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CHECKS AND BALANCES TV®

with MATTHEW J. RETTICK

THE TRUTH ABOUT TAXES

And ways to legally reduce them!

"Anyone may arrange his affairs so that his taxes shall be as low as possible; he is not bound to choose that pattern which best pays the treasury. There is not even a patriotic duty to increase one's taxes. Over and over again the courts have said that there is nothing sinister in so arranging affairs as to keep taxes as low as possible. Everyone does it, rich and poor alike and all do right, for nobody owes any public duty to pay more than the law demands."

Source: Judge Learned Hand (1872-1961), Judge, U. S. Court of Appeals.
In the case of Gregory v. Helvering 69 F.2d 809, 810 (2d Cir. 1934)

Taxes. There are few other words I know that anger people so quickly. Most Americans do *not* like paying taxes, yet everyone at some point realizes that to some degree, taxes are a necessary evil. Like taxes or not, they are *not* going away. As the old saying goes, "Nothing in life is as certain as death and taxes." So, let's take a look at them with an eye towards, as Judge Learned Hand wrote, "arranging affairs as to keep taxes as low as legally possible."

Our country was founded, in no small part, in protest against *unfair* taxes. What *are* "fair taxes"? One important premise for the founding fathers was there would be no "taxation without representation." (Don't tell residents of Washington D.C. that. They're subject to federal income taxes, yet they do *not* have any representation in Congress or the Senate. Maybe we haven't come that far from the days of our revolution against England, after all!)

DIFFERENT TYPES OF TAXES – INCOME, ESTATE, SALES, FEES AND MORE

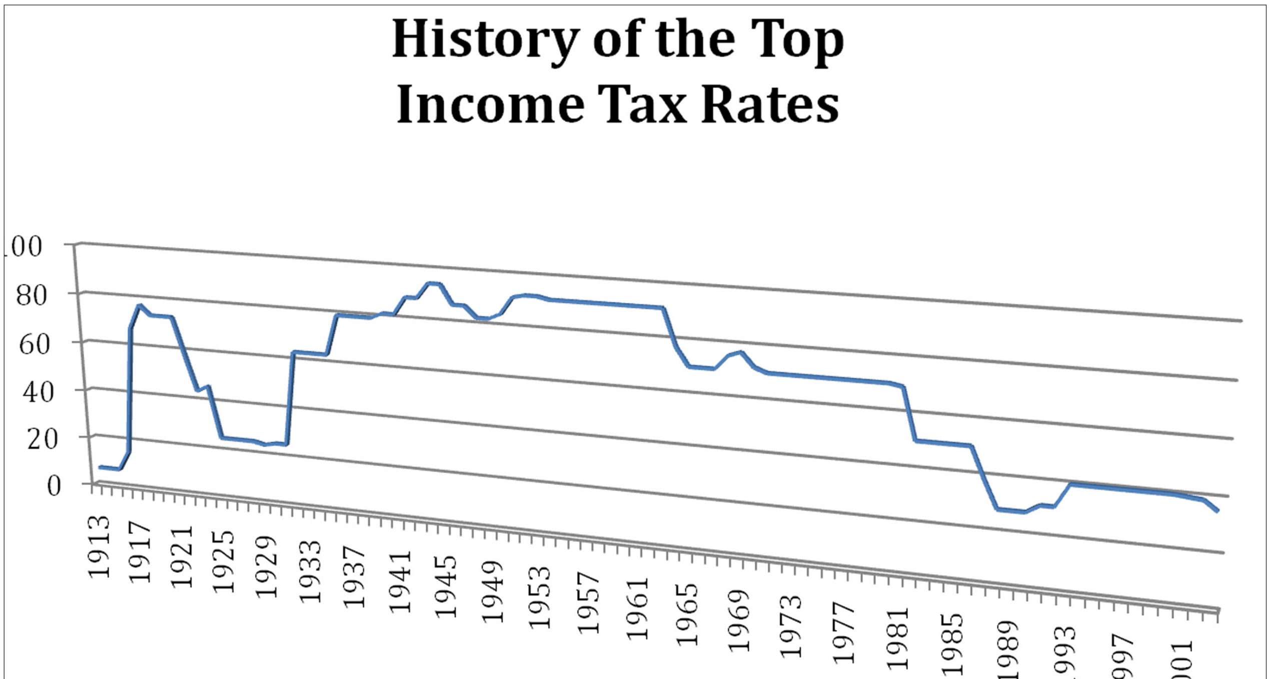
When most people hear the word taxes, they think of income taxes. They think of the money that is deducted from their paycheck, or in the case of self-employed people, the money they have to pay quarterly on their estimated income. But there are, in fact, DOZENS OF TAXES THAT WE ALL PAY OVER THE COURSE OF THE YEAR WITHOUT EVEN GIVING THEM A THOUGHT! Take a look at this *partial* list:

Accounts Receivable Tax
Alarm Permit Tax
Building Permit Tax
Capital Gains Tax
CDL License Tax
Cigarette Tax
Corporate Income Tax
Court Fines (indirect taxes)
Dog License Tax
Federal Income Tax
Federal Unemployment Tax (FUTA)
Fishing License Tax
Food License Tax
Fuel Permit Tax
Gasoline Tax (42 cents per gallon)
Hunting License Tax
Inheritance Tax
Interest Expense (tax on the money)
Inventory Tax I
RS Interest Charges (tax on top of tax)
IRS Penalties (tax on top of tax)
Liquor Tax
Local Income Tax
Luxury Taxes
Parking Tax
Marriage License Tax
Medicare Tax
Premium Tax
Property Tax
Real Estate Tax
Recreational Vehicle Tax
Road Toll Booth Taxes
Road Usage Taxes (truckers)
Sales Taxes
School Tax
Septic Permit Tax
Service Charge Taxes
Social Security Tax
State Income Tax
State Unemployment Tax (SUTA)
Telephone Federal Excise Tax
Telephone Federal, State and Local Surcharge Taxes
Stadium Tax
Telephone Federal Universal Service Fee Tax
Telephone Minimum Usage Surcharge Tax
Telephone Recurring and Nonrecurring Charges Tax
Telephone State and Local Tax
Telephone Usage Charge Tax
Toll Bridge Taxes Toll
Tunnel Taxes
Trailer Registration
Tax Utility Taxes
Vehicle License Registration Tax
Vehicle Sales Tax
Watercraft Registration Tax
Well Permit Tax
Workers' Compensation Tax

Even with this list, I'm sure there are more I haven't thought of. The fact is, we pay a lot of taxes beyond just income taxes.

A Brief History of the Income Tax

While there are those who would like you to believe that the 16th Amendment was never formally ratified, for the rest of us income taxes are a reality. They began as a "temporary tax" in 1913 at which time the *maximum* rate was only 7%. Fast forward to 1951 and the picture looked quite a bit different



Source: www.TaxFoundation.org

when the maximum rate rose to 91%. It stayed at that high level until 1963 when it dropped to the *low level* of "only" 77% in 1964.

Mind you, we're talking about the *highest rates* here. Not everyone paid at that level. The rate you would have paid was based on your income. For example, in 1913, you wouldn't get hit with the top rate unless your income topped $500,000. Even in today's dollars, that's not chump change, but, back then, it was roughly the same as (are you sitting down?) $8,793,886 assuming a constant 3% inflation, and $8.8 MILLION dollars to get to the top bracket in 1913! When the rate dropped to 77% in 1964, in order to find your way into the top bracket, you would have had to earn a little less; $400,000. In today's dollars, that's equal to about $2.2 million.

Today… to get into the top bracket, you only have to earn $373,650 as a single person or married couple. So while the top tax rate today is only 35%, a *lot* more people actually have to pay the tax compared to the past. By the way… in 1913 dollars, today's $373,650 was equal to only about $21,245. Back then, the *average household income* was only about $15,000!
(Source: www.VisualizingEconomics.com)

Macy's Department Stores Change Everything

It was a pipe puffing man named Beardsley Ruml, the Treasurer of R. H. Macy & Company, who developed the tax *collection* system that survives to this day. Back in 1942, it's said the "class tax" became the "mass tax." The problem was workers weren't used to setting aside money from their paychecks to send to the Internal Revenue Service. As a result, many people fell behind, and the government wasn't able to collect. So Ruml, who was also on the Federal Reserve Board at the time, came up with the idea that *employers should deduct the taxes from people's paychecks before they could spend the taxes, and send the taxes directly to the government!* That idea solved the problem of not being able to collect taxes because it turned employers into tax collectors! In essence, it's exactly what we have today.

Not All Taxes Are Created Equal…

There are some taxes that you can't do a darn thing about, and others where there are a lot of opportunities to arrange your affairs, as Judge Learned Hand wrote, in order to legally pay as little tax as possible. The two taxes that you can do the most about are the *income tax* and the *estate tax*.

Reducing Your Income Tax, or Postponing It.

When we talk about reducing income taxes, we have to be careful to differentiate between *delaying* or *postponing* taxes and actually *reducing* taxes. Both can be good, but one is (obviously) better! Problem is, there aren't as many ways to eliminate tax as there are to defer it, so we'll cover both.

Eliminating Tax on Income – Legally

Let's start with the ways you can have income and (hopefully) never pay income tax on it. There are three "tax-free" sources of income available: municipal bond interest income, life insurance, and ROTH IRA's.

Tax Free Municipal Bond Interest

Municipal bond interest is free from Federal Income Tax. You should be aware, however, that there are two potential traps that will cause "municipal bond" income to count for tax purposes. The first is the Alternative Minimum Tax or AMT. The AMT is the government's way of saying, "Look, we know we couldn't tax you any other way, so we came up with the AMT to tax people we couldn't find any other way to tax." In essence, the government realized that smart people were following the rules to arrange their affairs to reduce their taxes and they didn't like that so… poof! The AMT was born. Be aware that municipal bond interest can be counted for AMT purposes.

The second income tax trap that causes municipal bond income to be countable for tax purposes is the tax on Social Security. If you're retired and receiving Social Security income, there is a formula that is used to figure out whether or not your Social Security income will be taxed. It's called "Provisional Income," and *it includes municipal bond interest!*

I can't begin to tell you how many times I've seen the proverbial little old lady who had a large amount of her money invested in municipal bonds in order not to pay income taxes, but who ended up paying tax on almost all of her Social Security income as a result. The table below shows how much income you need before a certain percentage of your Social Security income will be taxable.

The formula that's used to calculate these income levels (Provisional Income) below includes *all* income (including municipal bond income) plus half your Social Security. So if you're a widow(er) and your annual Social Security is $24,000 you'd take half of that ($12,000) and add all the rest of your income together, and, if the result is over $25,000, you'll be paying tax on your Social Security.

Marital Status	**50% of Social Security is included in your taxable income if your Provisional Income exceeds:**	**85% of Social Security is included in your taxable income if your Provisional Income exceeds:**
Single	$25,000	$34,000
Married	$32,000	$44,000

Let's look at an example:

Mary has annual Social Security of $18,000 plus a small pension of $15,500. Her house is paid off, and she lives comfortably on this income. She also has $250,000 in savings and investments from which she never takes withdrawals. She lets her earnings stay in the account and compound. She earns an average of 3% on her account or about $7,500 per year.

Without the earnings on her account, Mary's Provisional Income is her pension ($15,500) plus half her Social Security ($9,000) for a total of $24,500. At this point, Mary doesn't have to pay a penny on her Social Security income. But… when we add in the earnings on her savings and investments of $7,500 it brings her Provisional Income to $32,000 which means Mary will have to count 50% of her Social Security -- $9,000 -- as taxable! If her savings and investment earnings *increase* to $9,500, as her accounts (hopefully) grow, she'll have to include 85% of her Social Security as taxable! And it's all due to the earnings on her savings and investments. *Even if she has it all invested in municipal bonds!!!*

Stopping The Tax On Social Security Income

In Mary's case, because she is not withdrawing her interest and doesn't need it to live on, she could be much better off by moving it from accounts that generate taxable earnings, such as Certificates of Deposit or a typical brokerage account with her stock broker, into a Tax Deferred Account.

Interest earned in tax-deferred accounts is *not included* in the Provisional Income formula. Thus, Mary could earn as much as she wanted in the tax-deferred account and *not* have a penny of her Social Security included for tax purposes. In that case, Mary's total annual tax bill would be about $775 after taking the standard deduction and personal exemption on the only countable income she'd have-her small pension. The table below shows a side-by-side comparison of her current situation versus her situation after transferring her savings into a tax deferred account.

	Current Situation	**Using A Tax Deferred Account**
Pension	$15,500	$15,500
Interest Earnings	$7,500	$0*
Social Security	$16,000	$16,000
Provisional Income	$32,000	$24,500
Adjusted Gross Income	$32,000	$15,500
Standard Deduction & Personal Exemption	$7,750	$7,750
Taxable Income	$24,250	$7,750
Income Tax	$3,138	$775

**Mary still earns $7,500 in interest in a tax deferred account, but only has to report that if she withdraws it.*

By arranging her affairs using tax deferral, Mary saves herself $2,363 in income taxes – per year. That's an extra $23,630 in spending money for her over ten years. And that is *tax savings* – which means the IRS will never get that money.

What's the catch? Do the taxes on those earnings *ever* have to be paid. Of course. If Mary makes a withdrawal from the tax-deferred account, the *first* money she withdraws will be considered as her interest earnings and will be taxed as ordinary income. The diference is this: *Mary is now in control of her taxes!* If she continues not to need to take withdrawals, she won't be taxed. In her current accounts, no matter if she takes a withdrawal or not, every penny of her earnings is taxed each year.

If Mary lets her account grow and then dies, leaving the account to her children, they would have to take money out of the inheritance to pay taxes on the earnings. Assuming Mary lives for ten years and never earns more than 3% interest, her original $250,000 account will have grown to be about $336,000. That means that her heirs would owe taxes on about $86,000 of interest. Depending on how many heirs she has, that amount would be divided between them. If they take out their inheritance over a five year period, it would reduce the annual taxable interest to about $17,200 per year. In a 15% tax bracket they'd pay taxes of $2,580 per year for five years in order to receive an inheritance of $336,000.

By the way, note in the above scenario Mary had an extra $23,630 in spending money by implementing this strategy. That was her tax savings. And after she died, her kids paid taxes of $12,900 which means even *after* paying taxes on the inheritance, Mary's family saved $10,730 in taxes ($23,630 minus $12,900).

The Power of Tax Deferral: Triple Compounding

The example above brings us to the value of deferring taxes which is *triple compounding.* Albert Einstein called compound interest the 8th wonder of the world, and rightfully so. Triple compounding is earning interest on your principal; interest on your interest *AND* interest on the money you would otherwise have to pay in taxes. With triple compounding, if you start with a dollar and double your money every day for thirty-one days, you'll end up with over one billion dollars. Here's the math!

Day	Account Value	Day	Account Value
1	$1	17	$65,536
2	$2	18	$131,072
3	$4	19	$262,144
4	$8	20	$524,288
5	$16	21	$1,048,576
6	$32	22	$2,097,152
7	$64	23	$4,194,304
8	$128	24	$8,388,608
9	$256	25	$16,777,216
10	$512	26	$33,554,432
11	$1,024	27	$67,108,864
12	$2,048	28	$134,217,728
13	$4,096	29	$268,435,456
14	$8,192	30	$536,870,912
15	$16,384	31	$1,073,741,824
16	$32,768		

But, what if you have to deduct taxes from your account each year? If your tax rate is 15%, does that mean instead of ending up with $1 BILLION at the end of 31 days that you'd only end up with around $850 MILLION? Wouldn't that seem to make sense? Here's the same math with only one difference: each year you have to withdraw 15% of your annual earnings in order to pay the Internal Revenue Service.

Let's take a look on the next page...

Day	Account Value	Day	Account Value
1	$1	17	$18,826
2	$2	18	$34,827
3	$3	19	$64,430
4	$6	20	$119,196
5	$12	21	$220,513
6	$22	22	$407,949
7	$40	23	$754,706
8	$74	24	$1,396,207
9	$137	25	$2,582,983
10	$254	26	$4,778,518
11	$470	27	$8,840,258
12	$869	28	$16,354,477
13	$1,607	29	$30,255,783
14	$2,973	30	$55,973,198
15	$5,501	31	$103,550,417
16	$10,176		

(Note: Due to rounding, year two still shows $2. In reality, it is only $1.85.)

Look at the difference! Now instead of ending up with $1 BILLION, paying only 15% in taxes gave you an ending balance that was 90% less!!! You didn't end up with $850 million as intuition might tell you; you ended up with (only) $100 million!

So even though you still need to pay taxes on all the earnings when you start to withdraw from the account, clearly deferring taxes is better than paying as you go, even at low rates.

Pay Now or Pay Later?

Is there *ever* a time when you might want to *pay now?* Yep. There is. Imagine this… you *knew* that tax rates were about to go up, big time, but you had the opportunity to pay them today at a much lower rate. Wouldn't it make sense to pay them at the lower rate today rather than the higher rate after the rates went up? Of course! It's no different than knowing that you could buy something on sale, but instead decided to wait until it goes back up to full price. Not a very smart move.

With taxes, there can be times when you are pretty sure that your current tax rate is lower than what it will be in the future. In that case, it makes sense to pay taxes now instead of deferring them. When are these times? Potentially *right now!* Recently (as of this writing, it's December 2010), it seemed that Congress might let the so-called "Bush Era Tax Cuts" expire. If they had, tax rates would have gone UP! Instead, they extended the current tax rates for another two years. Political observers call this "kicking the can down the road" for someone else to deal with it. At this time, coming off the past few years of government bailouts and historically high deficits, it seems like a fairly safe guess that tax rates will have to *rise* over time. Go back to the historical tax rate chart at the beginning of this paper, and you'll see that we're at very low tax rates, from a historical perspective. What does this tell you?

To 401(k) and IRA or not?

It used to be that it made sense to stash as much money as you possibly could into the company retirement plan or other tax-deductible account. The thinking was you could take a tax deduction today, and then, when you retired, you would be in a lower tax bracket, so when you had to pay the taxes you postponed, you'd pay them at a lower rate. But things have changed. Years ago we had a lot more tax brackets. Each bracket was smaller. That meant if you earned $50,000 while you were working and then in retirement only earned $25,000, you'd be in a lower tax bracket. Today, that's no longer true. With tax brackets being as big as they are, you'd still be in the same bracket!

More importantly, the example above assumes the rates and brackets themselves stay the same from now until the time you retire. I can't tell you for sure that taxes will go up, but I can tell you I don't see how they can't go up given everything that's going on in our economy. And if I'm right, taking a tax deduction today at 15% (or 25%) and then having to re-pay those taxes down the road at 30% or more would be a big financial blunder!

So before you "max out" your tax deductible retirement plan, you might want to think twice. If you are eligible for a 401(k), it almost always makes sense to contribute enough so you get the full "company match." Beyond that, consider a ROTH IRA where you pay taxes today (no tax deduction) and then *pay no taxes at all* when you withdraw money in the future. (Of course, you do have to follow the ROTH rules in order to achieve that.)

While a ROTH IRA can be a great thing, you can't really contribute that much to a ROTH. The government doesn't want you to have *too much of a good thing!* That's where the ultra-wealthy use alternative investments such as life insurance.

The Miraculous Features of Life Insurance

I know that the "common wisdom" is that life insurance is "never a good investment," but there are ways to use the tax law to make life insurance a powerful tax shelter for retirement income. In fact, as part of an overall financial plan, life insurance can be one of the best ways to generate *tax-free* retirement income just like a ROTH IRA.

In most cases, people buy life insurance with one thing in mind: getting the most coverage possible with the least cost (premium). But if you take the opposite strategy, you maximize the tax shelter and minimize the coverage. In English? Stuff as much money as you can into the smallest policy possible. That minimizes the drag on growth by minimizing the life insurance costs and allows the money you put in to grow as quickly as possible. When it comes time to taking money out of the policy, if you do it right, you'll have a tax free income.

What's *the right way* to take money out of a life insurance policy? Well, there are three ways to get money out of life insurance; one's kind of sad, one's kind of dumb and the other way is very smart. The sad way is to die. In that case the policy has what I like to call a "Yield To Maturity" that is always higher than what you've contributed, and it's tax-free to your heirs, in most cases. The dumb way is to cash it in. If you do that you'll owe taxes on all the earnings beyond whatever you paid in. The smart way to take money out is to withdraw (up to the amount you contributed) and borrow anything above your total deposits. Loans on life insurance are *not* counted as income. If you do this properly, the loan is ultimately paid back by the death benefit. This is a strategy that many millionaires use every day and a strategy that you can use as well. See a competent financial advisor to get more details on these strategies.

Ordinary Income versus Capital Gains

So far we've talked about what's called "ordinary income." That's income from your job and dividend or interest income, generally speaking. But there's another type of income that gets favorable tax treatment called *capital gains.* A capital gain occurs when you buy something for one price and then later sell it for a higher price. You might think of it as profit. If you bought a stock for $3,000 and two years later sold it for $4,000 you'd have a $1,000 capital gain. That gain is *not* taxed at the same rates as your income from work or like interest; it's taxed at the *lower Long Term* capital gains tax rates.

Capital Gains: Short Term Versus Long Term

If you own an asset for at least one year and then sell it, at a gain it's considered a *long term* capital gain. If you sell the asset before you've owned it for at least a year, it's considered a *short term* capital gain. Short term capital gains are taxed the same as ordinary income but,currently, and through the end of 2012, the maximum tax on *long term* capital gains is 15% for people who are in a 25% or higher ordinary income tax bracket, and 0% for people who are in the 15% or lower ordinary income tax bracket.

Capital Losses

But what if you bought that stock for $4,000 and then sold it later for $3,000? Then you'd have a capital *loss*. You can match up your capital gains and losses and use your losses to reduce your gains. If you have more losses than gains, you get to use up to $3,000 of capital losses to reduce your ordinary income. After that, if you still have losses left over that you weren't able to deduct against ordinary income you get to carry those losses forward to future tax years and try to use them to offset capital gains from future years. If your gains aren't sufficient to match up against your losses, you can deduct another $3,000 against ordinary income each year and continue to carry the remaining losses forward for as long as you need until you use them up. By the way, you can offset any type of capital gain with any type of capital loss, meaning a short term capital loss can be used to offset a long term capital gain and vice-versa.

Tax Deductions

Speaking of using losses to offset gains, you can use certain expenses that you incur over the course of the year to offset income. To get into a highly detailed discussion of tax deductions is beyond the scope of this paper, but we can talk in general terms.

As of this writing at the end of January, 2011, the biggest three tax deductions that are available to most Americans are related to real estate and charity. First, if you own real estate and pay taxes on that, you can deduct that tax against your income. Second, if you have a mortgage on your home, you can (subject to some limitations) *generally* deduct the cost of interest on that mortgage loan. Finally, if you make contributions to your church or a charity, you can deduct the full amount of those donations if they are in cash or check. (Donating personal property can also be deducted subject to some additional substantiation and valuation rules.)

The Biggest Tax Deduction of All: Your Business

Let's start this conversation by emphasizing we're talking about a legitimate business that has a profit motive. You cannot start a business with no motive other than to reduce your taxes and expect the IRS not to catch up with you sooner or later!

But, in thinking about what a legitimate business is, it doesn't take that much. Have you ever made things and sold them? Set up a table at the flea market? Had a multi-level, aka network marketing business? Sold things on ebay? Guess what? If you did that in order to make a profit, you have a legitimate business. It doesn't matter whether or not you actually made a profit every year, as long as you are trying to operate a business.

Let's say you decide to begin to go to flea markets to buy items you will sell on ebay or Craigslist and think of the items that could be legitimate deductions attributable to that business. You would need to have an internet connection, meaning your internet cost is now deductible. You'd need to get a newspaper in order to know when and where the flea markets and yard sales are, so that's a deductible expense. Need a new computer? Deductible. Desk for your home office? That's deductible, too.

Find yourself a good accountant who can help you in this regard and who will guide you as to what's a legitimate expense and what isn't. You'll find this to be, potentially, a huge benefit to your bottom line tax bill.

Summary

In summary, taxes are unlikely to go away anytime soon and there's a good chance they'll increase, perhaps in a big way after 2012. So, it's important you *plan* to reduce your taxes instead of just to *pay* your taxes. I'm *not* suggesting you don't pay your taxes! Please pay your tax bill! What I am suggesting is that you take heed of Judge Learned Hand's words and arrange your affairs so as to minimize your taxes in every legal way possible. I sincerely hope this FREE report will help spark some valuable ideas on how you can pay *less* taxes and keep *more* of your hard-earned money!

For more information regarding this topic or any other financial product or area of interest, email us at ***Info@ChecksandBalances.TV.***

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"Anyone may arrange his affairs so that his taxes shall be as low as possible; he is not bound to choose that pattern which best pays the treasury. There is not even a patriotic duty to increase one's taxes. Over and over again the courts have said that there is nothing sinister in so arranging affairs as to keep taxes as low as possible. Everyone does it, rich and poor alike and all do right, for nobody owes any public duty to pay more than the law demands."

Source: Judge Learned Hand (1872-1961), Judge, U. S. Court of Appeals.
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