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Seven Steps to Lower Your Taxes (4 min read)

We've all heard that death and taxes are inevitable. Well, death may be inevitable, but taxes are not. With some tax planning, you can owe less money to the IRS at the end of the year.

Here's a quick look at seven steps you can take to reduce your taxable income and the taxes you will owe. These are basic tax-saving strategies that every taxpayer should know. They don't involve offshore bank accounts or convoluted tax shelters. These tax planning devices are easy to understand and put to use, and are most likely to save you -- the average taxpayer -- money.

Step 1: Earn Tax-Free Income. Certain types of income aren't subject to income tax at all. The single best way to avoid taxes is to earn as much tax-free income as possible. There are many ways to do this. Some of the most common are selling your home (the home sale tax exclusion), saving money for your children's education, investing in municipal bonds, contributing to a health savings account, receiving health insurance and certain other employee benefits from your employer, spending some of your salary on out-of-pocket health costs, and giving some investments to your children.

Step 2: Take Advantage of Tax Credits. Obtaining a tax credit is the next best thing to paying no taxes at all because it reduces your taxes dollar for dollar -- something a deduction does not do. Congress has taken a great liking to tax credits in recent years and is adding new credits all the time. Some examples include tax credits for buying a hybrid car or making certain home energy improvements, such as adding insulation or a solar water heater to your home. There are also child and child care tax credits and education tax credits.

Step 3: Defer Taxes. You'll have to pay income tax on your taxable income sooner or later, but you'll usually be better off if you make it later. Deferring payment of taxes to a future year is like getting a free loan from the government. There are many ways to do this, from postponing an employer bonus to investing in IRAs and other retirement accounts.

Step 4: Maximize Your Tax Deductions. Perhaps the most well-known way to reduce taxable income is to take tax deductions. The more deductions you have, the less tax you'll pay. People in business can deduct all their business expenses, such as inventory, office or home office, travel, operating costs, and so on. Every taxpayer is entitled to take a standard deduction or itemize their deductions. Itemized deductions are usually personal in nature and include things like your home mortgage interest, property taxes, charitable contributions, and state income tax. There are many ways you can increase your business or personal itemized tax deductions.

Step 5: Reduce Your Tax Rate. Federal income tax rates can vary dramatically, from as low as 5% to as high as 35%. You can benefit from the lowest rates available if you earn income from investments like stocks, bonds, mutual funds, and real estate. The profits you earn from these investments are taxed at capital gains rates, which are right now at the lowest they have been since 1933 -- as low as 5%. In contrast, the average working stiff must pay income tax on his salary or business income at ordinary income rates, which can be as high as 35%.

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Step 6: Shift Income to Others. If you're in a high tax bracket you can save substantial taxes by shifting your income to someone in a lower tax bracket -- for example, your children. This process is called income shifting or income splitting. Recent changes in the tax law make this harder to do than it was in the past, but it's still a viable planning tool for many taxpayers.

Step 7: Take Advantage of Your Filing Status and Tax Exemptions. Few people give much thought to their tax filing status, but it can have a big effect on the taxes you pay. Which filing status you choose (and taxpayers often have a choice) will determine the tax bracket you fall in. Your filing status is also crucial for calculating your standard deduction, personal exemptions, and income levels for phase-outs of your itemized deductions and personal exemptions. It's also important to know about tax exemptions and which ones you are entitled to take. There are personal exemptions for you and your spouse and dependent exemptions for children and other family members. Not everyone can take advantage of tax exemptions because they are subject to income restrictions.

You owe it to yourself to learn these basics about tax planning and how they can help you. The sooner you start to take advantage of these tax saving strategies, the better off you will be at tax time. Then you can rest assured that you are not one of the many people paying too much money to the IRS.

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