

## **MoneyWise Workshop Module 4: Tax and Long-term Planning: Key Issues**

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### **Introduction**

The purpose of this chapter is to aid you in understanding some of the basic concepts with planning, including life planning, budgeting, filing your taxes, and long-term planning. Since taxes are one of the largest single expenses for most families each year, it is important that you learn tax basics that can help you minimize your taxes owed. Tax principles discussed will mainly be regarding your Federal tax return, since each state is different. Our purpose is to give you a basic framework for understand planning and making wise financial choices.

### **Objectives**

There are six objectives for this chapter:

1. Financial Perspectives: Planning
2. Learn the Tax Rules
3. Credits: First Prize
4. Deductions: Second Prize
5. Shelters & Savings
6. Estate Planning and Wills

### **1. Financial Perspectives: Planning**

As you've been going through these chapters, we have tried to focus on the financial perspectives, showing how finance ties into the gospel of Jesus Christ. These are important if we are to use our resources in the way God would like. Ezra Taft Benson said:

*Plan for your financial future. As you move through life toward retirement and the decades which follow, we invite all ... to plan frugally for the years following full-time employment. Be even more cautious ... about "get-rich" schemes, mortgaging homes, or investing in uncertain ventures. Proceed cautiously so that the planning of a lifetime is not disrupted by one or a series of poor financial decisions. Plan your financial future early; then follow the plan.<sup>i</sup>*

At the end of this quote, he says "Plan your financial future early; then follow that plan". One of the most important things you can do right now is plan for your financial future. Be wise in the things you wish to accomplish. Seek the Lord's help as you set goals as to what you want to

accomplish. Remember the admonition to “Be thou humble; and the Lord thy God shall lead thee by the hand, and give thee answer to thy prayer.”<sup>iii</sup>

Benson cautions: “Be even more cautious about get-rich schemes, mortgaging homes, or investing in uncertain ventures”. It is not good when people have investment losses, but it is even worse when they have investment losses with money that they borrowed. Do not borrow to invest. Be wise in your investments as discussed in the previous chapter.

A key component of planning for your financial future is your budget. Spencer W. Kimball said: “Every family should have a budget.”<sup>iii</sup> This means everyone! Regarding budgets, Marvin J. Ashton said:

Some claim living within a budget takes the fun out of life and is too restrictive. But those who avoid the inconvenience of a budget must suffer the pains of living outside of it. The Church operates within a budget. Successful business functions within a budget. Families free of crushing debt have a budget. *Budget guidelines encourage better performance and management.*<sup>iv</sup>

“Those who avoid the inconvenience of a budget must suffer the pains of living outside of it”. This is a principle that we familiar with in relation to the gospel and commandments. Some people look at commandments and think they are restrictive and not very fun. However, experience has shown that they are not restrictive, but protective and that they bring peace. There is protection and peace in living the commandments, including the commandment to live on a budget. Is the budget restrictive, or does it teach us to make choices? We learn to work within our means making important choices that show what we really think and value. There is peace in being prepared financially.<sup>v</sup>

Budgeting is not a watch-where-it-went strategy, it is planning. It is the spiritual creation before the physical creation. It is following the commandments of God. We must learn to be better in our planning.

## **2. Learn the Tax Rules: To Win the Game You Must Know the Rules**

Charles Warner said: “Everybody talks about the weather but nobody does anything about it.”<sup>vi</sup> Some think the same thing about taxes. They are wrong. Taxes are something that you can plan for, and you can make changes to reduce your tax expenses. Tax-planning methods are something you can plan for to know what to expect.

Milton Bradley created a game called “The Game of Life”. Some have also referred to tax rules as a game. But tax planning is not an optional activity if you have income. If tax planning is a game, then you must understand the rules so you can win the game, which is to pay every dollar you owe, and not a penny more.

### **Tax Rules: The Tax Process Simplified**

Let's go through the basic framework for tax planning; this is as if you were looking at a basic 10-40 or 10-40 EZ individual tax return.

1. Start with your gross income from all sources. Gross income pretty much includes everything, less a few exclusions and deductions. If you earned something, then you are likely responsible to pay taxes on it, and you need to report it in your gross income.
2. Next, subtract adjustments to your gross income to get your adjusted gross income (AGI). Adjustments include flexible spending amounts, contributions to individual retirement accounts (IRAs), student loan interest deductions, and health savings accounts (HSAs). Be familiar with your AGI, as a lot of your credits and deductions are based on your AGI.
3. Subtract the greater of your standard or itemized deductions. You can calculate your itemized deductions yourself (based on IRS rules), or you can use the IRS determined standard deduction.
4. Then subtract your exemptions. Your exemptions are an automatic deduction that you get for each individual on your tax return.
5. You look up your tax amount in the tax table which gives your tentative tax.
6. Subtract any credits (which we'll go over further as well), which gives your total tax owed.
7. Finally, once you have your tax owed, you would subtract any estimated payments that you've already submitted or had withheld from your tax return to give you your balance due or amount of your refund.

Ideally, you should have sufficient taxes taken out each month so that come tax time you do not get money back (which means you gave a no-interest loan to the government) or owe money.

### **Tax Rules: Simplified Tax Format**

This is the mathematical formula, which give the same message. Start with your gross income, subtract any above-the-line adjustments to give you your AGI. Subtract the greater of your itemized or standard deduction, minus your personal exemptions to get your taxable income. Using the tax tables, calculate your tax owed, minus your credits, less amounts paid in taxes so far, and you get your refund or amount owed.

### **Tax Rules: Taxing Terms**

Let's start with a few definitions. Tax deductible refers to being able to subtract an amount from your income on your tax return when you're calculating taxes. When people say "Is this tax deductible", they are asking "Can I deduct it from my income before I calculate my taxes".

The pretax is something that is subtracted from your income before you report it in your tax return. So the gross income we started with, pretax deductions are not included automatically. An example of a pretax deduction would be a 401k contribution, an investment vehicle we discussed in earlier chapters. In that plan, money you contribute is deducted from your income before you pay taxes. Another example is health insurance that's withheld from your paycheck. Those are pretax deductions and your employer will subtract that from your gross wages on your W-2.

If something is tax deferred, it means it is not taxed now, but will be taxed later. Your traditional IRA contribution is tax-deferred, where the pretax deduction meant you didn't pay any tax on it now, but in the future you will have to pay tax on both principle and interest—it is not tax free.

If something is after tax (or tax eliminated), it means that you get no tax benefit now, but when you take it out at retirement, you will pay no taxes on both principle and earnings. A Roth IRA or Roth 401k are examples of after tax or tax eliminated vehicles.

Tax free indicates it is not taxed at all. Certain types of income, such as interest on municipal bonds, are federal tax free, and other types, such as interest on government securities, are state tax free.

### **Tax Rules Example: Tax Deduction versus Tax Credit**

There is a different value to you of a tax deduction versus a tax credit. The worth of a deduction is that deduction amount times your tax rate in percent. For example, if you are in the 10% marginal tax rate with a \$1,000 deduction, the value of that deduction to you is the amount times the tax rate, or  $\$1,000 * 10\%$  or \$100. This deduction would reduce your taxes owed by \$100.

A tax credit is different. A tax credit is a dollar for dollar reduction of your taxes owed. For example, if you have a \$1,000 tax credit, you would take your tax owed and subtract from that \$1,000. It would reduce your taxes by \$1,000. Tax credits are significantly more important to you than tax deductions.

### **Tax Rules: Uncle Sam's Big Plans for You**

The U.S. tax system is not just to generate revenue. It also drives social objectives the government thinks important: home ownership, education, giving, retirement, and welfare. That is why the tax code is so complicated.

### **Tax Rules: Tax Withholding**

The IRS requires employers to withhold taxes from your paycheck. That accomplished multiple purposes: ensures the IRS gets paid, reduces the amount that you must pay each year, and disguises, to a degree, the actual amount of taxes we pay each year. Part of that tax withholding includes Federal income tax, state income tax, FICA tax (federal insurance contributions act) which includes contributions for Social Security and Medicare. These withholdings are mandatory and cannot be adjusted. The withholding of federal and state taxes prepays any amount you would owe on April 15<sup>th</sup> of the next year.

You decide how much you are going to have withheld each paycheck. You do that when you complete the W-4 form when you're first hired, but you can also change that form at any time. If you decide that each year your refund is too large and you'd like to have more in your take home pay during the year, or if you end up paying a large sum in April, it is because of the amount you are having withheld is not correct. You can change that at any time with the payroll department and complete a new W-4 form and change your exemptions.

The logic is that the more exemptions you claim, the less tax is withheld. The reason for that is when you have more exemptions, you are likely married with children, which increases your exemptions and reduces your taxes owed as you often have a child tax credit and lower tax rates. The goal is to have your taxes balanced out so you do not owe too much tax or get a small refund at tax time.

Some people like large refunds each year—it is their way of saving for their family vacation. However, the IRS does not pay you any interest for holding your money so that might not be the best investment vehicle to choose. There is an IRS withholding calculator on the IRS website at <http://www.irs.gov/individuals/article/0,,id=96196,00.html> that may be helpful in calculating how many exemptions you'll need to help you choose what you should do for your withholding.

### **Tax Rate Example: Tax Withholding**

Let's use an example. Jack and Jill both have \$30,000 in gross income, use the standard deduction, and have the same tax rate, so everything is the same, even the tax they owe (they both owe \$1,050). In this example, Jack had \$1,500 withheld, which resulted in a Refund of \$450, while Jill had only \$550 withheld, which results in her owing \$550 to the IRS. When you take into account the taxes withheld, that is what determines whether they owe or whether they get a refund.

### **3. Credits: First Prize**

Credits are a social tool to support the government's agenda. There are credits for education, saving, children, dependent care and earned income, to name a few. We will mainly focus on a few that may be applicable to you right now.

### **Credits: Education (American Opportunity Credit and Lifetime Learning Credit)**

Credits change year-to-year, and there are some good education credits available now to encourage education. The first is the American Opportunity Credit (AOC), previously called the Hope Credit. It is the most preferred credit. It is only available to students in their first four years of post-secondary education, so it is not available to graduate students. For the first four years, it is available for qualified expenses which are required expenses of books, supplies, and equipment. The credit is \$2,500 maximum per student. It is calculate as 100% of the first \$2000 of qualified expenses, and then 25% of the next \$2,000. You can include payments that you make with student loans because the borrowed the money is considered yours. Forty percent of this credit is refundable--can receive up to \$1,000 back in a refund even if owe no taxes. If you are paying your tuition with scholarships or Pell grants, you're not allowed to take this credit because you've already received that income tax free.

If you don't qualify for the Hope credit, the next best thing is the Lifetime Learning credit. This is available for any number of years. It's not limited to the first four years and it is 20% of the first \$10,000 per family. You take this credit or the AOC credit but you can't take both. If you qualify for the AOC, you would want to take that credit. If not, then you would take the Lifetime Learning credit.

### **Credits: Education Incentives**

There are a few other education incentives you should be aware of. While they are listed here with education credits, they are deductions rather than credits.

The education expense deduction is an above-the-line deduction which reduces your AGI by the deduction amount. It is \$4,000; however, you can't take this deduction and the credit. Use which ever credit or deduction benefits you the most.

Another deduction is Student Loan Interest. That is any interest and student loans that you took out for qualified expenses such as tuition, fees, books, supplies, equipment, transportation costs, and includes room and board (the qualified expenses discussed with the education credits did not include room and board). It is up to \$2,500 in interest a year; however, there is a phase out if your modified AGI (which includes your AGI plus foreign earned income and a few other things) is between \$125,000-155,000 for 2013.

### **Credits: Savers Credits**

There are credits to help you save for retirement. The Savers Credit is to encourage saving for retirement and it is 10-50% of your first \$2,000 contributed to a 401k, IRA, or Roth IRA. The percentage depends on your adjusted gross income. In 2013, if your AGI is greater than \$57,500 MFJ, then the credit rate is 0%; \$37,501-57,500, 10%; \$34,501-37,500, 20%; and \$0-34,500,

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50%. Full time students are ineligible for the credit, but if your spouse contributes, they are still eligible and you can get the credit.

### **Credits: More Credits**

The child tax credit is a \$1,000 credit per child on your tax return for children under age 17. If you're debating to have your child December 31<sup>st</sup> compared to January 1<sup>st</sup>, you'd save \$1,000 in taxes if you had the child in the earlier year.

The dependent care credit is a credit supporting those couples that have to get daycare for their children while they're both out of the home working. There is an exception if one of the spouses is a fulltime student. So if you have a student and someone working and you need to pay for daycare, this credit is up to \$3,000 in qualifying expenses but the credit is only 20-35% of those expenses depending on your income.

There is an adoption credit for those going through adoptions, there's also residential energy credit for energy improvements you make to your home to meet certain qualifications such as water heaters, windows, doors, etc. that meet specifications for additional credits.

### **Credits: Earned Income Credit**

The earned income credit is based on earned income so it is beneficial to those that are in lower income levels. It is a refundable credit, so even if you don't owe any taxes, you can receive the earned income credit. It is dependent on earned income and it phases out pretty quickly. For 2012 the earned income and the credit amounts are:

- >2 children and earned less than \$50,270 (Maximum credit of \$5,891)
- 2 children and earned less than \$47,162 (Maximum credit of \$5,236)
- 1 child and earned less than \$42,130 (Maximum credit of \$3,169)
- No child and earned less than \$19,190 (Maximum credit of \$475)

If you have no children and you earn less than \$19,190, you have a maximum of credit \$475. As your children and income increases, the maximum credit you can take increases then starts to phase out again as your income gets too high. With the earned income credit you can't have any investment income over \$3,200 and you must be age 25 or older (you can be younger if you have a child).

### **4. Deductions: Second Price**

If you can't take the credit, the next best thing is for deductions. In calculating your taxable income, the key is to take the higher of the standard or itemized deductions to reduce your income. The standard deduction amount in 2013 is \$12,200.

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There are a number of deductions. One of the main deductions is the mortgage and home equity loan interest; you can deduct the interest on your mortgage from your taxes. There is also the deduction for charitable contributions; you can deduct cash contributions such as tithing, fast offerings, missionary, etc., but also non-cash contributions such as donations in kind and contributions to Deseret Industries and the Salvation Army. Property and state taxes are an itemized deduction, as is excessive medical expenses, that amount in excess of 7.5% of your adjusted gross income. If you have insurance and are covered, you may not have as many out of pocket medical expenses and you might not reach that 7.5% limitation.

### **5. Shelters and Savings: Company and Individual Retirement Plans**

Shelters and savings plans are some of the easiest ways to reduce taxes. Some reduce taxes now, and others reduce taxes in the future. Traditional vehicles (IRA, 401k, 403b, SEP-IRA, etc.) are an above the line adjustment and reduce your taxes now. You will, however, have to pay taxes on the principle and earnings amount when you take it out at retirement. Roth vehicles (Roth IRA, Roth 401k, Roth 403b), on the other hand, are after-tax vehicles. You get no tax benefit now, but you get the tax benefit in the future when you take out principle and earnings at retirement or later totally tax-free.

The decision as to whether to choose a Roth versus a traditional vehicle depends on five questions:

1. Do you think tax rates will drop in retirement? If so, choose the traditional vehicle.
2. Do you want to save more for retirement? If so, use the Roth as you pay the taxes outside of the retirement vehicle.
3. Do you need the tax break now? If so, use the traditional vehicle.
4. Can you pay the taxes outside the retirement vehicle? If so, choose the Roth vehicle.
5. Will you need to take some money from your retirement vehicle before retirement without penalty? If so, use the Roth as you can take out principle (not earnings) after 5 years without penalty.

In saving for retirement, always contribute enough to get your full employer match if your company has a match. This is a 100%, risk-free, and instant return which can help you reach your financial goals faster. If the employer match is from a Roth 401k or Roth 403b vehicle, the match is put into a traditional vehicle.

If you choose to save in traditional retirement vehicles and your company only has a traditional 401k/403b, invest sufficient to get your company match and then put the remainder in your traditional vehicle. This is also helpful if the payroll deduction is the only way you can save.

If you choose to save in Roth vehicles but your company only has a traditional vehicle, invest sufficiently to get your company match first. Then put the remainder in a Roth IRA to your

maximum limits for you and your spouse (if married), and any funds beyond your Roth IRA limit invest in your traditional vehicle.

If your company has a Roth 401k or Roth 403b and you prefer the Roth vehicle, invest sufficient to get the company match, then put the remainder in the company Roth vehicle.

### **Shelters and Savings: College Savings Plans**

Another opportunity to shelter some income is through college savings plans. The decision to contribute to your children's education is an individual decision. You are not a bad parent if you choose not to put your children through law school.

Saving for your children's education can be a priority, if you so choose, as you are doing your financial planning. However, remember your retirement planning is a higher priority than your children's education. Education is their responsibility and they will be around many years to recognize the benefit of that education. If you have your emergency fund, are out of debt, and have are saving sufficient for retirement, then you could contribute to education and mission planning.

The key is to discuss with your children early your education plan for them, what help you will provide, if any, and help them to save for this important goal. Establish that understanding with your children earlier and encourage them to work hard in school and get scholarships if possible. Here are a few options to both save for education and reduce your tax expenses.

### **Shelters and Savings: Tax-favored Education Savings Options**

One of the preferred options for the tax-favored education savings is the 529 Savings Plan. This Plan is established state by state, so each state as a different plan with different options. For Utah, you can contribute up to \$397,000 per child. Money is contributed after tax, and if the principle and earnings are used for qualified educational expenses, it is all tax free. Find the state plan that best meets your needs and will work best for you. The state plan doesn't determine where the child needs to go to school, it's really just choosing an investment vehicle.

Some states also have tax credits to encourage you to save for your children's education. Utah's 529 Savings Plan is a very highly rated program (information is available at [www.UESP.org](http://www.UESP.org)). Utah has a state income tax credit for Utah residents to encourage contributions to their plan. It's a 5% tax credit for contributions up to \$3,680 in 2013. If you invest \$3,580, you would have a \$184 reduction in your Utah tax bill, which is still free money.

There's also a 529 pre-paid tuition program that in some schools allows you to pre-pay a school's tuition now. However, there is no guarantee that you child would want to go to that school or would be accepted to that school, so it does limit your options.

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The Coverdell ESA (education savings account or education IRA) is another after tax vehicle. You can contribute up to \$2,000 per child per year and the earnings will grow tax free. The difference with the Coverdell ESA and a 529 plan is that the Coverdell can be used for elementary, secondary, and post-secondary school whereas the 529 can only be used for post-secondary school.

## **6. Estate Planning and Wills**

Regarding estate planning and wills, there are a few important things that you can decide now. Most critical is who will be your guardian, the person who would take care of your children should something happen to both you and your spouse? Without a valid will, the court would decide that guardian. Make this decision carefully and prayerfully, and ensure that both you and your spouse agree.

Dividing your assets is a secondary concern. Look at what assets you have and what you want to do with them. Certain assets already have beneficiaries in place without a will. These include assets such as insurance policies, bank accounts and retirement accounts. Homes, vehicles, and other accounts may be set up as “joint tenancy with right of survivorship.” If set up this way, these accounts pass the assets to the surviving owner if something happens to just one person.

### **Estate Planning and wills: A Simple Will**

Other than these specific assets, you will need to craft a will to state your wishes on who gets what assets. There are three alternatives to a simple will. The first option is a holographic will (holographic means in your own hand). It is a handwritten will in your own handwriting which allows you and your spouse to make those determinations. If you have few assets, this may be OK. The second option is will preparation software. These can be helpful if done correctly and notarized carefully. Again, if your assets are small, this may be OK. However, as the size of your assets increase, you should definitely seek an attorney to carefully prepare a will. This is the recommended alternative.

### **Summary**

In summary, this chapter stressed the importance of planning in all areas of your life.

You should plan your financial life early, then live your plan. We have been commanded to live on a budget, and so we should. Plan your spending and then follow through on that plan. Planning, like the commandments, are protective, not restrictive.

Learn the tax rules. Taxes are the largest single expense for most people. There are simple basics to understand even though there are a lot of complex rules and laws. Understand the terms, know the difference between credits and deductions, and look at your tax withholding. Is

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your withholding sufficient, or do you pay significant taxes each year? Plan what you want to do.

Look at the list of credits. Which would you qualify for? The IRS website has information of these and other credits in more detail.

Look at deductions. Understand what are the key deductions for mortgage interest, charitable contributions, non-cash contributions and medical deductions. Understand how to calculate your standard versus your itemized deductions.

Look at your shelters and savings plans. What are your priorities right now? Is it saving for retirement, is it saving for college education for one of your beneficiaries? Shelter and savings plans can always be changed. Start them now, and you can always adjust them in the future if your situation has changed.

Finally think about long-term planning: estates and wills. For many, the most important decision would be who would be the guardian of your children should you pass away. Work together with your spouse to make that decision. Write a will. For starters, get out a sheet of paper and write a holographic will. As you get older and your asset size increases, have a qualified attorney help you write a will.

The objective of this chapter is to give you a basic understanding of the importance of planning, whether that be planning for life, planning budgets, tax planning, retirement planning, education planning and estate planning and wills. The key theme is education as to your options and then making good choices as to what you should do.

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<sup>i</sup> Italics added, "To the Elderly in the Church," *Ensign*, Nov. 1989, 4.

<sup>ii</sup> D&C 112:10.

<sup>iii</sup> Spencer W. Kimball, Conference Report, April 1975, pp. 166-167.

<sup>iv</sup> Italics added, Marvin J. Ashton, "It's No Fun Being Poor," *Ensign*, Sept. 1982, 72.

<sup>v</sup> D&C 38:30

<sup>vi</sup> Charles Dudley Warner, Hartford Courant, This Weather, 1897 August 24, p. 8, Hartford, Connecticut.