

## Diversity Article – February 2011

### Managing Taxes

Taxes. Yuck.

It's hard to say anything good about taxes, except that they pay for a lot of things that we take for granted. Whether or not you agree with how our government spends tax revenue, most people would rather pay less in taxes. There are some very simple strategies everyone can use to manage their income tax liability, and some more complex strategies for unmarried couples.

#### Simple Strategies

**Take advantage of opportunities to make deductible contributions to tax-deferred accounts.** If you are in the 25% tax bracket your taxes will be reduced by \$25 for every \$100 that you are allowed to deduct.

- Your contributions to qualified retirement plans at work are deductible. Plus, you won't pay tax on the earnings in those accounts each year. Keep in mind that you will pay taxes when you take money out of those accounts. Most IRAs are treated similarly.
- Roth IRAs offer different tax advantages. While contributions to a Roth are not tax-deductible the earnings will grow tax free, and you will not have to pay tax when you withdraw the funds if the account has existed for more than five years.
- Flexible Spending Accounts (FSAs) offered by some employers, and Health Savings Accounts also offer tax advantages. Your contributions are deductible, the accounts grow tax-free, and you don't have to pay tax on withdrawals for qualified expenses.
- 529 Plans offer a tax-efficient way to save for college expenses. Contributions to a 529 plan are not deductible for federal taxes, but the account grows tax free and you don't pay tax on withdrawals used for qualified educational expenses. Idaho offers a state tax deduction for contributions to its 529 Plan.

Idaho also offers some "double" state tax deductions for contributions to Idaho educational and youth facilities, which include more than 30 different entities. This means that you get to take the federal deduction and then deduct a portion (up to certain limits) *again* on your state taxes.

#### Additional Strategies for Unmarried Couples

Unmarried couples that have merged their finances can take several steps to reduce their overall tax liabilities, particularly if one partner makes significantly more money than the other. By channeling income and deductions to different partners based on the effective tax rate (percent of income actually paid in taxes, which will be lower than the tax bracket) of each, couples can reduce the total amount paid in taxes. Keep in mind, though, that only the individual who pays specific expenses can take the corresponding deductions.

- The partner with the highest effective tax rate can pay for the expenses that offer the biggest deductions, particularly the mortgage. This person can also make all of the charitable contributions.

- The partner with the lowest effective tax rate can pay for medical and miscellaneous expenses that qualify for deductions. These deductions can only be taken if they total more than 7.5% of income.
- The partner with the lowest effective tax rate should be the first name on joint bank or investment accounts with earnings. The IRS sends the 1099 to the first name on joint accounts, so the partner with the lowest tax rate will be declaring this income.

If one partner is supporting the other partner there may be a temptation to claim the non-working partner as a dependent. The IRS has very strict rules about who qualifies as a dependent (including that the dependent cannot have income of more than \$3,650 for 2010), so be very careful about this.

Tax rules and regulations can be very complex and you do not want to get yourself in trouble with the IRS. If you have any uncertainty about your taxes you should consult a tax professional.

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