Guide To Understanding Your Taxes

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Understanding Your Taxes

How to finally understand your taxes and create a more powerful strategy to become a more tax efficient investor.

Taxes will likely be the single largest expense you will have in your lifetime. Unlike your mortgage, that hopefully will eventually be paid off, you will pay taxes for your entire life. Since this could be your biggest expense, its important to understand how you are taxed, and learn strategies that could potentially minimize the amount of taxes you pay.

How your taxes are calculated
Lets begin by taking a look at how our taxes are calculated.

The 2016 Income Tax Schedule.

<table>
<thead>
<tr>
<th>If Taxable Income Is Between:</th>
<th>The Tax Due Is:</th>
</tr>
</thead>
<tbody>
<tr>
<td>0 - $18,550</td>
<td>10% of taxable income</td>
</tr>
<tr>
<td>$18,551 - $75,300</td>
<td>$1,855 + 15% of the amount over $18,550</td>
</tr>
<tr>
<td>$75,301 - $151,900</td>
<td>$10,367.50 + 25% of the amount over $75,300</td>
</tr>
<tr>
<td>$151,901 - $231,450</td>
<td>$29,517.50 + 28% of the amount over $151,900</td>
</tr>
<tr>
<td>$231,451 - $413,350</td>
<td>$51,791.50 + 33% of the amount over $231,450</td>
</tr>
<tr>
<td>$413,351 - $466,950</td>
<td>$111,818.50 + 35% of the amount over $413,350</td>
</tr>
<tr>
<td>$466,950 +</td>
<td>$130,578.50 + 39.6% of the amount over $466,950</td>
</tr>
</tbody>
</table>

In the United States we have what is known as a progressive tax system. This means that we pay a higher percentage in taxes as our income goes up. What people may not necessarily realize is that we actually pay taxes at each one of these tax brackets along the way.
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Here's an example...

Steve and Jennifer are married with 2 dependent children and their gross income for the year is $200,000.

Fortunately not all $200,000 is taxed. Everybody is entitled to a personal exemption, which for 2016 is $4050. For Steve and Jennifer, they are entitled to 4 personal exemptions, which is $16,200. ($4050 x 4 = $16,200)

They are also entitled to a standard deduction or they can itemize their deductions. For 2016 the standard deduction was $12,600, however with mortgage and property tax deductions, along with charitable donations and state income taxes, they have $25,000 in itemized deductions, so they will use that.

Here's how their taxable income would be calculated
$200,000 Gross Income
- $16,200 Personal Exemptions
- $25,000 itemized Deductions
= $158,800 Taxable Income

By looking at the tax table, you can quickly see that they are in the 28% marginal tax bracket, but that doesn't mean that they pay 28% on all of their taxable income.

How their tax breaks down
10% tax on the first $18,550 ($1,855)
15% tax on the amount between $18,551 and $75,300 ($8,512.35)
25% tax on the amount between $75,301 and $151,900 ($19,149.75) 28% tax on the amount between $151,901 and $231,450 ($1,931.72)

Even though they are in the 28% marginal tax bracket only $6,899 actually gets taxed at that rate.
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Different Types of Income

There are three basic types of income that is important to know about.

**Ordinary income.**
This income that is taxed on your normal tax bracket. Its the income that is taxed the most.

- Earnings from your job or business.
- Short term capital gains (Investments sold at a gain that you've held for less than 1 year)
- Non-Qualified dividends
- Interest income
- Distributions from traditional retirement accounts.

**Tax favored income**
Income that is taxed a reduced income tax rate. Maximum of 15% for most investors.*

- Qualified dividends
- Long term capital gains. (Investments sold at a gain that you've held for less more than 1 year)

**Tax free income**
Income that doesn't get taxed at all

- Interest from tax free municipal bonds
- Qualified distributions from qualified Roth retirement accounts
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Stealth Taxes

There are two factors in determining your taxes. Your tax rate and the amount of your income that you pay taxes on. The amount of money you pay in taxes can go up because your tax rate increased, or because you are taxed on more of your income.

Stealth Tax #1 Higher Medicare Part B Premiums

Many people might not realize that your Medicare Part B Premiums are actually tied to your income. If you make more money and you cross over an income hurdle your premiums will go up. This could potentially cost you a lot of money.

![Medicare Part B Premiums Table]

*Bill’s Tip: Be careful when taking withdrawals from your tax deferred retirement plans that the distribution doesn't push you up over one of these limits.*
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Stealth Taxes

Stealth tax #2 Phase out of Itemized deductions and personal exemptions.

Itemized deductions and personal exemptions reduce the amount of money that you pay taxes on. For those in the higher tax brackets these deductions and exemptions begin to get phased out.

Phase Out of Itemized Deductions
The phase out of itemized deductions begins at $259,400 for single tax filers or $311,300 for married couples filing jointly. The rules can be complicated based on the types of deductions you have, however you can generally expect that your itemized deductions will be reduced by about 3% of the amount your AGI exceeds the limit for your filing status. Your total phase out of itemized deductions can not be greater than 80%.

Itemized Deduction Phase Out Example
Sam and Diane are married with $400,000 Adjusted Gross Income for the Year and they have $60,000 in itemized deductions. Their phase out amount would be as follows...

$400,000 Adjusted gross income
- $311,300 Phase out threshold for married filing
  joint = $88,700 Amount of AGI over the threshold

$88,700 x .03 = $2,661 (Amount of the phase out)

They would only be able to use $57,339 of their itemized deductions ($60,000-$2,661= $57,339)

Phase out of Personal Exemptions
The Phase out of personal exemptions is another costly stealth tax that can affect upper income tax payers. As shown below, At $381,900 for single filers and $433,800 for joint filers your personal exemptions are completely phased out.

<table>
<thead>
<tr>
<th></th>
<th>Begins Phase Out</th>
<th>Fully Phased Out</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single</td>
<td>$259,400</td>
<td>$381,900</td>
</tr>
<tr>
<td>Married Filing Joint</td>
<td>$311,300</td>
<td>$433,800</td>
</tr>
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</table>
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Stealth Taxes

Stealth tax #3 the 3.8% Medicare Surtax
The 3.8% Medicare Surtax went into effect in January 2013 as part of the affordable care act and it can affect the amount of taxes you pay on your dividends, interest and capital gains from investments that you own, known as investment income.

This tax will effect married filers who make over $250,000 and single filers who make over $200,000.

Pay an additional 3.8% tax on the lesser amount of...
Your income thats over the threshold or the amount of net investment income that you have in total.

Here's an example...
Mary is single and has $240,000 in Adjusted Gross Income for the year, which includes $25,000 in investment income from dividends, interest and capital gains on her portfolio. In this case she would pay the 3.8% surtax on the entire $25,000 of investment income. ($25,000 x 3.8% = $950)

Stealth tax #4 Higher Long term capital gains and qualified dividend tax rates
Qualified dividends and long term capital gains fall into a favorable tax rate category of income. For most tax payers this means a top tax rate of just 15%. However, if you are in the top tax bracket, 39.6%, then you will get hit with an additional 5% tax on your qualified dividends and long term capital gains, raising the tax rate from 15% to 20%. This would be in addition to the 3.8% Medicare Surtax, which would likely bring your tax rate on qualified dividends and long term capital gains from 15% to 23.8%.

This affects anyone who is in that top 39.6% tax bracket. For single filers thats anyone who's AGI is
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The So Called Marriage Penalty

The marriage penalty is the term given to the disparity in your total tax as a result of being married. It is determined by comparing your tax bill filing a joint tax return versus what it would have been had you been single and each of you filed your own separate tax returns. It typically affects married couples who both work and make close to the same amount of income.

It can also be a Marriage Bonus
If there is a bigger discrepancy in income, especially if one spouse doesn’t work, then instead of a marriage penalty, it might mean a marriage bonus. A marriage bonus occurs when the total amount of tax is less filing a joint tax return than it would have been had you been single and each of you filed your own tax return.

Don’t mistake filing two tax returns as single individuals with Married filing separately! Married filing separately is the worst filing status in terms of tax rates.

Examples of what the marriage penalty affects
Even though some tax payers will benefit by filing a joint tax return, the tax brackets, deductions and rules are not as proportional as you would think it would be by adding another tax payer to your return.

Especially if all, or the majority of income comes from one spouse, getting married can actually save you money in taxes. Lets take a look at a few examples.

One Primary wage earner.
Steve has $200,000 in taxable income, and his wife Cindy stays home to raise their 3 children. In this example their total tax filing a joint tax return would be approximately $42,985. If Steve were single his tax bill would be approximately $49,528. A difference of $6,543.

Two High Wage Earners
Keith and Diana both earn high salaries and have $400,000 in total taxable income. Filing a joint tax return, their tax bill would be approximately $107,412. However if they were single, and each had $200,000 in taxable income their tax bill would be $99,056. A difference of $8,356!

There are several other instances of the marriage penalty or bonus, including the taxation of Social Security benefits, rules for contributing to Roth IRA accounts, the phase out of personal exemptions and itemized deductions, the 3.8% Medicare surtax. Everyones situation will be unique, but in most cases if your income is similar to your spouses income, then it will likely result in a marriage penalty. However, if there is a large difference in your income and your spouses income, it may result in a
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The 4 Greatest Benefits in the US Tax Code

1. Tax free proceeds from life insurance
If you or your heirs inherit proceeds from a life insurance policy, whether it’s a $10,000 policy or a $10 million policy there are no federal income taxes. Depending on the size of the estate or the amount of insurance and how its structured, it may be subject to estate taxes.

2. Step up in cost basis
Your beneficiaries are entitled to a step up in cost basis on any investments that you may have in your estate when you die. This could be real assets like property or paper assets like stocks or bonds.

*Step up in basis example*
Imagine that you had been lucky enough to buy shares of Apple when it first went public in 1980. You invested $10,000 and held onto the stock until you died. After all of the splits and growth the stock is worth $1 million at the time of your death. Even though there is a $990,000 capital gain on the stock, your beneficiaries would inherit the stock with a cost basis of what it was worth at the time of your death. They could immediately sell the stock for $1 million ad pay zero capital gains tax.

3. Capital gain exclusion from sale of your primary residence.
When you sell your primary home you can have up to $250,000 in capital gains completely tax free, as long as it was your primary residence for the past two years. If you're married, you are entitled to a $500,000 capital gains tax exclusion.

4. Roth IRA
5 reasons I love the Roth IRA

1. Tax Free Withdrawals
Probably the best feature of the Roth IRA is tax free withdrawals. You contribute money on an after tax basis, and as long as the withdrawal is qualified you pay no taxes on the distribution. In order for the withdrawal to be considered qualified you must have had your Roth IRA open for at least 5 years, and you need to be at least 59 1/2. If you are taking out any money that originated from a Roth conversion, it needs to have been at least 5 years since you did the conversion, regardless of your age. So if you did a Roth conversion when you were 58, you would still have to wait 5 years for the withdrawal to be a qualified distribution Anytime Without

The second reason I like the Roth IRA so much is because you can withdrawal your contributions at any time without penalties or taxes. Even though the Roth IRA is intended to be a long term retirement savings vehicle, its nice to know that if you got in a pinch and needed some money, that you can get at
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3. Tax Diversification
Because traditional retirement savings accounts have been around a lot longer than the Roth IRA, you may have the bulk of your money in tax deferred accounts like 401k plans or the traditional IRA. While tax deferral is nice, you will of course eventually have to pay taxes on this money when you withdrawal it. Building retirement savings in Roth accounts creates what I like to call tax diversification. When you need to take a distribution, especially if its a large one, you can choose which account you want to take the withdrawal. If taking the withdrawal will push you up into a higher tax bracket, you can choose to take the money from your Roth tax free based on the guidelines I previously discussed. That really gives you a lot of flexibility.

4. No Required Minimum Distributions (RMD’s)
As you probably know, with your traditional retirement accounts, you will eventually be forced to take mandatory required minimum distributions after you turn 70 1/2, whether you want to or not. Basically, its the governments way of saying. Ok. You've gone long enough without paying any taxes on this money, now you need to start taking some of this money out so we can get some tax revenue. With the Roth IRA you can leave this money in the account as long as you want. You are not required to take minimum distributions from a Roth IRA. You can leave it there for as long as you want and continue to grow completely tax free.

5. Wealth Transfer to the Next

For most investors your Roth IRA should be the last money that you ever spend. If you think about the 3 basic types of accounts and how they are taxed. With money invested in non retirement accounts you generally have to pay taxes every year on the gains and interest that the account makes. Money in traditional retirement accounts will eventually be taxed, either when you willingly withdrawal it, or when you are forced to withdrawal it when you turn 70 1/2. Or if you die with money left in the account your kids or other beneficiaries will be forced to withdrawal the money and pay taxes on it. The Roth IRA account can just continue to grow and compound with tax free gains throughout your lifetime. If you die, the account can pass completely tax free to your spouse, and continue growing tax free for their lifetime as well. When the account passes to a non-spouse, its also tax free. However, when a non-spouse inherits an IRA, they will be required to begin taking mandatory withdrawals based on their life expectancy.

This information is not intended to be a substitute for specific individualized tax advice. We suggest that