How to Save on Taxes (aka Taxation Basics Workshop) on **3/11/21**

*Disclaimer: Please note all information presented today is intended for general financial literacy education purposes and does not create a financial client/advisor relationship. We are not liable for any possible claim for damages arising from any decision you make based on this information. Please always remember to consult your accountant and financial advisor.*

*Although it is important as U.S. citizens to pay our taxes, taxes are one of the major obstacles to financial freedom.*

I. Are you aware of how much you pay in taxes?

A. Types of Taxes

1. Income tax

2. FICA (Federal Insurance Contributions Act) taxes

They are taxes taken from your paycheck to fund Social Security and Medicare programs.

a. 6.2% tax rate for Social security

b. 1.45% tax rate for Medicare

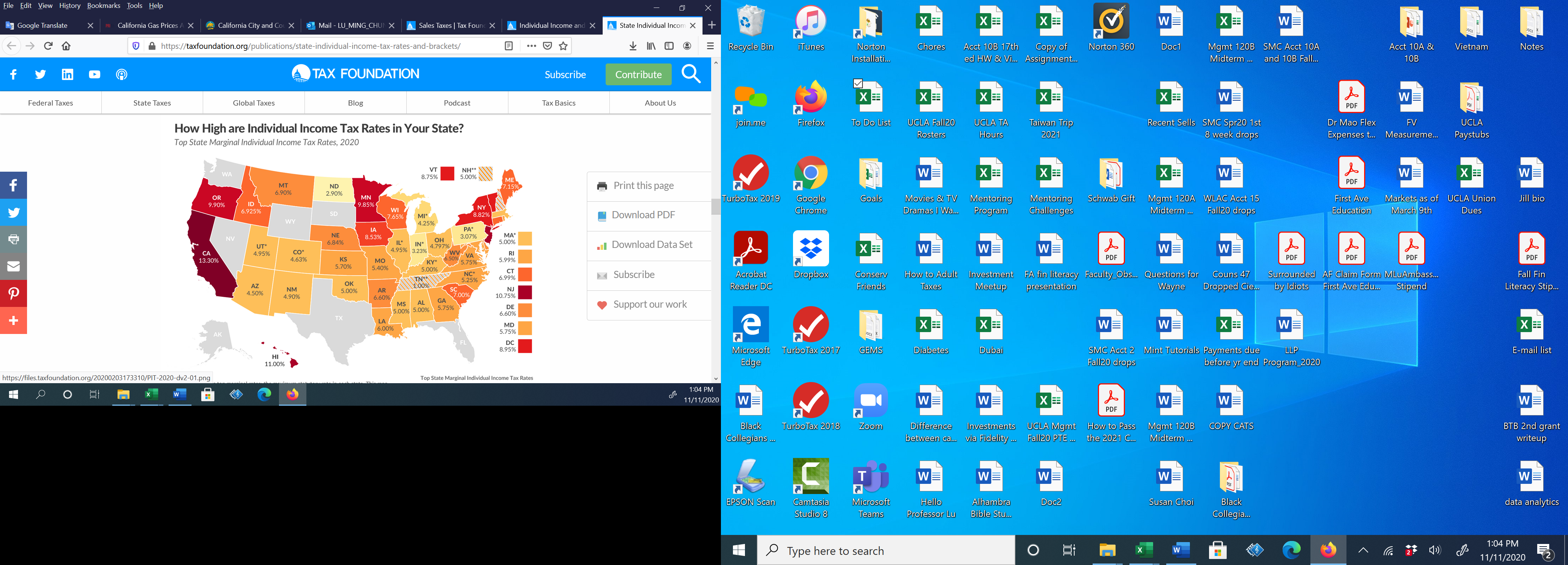
3. Sales Tax

4. Property Tax

5. Gift and Estate Tax

B. Living in California

1. California has the highest state income tax in the U.S. with a top marginal tax rate of 13.3%. Compare this to 7 other states (i.e. Nevada and Texas) that do not have a state income tax.



2. California has the highest state income tax on small businesses in the U.S. Why?

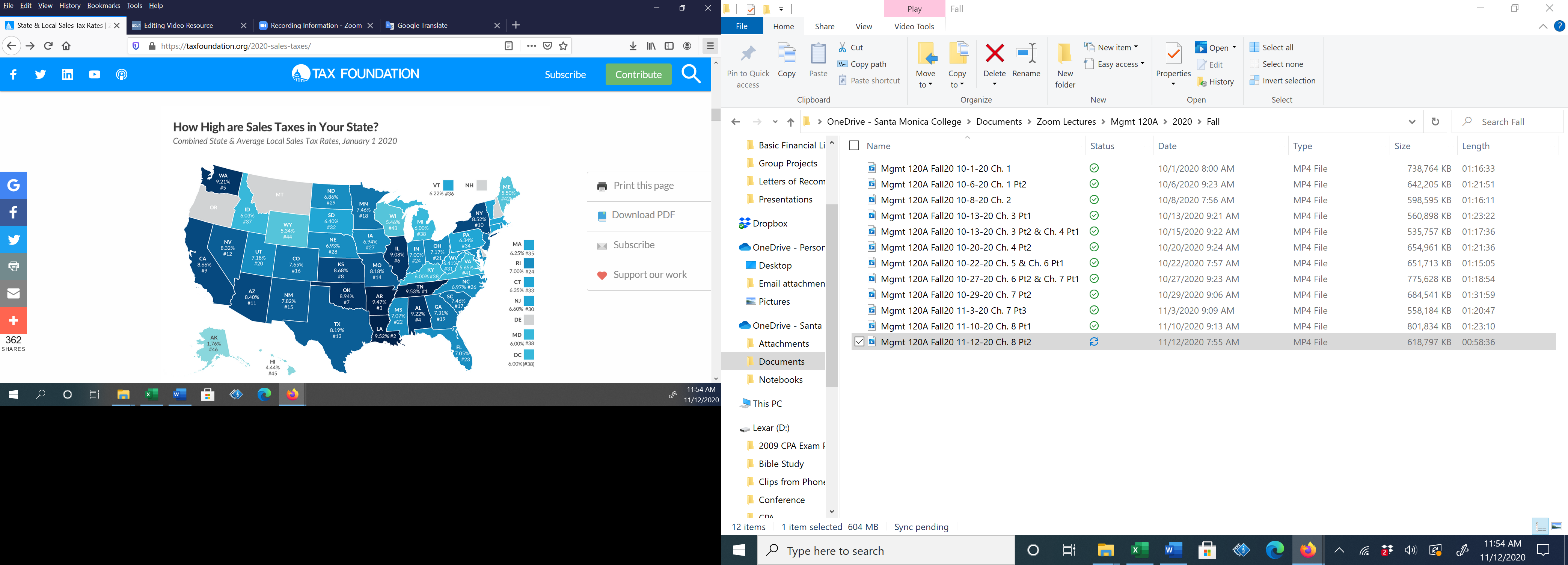
Most small businesses are set up as S Corporations, partnerships, or sole proprietorships so they basically pay their business taxes at the same rates for individuals.

3. California has the highest state corporate income tax in the U.S. with a top marginal tax rate of 8.84%.

4. California has the highest sales tax in the U.S.

a. 10.25% in Santa Monica

b. 9.5% in Los Angeles



5. California has the highest gas tax in the U.S.

California’s state excise on gasoline is 50.5 cents per gallon. When you factor in other state taxes/fees and the federal excise tax of 18.4 cents per gallon, we pay 82.2 cents per gallon in taxes every time we fill up our gas tank.

6. Although California doesn’t have the highest state property tax in the U.S. (due to Proposition 13), it still has high property tax. Why?

a. California’s property values are high to begin with.

b. Many California property owners also are required to pay costly parcel taxes, which are annual property taxes (not based upon the value of the property) imposed by many school districts, special districts and other jurisdictions.

II. What can I do about this?

A. Decrease your spending be less materialistic.

1. If you spend less, you pay less sales tax

2. If you can drive less, you pay less gas tax

3. If you buy a smaller less expensive home, you pay less property tax

B. Change your spending habits

1. Most grocery items are not subject to sales tax, so…

a. Make your own food and eat out less.

b. Brew your own coffee instead of buying it from outside vendors like Starbucks

2. If you do eat out, try to buy some non-heated items such as (Subway or Jersey Mike’s) sandwiches. They are not subject to sales tax either.

C. Start your own business

1. This is one of the main themes of the well-known book Rich Dad, Poor Dad by Robert Kiyosaki. If you are an employee, you are taxed on all your income. When you have your own business, you are taxed on your income AFTER you pay your expenses.

D. Own your own home

1. You can write off mortgage interest and property tax expense on your tax return.

2. When you eventually sell your home, you will be shielded on capital gains up to $500,000 (if you are married) and $250,000 (if you are single).

E. Learn more about taxes

1. Take a tax class (at SMC they are Acct 15 or 17). Prof Cesar Rubio teaches the tax classes at SMC and is an excellent instructor.

2. Read more online and watch Youtube videos

Invest Your Money Instead of Putting it All in a Savings Account

I. As your money grows in your bank (known as interest income), it is taxed each year the same way as money you earn from your wages—at the ordinary income tax rate which can be very high.

**2020 Federal tax brackets (for taxes due April 15, 2021)**

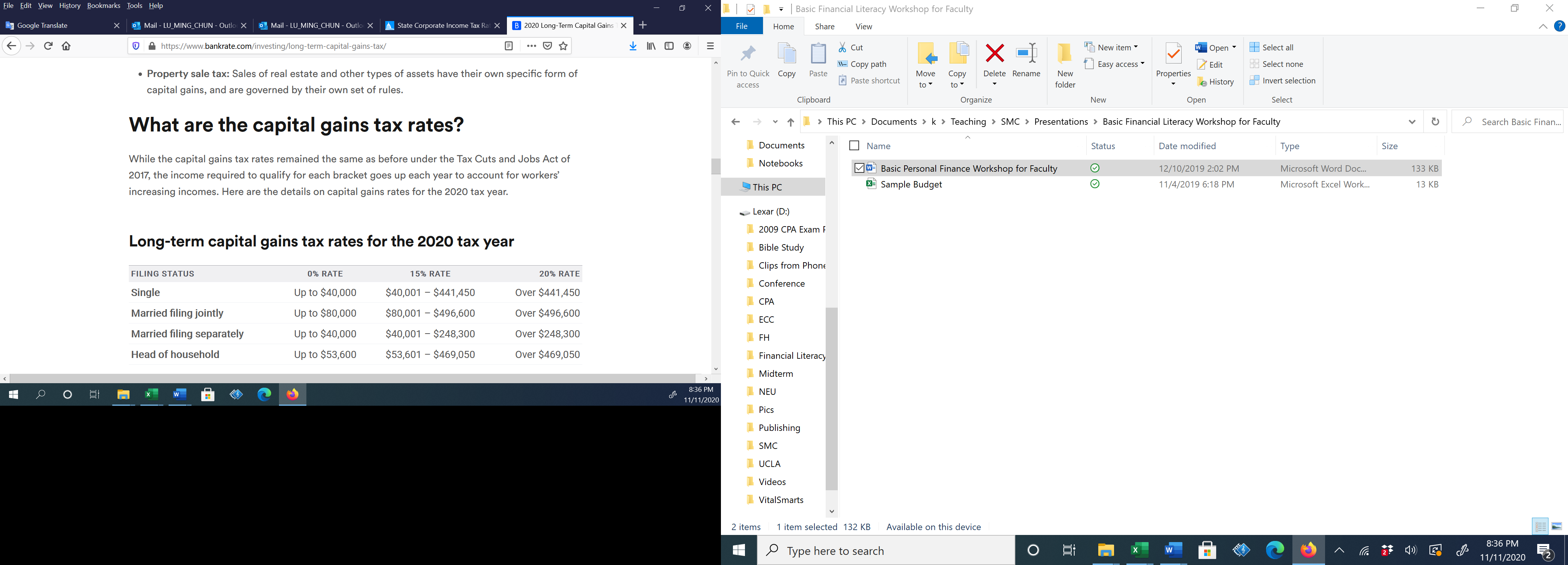


II. Compare this to if you had invested your money in the stock market and mutual funds

A. Stock and mutual funds that grow in value are not taxed until they are sold and the gain is realized. This, in a sense, acts like a tax shelter.

B. Also, if you had your investments for longer than 1 year (long term), you are taxed at a capital gains tax rate (usually 15%) which is lower than the ordinary income tax rate.

**2020 Long-term capital gains tax rates (for taxes due April 15, 2021)**



C. Some stocks also pay dividends which are a way to reward the stockholder for holding on to the company’s stock. Most dividends are considered to be qualified dividends and are taxed at long term capital gains tax rates, which again are lower than the ordinary income tax rate.

D. Examples

1. Example 1

Suppose you are single and made $90,000 in wages this year. You also have $100,000.

Scenario #1

If you put all the money in a savings account and the bank pays 1% interest, your money would grow to $101,000 by the end of the year. That 1,000 would be taxed at the federal ordinary income tax rate of 24% so you would pay $240 in federal taxes. Thus, your money grows by $760 ($1,000-$240).

Scenario #2

If you instead bought a stock and the stock went up in value by 1% to $101,000 by the end of the year and you did not sell it, you would not have to pay any taxes at all. If the stock also paid out a 3% dividend, that dividend income would be taxed at 15%. When you eventually sell the stock in the future, assuming it only increased in value by $1,000, you would be taxed at the federal capital gains tax rate of 15% so you would only pay $150 in taxes. Thus, your money grows by $850 ($1,000-$150).

2. Example 2 (a more realistic example in today’s society)

Suppose you are single and made $90,000 in wages in year 1, 2, and 3. You also have $100,000 in the first year.

Scenario #1 (most Americans)

You put the $100,000 in a savings account and the bank pays 0.01% interest. Each year, your interest income will be taxed at 24% which eats away at its already limited growth. After 3 years, your money will grow to be $100,022.80. Your income over 3 years was around $30 with taxes paid totaling $7.20. Basically, your money increased by $22.80 after taxes, which is a cumulative growth of 0.0228% after 3 years.

Scenario #2

You invest the $100,000 in stocks. The stocks grow by 10% each year and pay 3% in dividends. You don’t sell the stock until the end of year 3.

In this scenario, your stock will grow from $100,000 to $133,100. The $33,100 gain will eventually be taxed at 15% in year 3. Thus, your net gain will be $28,135. The dividends you earned over 3 years would be $9,930. Thus, your net dividend revenue after taxes is $8,441. Overall, you made $36,576 after taxes, which is a cumulative growth of 36.58% after 3 years.

*Note all of this is not even factoring the California income taxes. If that was factored in, in the difference would even be greater.*

Legal Tax Shelters

I. Employer Sponsored Tax shelters (401k, 403b, and 457 plans)

A. 401k plans

1. These are employer retirement plans for those who work in the private sector.

2. You won’t be able to withdraw your money until you are 59 ½. One caveat is that you can withdraw up to $10,000 for your first home purchase. You can also borrow off your account.

3. The money you contribute in will be not be taxed in the current year. It will also grow tax free until you take it out after you are 59 ½ or older.

Example

You make $95,000 in wages this year. If you decide to contribute part of your salary ($5,000) into your 401k plan, you will not be taxed on that amount. You will only be taxed on $90,000. That $5,000 will grow tax free each year. You will only be taxed when you take it out someday.

4. Most employers match employee contributions up to a certain amount

Example

One of my previous employers, Deloitte, matched 25 cents for every $1 I contributed to my 401k account. Thus, if I contributed $1,000 for the year, they would also put in $250.

5. As of 2020, you can contribute up to $19,500 each year into this plan.

6. Instead of a regular 401k, you can elect to get a Roth 401k. The difference is you are taxed now. However, once you put it in the Roth 401k account, it will grow tax free forever. You will not be taxed when you eventually take it out later on after you are 59 ½ or older.

Example

You make $95,000 in wages this year. If you decide to contribute part of your salary ($5,000) into your Roth 401k plan, you will be taxed on the full $95,000. However, that $5,000 in your Roth 401k account will grow tax free each year forever. You will not be taxed when you take it out someday.

**I recommend most people choose the Roth option because the Federal and California tax rates are only going to increase in the future because our government is in serious debt.**

B. 403b and 457 plans

1. These are similar to the 401k plan except these are employer retirement plans for those who work for the government (i.e. SMC professors, staff, and administrators).

2. The 403b plan has a Roth option. However, I don’t believe the 457 plan has a Roth option.

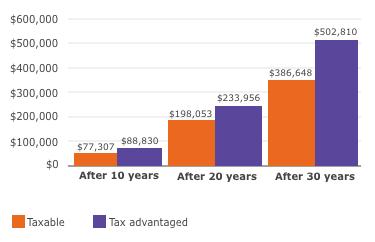
II. IRA or Roth Accounts

A. Even if your employer doesn’t have a 401k, 403, or 457 plans, you can still set aside money in an Individual Retirement Account.

B. You can open up an account at any bank or brokerage company (i.e. Schwab or Etrade).

C. Generally, IRA’s have the same rules as 401k, 403, or 457 plans except the contribution limit is only $6,000 (as of 2020).

**Check out the damage taxes does to your wealth over time**

*Hypothetical value of $6,000 in annual contributions over 30 years*

*Diagram from Wells Fargo Bank*

This diagram assumes a contribution of $6,000 a year, a 6% annual rate of return, and a 24% cumulative tax rate (which is actually kind of low).

In a taxable account, the value would be $386,648 after 30 years. In a tax shelter account (i.e. 401k, 403b, 457, or IRA), the value would be $502,810 after 30 years. The difference of $116,162 or 23.1% in retirement savings was eaten up by taxes.

**Check out the benefits of saving consistently each month using either 401k, 403b, 457, or IRA plan**

1. If you consistently save about $3.33 per day or $100 per month

- If the stock market averages a conservative 8% return per year (and you put it in an IRA account), you should come out with about $326,000 after 40 years.

- If the stock market averages 10% return per year (and you put it in an IRA account), you should come out with about $564,000 after 40 years.

2. If you consistently save about $5 per day or $150 per month

- If the stock market averages a conservative 8% return per year (and you put it in an IRA account), you should come out with about $490,000 after 40 years.

- If the stock market averages 10% return per year (and you put it in an IRA account), you should come out with about $846,000 after 40 years.

3. If you consistently save about $15 per day or $458.33 per month.

- If the stock market averages a conservative 8% return per year (and you put it in an IRA account), you should come out with about $1.5 million after 40 years.

- If the stock market averages 10% return per year (and you put it in an IRA account), you should come out with about $2.6 million after 40 years.

*Note the calculations above assume you make contributions at the beginning of each month and the money is put in a pre-tax shelter investment plan (i.e. IRA, 401k, 403b, 457, etc). Used financial calculator found on http://www.bankrate.com/calculators/retirement/investment-goal-calculator.aspx*

III. SEP IRA’s for Small Business Owners

- Take Acct 15 with Prof Cesar Rubio to find out more

IV. Educational Savings Tax Shelter Plans

A. Coverdell IRA

1. This is similar to a Roth IRA except the contribution limit is $2,000 each year.

2. Money you set aside in this account grows tax free. You can eventually withdraw it tax free if used for college and K-12 expenses.

3. You can open up an account at any bank or brokerage company (i.e. Schwab or Etrade).

B. 529 plans

1. Like the Coverdell IRA, the money you put in this account grows tax free. You can eventually withdraw it tax free if used for college and K-12 expenses.

2. Unlike the Coverdell IRA, the contribution limits are much higher.

3. Each state has their own 529 plan. Some states even allow for a tax deduction for 529 contributions. Unfortunately, California does not.

4. Current California promotion at www.scholarshare529.com

**Right now, for a limited time, if you set up account with California’s 529 plan with automatic monthly contributions, you can receive a match of up to $225 per child. Please see terms and conditions on their website.**

Flexible Spending Accounts

I. Most employers offer these accounts, which you set up to allow you to contribute a portion of your regular paychecks to pay for certain qualified expenses. In turn, you can save on your taxes.

II. There are 2 common types of accounts

A. Medical FSA accounts

1. For certain qualified medical expenses

2. Maximum contribution amount is $2,750 for 2021

B. Dependent care FSA accounts

1. For certain eligible dependent care services (i.e. such as preschool, summer day camp, before or after school programs, etc.)

2. Maximum contribution amount is $5,000 for 2021

III. When you sign up for the account, you elect to have a certain amount deducted from your paycheck. You first pay for these expenses out of pocket. Then you file a claim form to get reimbursed.

IV. Huge Tax Savings

A. Some people find it to be a hassle to set up these accounts, but the savings are huge.

B. Example

Assume your combined federal and state tax rate is 33.3%. If you contribute the maximum of $2,750 into your medical and $5,000 into your dependent care FSA accounts, that saves you $2,581 ([5,000+2,750]\*0.333) in taxes.

V. Drawbacks

A. Need to make sure expenses are eligible so check online first.

B. It is use it or lose it. That means if you don’t use the entire account balance by a designated (usually the end of the year), you forfeit the remainder.

Free Tax Preparation Services

I would like to share with you 2 free tax return preparation services you can use in the future as long as your income is not too high.

1. One program is called VITA (Volunteer Income Tax Assistance). There are actually VITA site locations throughout the U.S. You can use this link to find the site nearest you-- www.irs.gov/Individuals/Find-a-Location-for-Free-Tax-Prep.

2. Another free tax preparation program is called AARP Tax-Aide. You can use this link to find the site nearest you-- www.aarp.org/applications/VMISLocator/searchTaxAideLocations.action

I believe both programs have certain criteria. Your income must be less than $56,000 (note this amount increases each year due to inflation), you don't own your own business, you don't own rental property, and you don't have a lot of complex tax issues.