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May 2003 - What Can I Do to Prevent Paying Tax on Next Year's Return?

"I just filed my tax return and had to pay tax with it. What can I do to *not* pay tax next year?"

If this sounds familiar, the next few articles are for you. The solutions that will be covered in these articles include reviewing your withholding taxes at work, taking advantage of tax savings opportunities you have passed up before, and considering if you could save by paying quarterly estimated taxes.

Review Your Withholding Taxes at Work

Many people are surprised to learn that they should not automatically claim their marital status and the number of people in their family on the W-4 form they file with each employer that determines how much federal and state income tax is withheld from their pay. There are reasons both to claim more or less withholding allowances, and special considerations even for the marital status claimed.

Your employer uses payroll tax tables provided by the government to determine how much federal and state income tax to withhold from each paycheck. Most payrolls are now being prepared using computer programs which have the government tax tables built into them, and which are continually being updated as the tables change. These tables attempt to withhold the right amount so that a person with a given level of income, a standard deduction, and a specific number of dependents will have exactly the right amount of tax withheld over a year's time so that when they file their return they will not owe tax and they will not have overpaid their tax either.

Since you are a unique person with your own special circumstances, you need to understand how the payroll withholding tax tables work and then make appropriate adjustments on your W-4 form so that the tax that is withheld from each of your paychecks totals as close as possible to the actual tax you will owe when you file your return.

Marital Status and Number of Jobs You Work. When you file your income tax return, there are five possible filing statuses you might qualify for. Each of these filing statuses are assigned a standard deduction amount. These are single ($4,750 for 2003), married filing a joint return ($7,950), married filing a separate return ($3,975), head of household (with qualifying person) ($7,000), and qualifying widow(er) with dependent child ($7,950). Each also is assigned a tax rate schedule, with federal rates ranging from 10% to 38.6% of different levels of taxable income (after all allowable deductions have been claimed).

The payroll tax tables narrow these five possibilities down to two: single or married. It allows for the standard deduction for each of these two categories in small pieces throughout the year, for example on a weekly paycheck 1/52 of the yearly standard deduction is not taxed.

If you work more than one job, or if you are married and you both work, the payroll tax tables will exclude the standard deduction at each job, thus keeping withholding artificially low because when you later file your tax return you of course can only claim one standard deduction.

The solution here begins by figuring the amount by which the total withheld standard deductions are higher than the one on your tax return. Here's two examples that illustrate how to do this: You are married and you work a full-time job plus a part-time job, and your spouse works at one job, with each of you using the married status for payroll withholding. Your payroll withholding will reflect three married standard deductions, which is $7,950 + $7,950 + $7,950, or $23,850. Then subtract the one standard deduction you will be able to claim on your tax return you file at the end of the year with the status married filing jointly, which is $23,850 - $7,950 or $15,900. I will refer to the $15,900 figure as your "standard deduction difference".

In the second example, you are a head of household with qualifying person, and work one job where you use the single status for payroll withholding. Your payroll withholding will reflect the $4,750 single standard deduction, but you will able to claim a $7,000 head of household standard deduction when you file your tax return. Your standard deduction difference is $4,750 - $7,000 or negative $2,250.

If you have a high standard deduction difference, you may want to utilize the W-4 choice "Married But Withhold at Higher Single Rate". If you are married, you can reduce your standard deduction difference by $3,200 in 2003 for each job that you change your withholding at to the single rate.

Tax Deduction Adjustments. *Many people are entitled to more withholding allowances than they realize. If you itemize deductions, the amount by which your itemized deductions (such as mortgage interest, property and state income taxes, charitable contributions, etc.) exceed the standard deduction can be used to reduce your payroll withholding and increase your paychecks!* There are also twelve deductions you can claim on your tax return even if you use the standard deduction! They are:

- Additional standard deduction for those over 64 or blind ($950 to $1150 additional per person)
- Educator expenses (up to $250 for qualified educators)
- Some IRA (Individual Retirement Plan) contributions (ask if in doubt)
- Student loan interest deduction
- Tuition and fees deduction (you can choose this or the education credit, whichever is better)
- Archer MSA (medical savings account) deduction
- Moving expense (for qualified moves of 50 miles or more)
- One-half of self-employment (SE) tax
- Self-employed health insurance deduction
- Self-employed SEP, SIMPLE, and qualified plans
- Penalty on early withdrawal of savings
- Alimony paid (you must list the recipient's social security number on your return to claim this)

Other Income. When the IRS gives, it also takes away. If you receive any of the following income items, you should adjust your payroll withholding higher:

- Interest
- Dividends
- Certain state tax refunds (ask if in doubt)
- Alimony
- IRA or pension distributions that don't have withholding
- Some social security benefits (there is a table to help calculate this)
- Unemployment compensation
- Alaska permanent fund dividends

- Gambling winnings

How to Adjust Payroll Withholding Up or Down for Additional Income or Deductions. Add the income to and subtract the deductions from your "standard deduction difference".

Get the Benefit of Your Credits Now! (Why Wait Until You File Your Tax Return!) There are new credits being introduced almost every year. You may qualify for one or more of them! Credits are usually better than deductions because they reduce your tax dollar for dollar while you only realize a percentage of your deductions (the percentage is usually equal to your tax bracket).

You can reduce your payroll withholding if you qualify for these credits:

- Foreign tax credit
- Child and dependent care credit
- Credit for the elderly or the disabled (requires a very low income)
- Education credits
- Retirement savings contribution credit (popularly called the "Savers Credit"
- Child tax credit (or the Additional Child Tax Credit)
- Adoption credit
- Any one of 18 other special credits listed on the second page of Form 1040. (See lines 52&53)

Add all of these credits, then divide the total by your tax bracket.

If you don't know your tax bracket, you can look it up in the tax tables that came in your tax return booklet. You can also look at the tax table bracket in the Form 1040 instructions available at www.irs.gov. Since these tables aren't always clear, you may want to discuss them with a professional. A planning visit with a good tax professional could be very worthwhile to make sure you make these calculations correctly and that you are taking advantage of all the tax savings opportunities that are available to you!

After dividing by your tax bracket, subtract the resulting number from your "standard deduction difference".

Converting Your Deductions and Credits into Withholding Allowances That Will Make Your Paychecks Larger!

You can adjust the withholding allowances claimed on your W-4 form for your final standard deduction difference (after all adjustments) by choosing an appropriate combination of the following two steps:

1. You can change the number of withholding allowances you claim up or down as needed. Your standard deduction difference will change by $3,050 for each withholding allowance you add or subtract. So take your difference, divide by $3,050, and round down to the next whole number. The result is the number of withholding allowances to adjust your W-4 count by.

2. You can ask for additional withholding to be deducted from each paycheck. Take your standard deduction difference, divide by the number of pay periods in a year (24 for semi-monthly, 26 for bi-weekly, or 52 for weekly), and multiply by your tax bracket (see the previous page). Round up the result to the next increment of $5 (for example, round up $16.22 to $20) just to provide a small cushion.

The next article in this series, "What Can I Do to Prevent Paying Tax on Next Year's Return", *will highlight how you can qualify for some of the deductions and credits you may have passed up before so that you can create larger take-home paychecks throughout the year, and still not owe tax when it comes time to file your return. Be sure to read it!*

Important Note!

The information in this article is intended to inform you of some of the financial opportunities provided in the tax laws or elsewhere. It is not intended to give you specific advice for your personal situation. If you need such advice, please contact a qualified professional! Please call or e-mail me (doug@accuteksolutions.com) for an initial consultation to discuss your personal situation and how the tax laws might benefit you. Your first 30-minute visit is free to let you sample what we can do for you at no cost or obligation. We also invite you to submit questions you'd like to have answered in a future article!