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Good To Know Tax Planning Basics

Become confident in planning out how to minimize your tax liability next year.

Tax planning may sound like it's only for the super wealthy, but it's not-it's for anyone who wants to minimize their owed taxes and keep more of their hard-earned money. In fact, tax planning is an essential part of a good financial plan for anyone who wants to be smart with their money, no matter the size of their paycheck.

There are three ways to reduce your taxes, each with slight variations depending on each taxpayer's situation: reduce your taxable income, increase your deductions, and capitalize on tax credits.

Reduce taxable income

No, this doesn't mean you should try to earn less money. If you have the chance for a better paying job or a raise at work, take it! The goal in reducing your taxable income isn't to lose money but to reduce the amount you are taxed on. Here's how that works.

Your adjusted gross income (AGI) is a key element in determining how much you owe in taxes at the end of the year, i.e. your tax liability. AGI is your total income from all sources, minus any adjustments.

The bigger your AGI, the more taxes you'll pay. The best way to lower your AGI (without taking a pay cut, of course!) is to contribute money throughout the year to a qualified retirement plan, like a traditional IRA or 401(k).

The money you contribute each month from your paycheck to one of these retirement plans reduces your AGI because you're not "taking home" this money.

You're saving and investing it for the future, when you'll eventually pay taxes on it. It's a win-win for you because you're reducing your taxable income (and therefore tax bill) now while also building your nest egg for the future.

There are other adjustments you can make to lower your AGI, although they apply to fewer people. They include student loan interest paid, alimony paid, and classroom-related expenses. A complete list of adjustments is on tax Form 1040, page 1, for reference.

Increase tax deductions

Tax deductions lower your taxable income, which lowers your tax liability. There is a standard tax deduction that most people qualify for, although the amount changes from year to year.

The deductions and personal exemptions you can take depend on your filing status (e.g. single, married, head of household) and how many dependents you have.

Your alternate option to taking the standard deduction is to itemize your deductions. You want to take whichever amount is highest, as that removes the most amount from your taxable income.

Itemized deductions include costs for health care, state and local taxes, personal property taxes (such as car registration fees), mortgage interest, gifts to charity, job-related expenses, tax preparation fees, and investment-related expenses. For most people, the three biggest deductions are mortgage interest, state taxes, and gifts to charity.

If you think you might be able to deduct more from your taxable income with itemized deductions, it’s vital that you keep track of qualified expenses throughout the year.

Then at the end of the year, you can add them up and see if they’re greater than that year’s standard deduction.

Once you have applied all valid adjustments, deductions, and exemptions to your AGI, the amount of money left over is called your “taxable income.” This is the amount the government will tax you on and the amount that will determine what tax bracket you fall into.

Capitalize on tax credits

Once you have your final taxable income calculated, it’s time to apply tax credits. While adjustments and deductions reduce the amount of money you’re taxed on, credits then reduce the amount of taxes you owe on that amount. It may feel like a very slight distinction, but it’s important to understand if you want to make the most of tax planning and keep the most money at the end of tax season.

There are tax credits for college expenses, for saving for retirement, and for adopting children. The highest credits are for adoption and college expenses. One of the biggest tax credits is the Earned Income Credit (EIC) for moderate to low income households.

If you meet the EIC requirements, this tax credit is actually credited to you as a payment from the IRS, instead of simply being subtracted from the taxes you owe.

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