reform legislation passed in 2017 further stipulated that student loan debt forgiveness due to death or permanent and total disability is excluded from income.

What's the tax relief for education savings bonds?

Interest on redemption of Series EE bonds is tax-exempt if you redeem them in a year you have qualified education expenses. Exemption depends on the amount of your income in the year you redeem the bond.

Must I pay tax on my employer's payment or reimbursement of my education expenses?

Maybe not. Starting in 2013, up to $5,250 can be tax-free. Exemption can apply to graduate level courses.

Can I take tax deductions for education I pay for that helps me in my work?

For tax years prior to 2018, the answer was, yes, if it's to maintain or improve skills in your present job, but no, if it was to meet minimum requirements of that job, or to qualify to enter a new business. Furthermore, employee's deductions were subject to the two percent floor on miscellaneous itemized deductions. However, under the Tax Cuts and Jobs Act of 2017 ("tax reform"), for tax years 2018 through 2025, employee business-related deductions (including education expenses) are disallowed. That is, there are no miscellaneous deductions on Schedule A as there were previously. Self-employed individuals are still able to deduct qualifying educational expenses on Schedule C.