5 Legal Tax Loopholes

MAXIMIZING YOUR TAX SAVINGS

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TRULY BOOKED ACCOUNTING

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Tax Loophole #1

The Capital Gains Tax

• Capital gains tax is what you must pay when you sell an asset for more than your basis in it—what you paid for it plus certain expenses that contributed to its improvement or to the sale. Your profit is the difference between the sales price and your basis and it's reportable on Form 1040.

• So why is this considered a loophole? It's something you have to pay , right? Yes, but the capital gains tax rate is lower than the rate at which your ordinary income is taxed. If you earn most or even some of your income from investments, you'll pay less in taxes than you would if all your income came from employment or self-employment.

• The capital gains rate is just 15 percent on most long-term gains for the majority of taxpayers. Compare that to what someone who earns $80,000 in ordinary income would pay: 22 percent as of 2018, a significant 7 percent more.

• So if you have the skill and the finesse, you could buy and sell almost any kind of property for a living and pay less in taxes than you would working at a traditional job. The Joint Committee on Taxation estimates that this loophole cost the federal government about $457 billion from 2011 through 2015.

Tax Loophole #2

The Home Based Business

• If you've ever thought about going into business for yourself as a sole proprietor, you might want to consider the tax benefits when you're weighing the risks. They include some loopholes that might not seem fair to employed individuals but which can be pretty beneficial for those who strike out on their own.

• Let's say Edna and John live next door to each other. Their mortgages are about the same, maybe $1,500 per month including principal, interest, taxes, and insurance. John works for someone else. He does not keep an office in his home. Edna is a freelance consultant. She runs her business out of her home's spare bedroom. Edna gets a tax deduction for that home office on her Schedule C, the tax form that calculates her taxable business income—her overall income less certain allowable business expenses, including the home office deduction.

• If 15 percent of Edna's home's square footage is dedicated to her business, she can deduct 15 percent of her mortgage interest, her property taxes, and her insurance premiums. As for the principal part of her mortgage, she gets a break there, too, because she can claim depreciation for that portion of the property. She can also deduct 15 percent of her annual heating, electric, and water bills, as well as anything she spends on office supplies, travel, auto mileage, or advertising, among numerous other business expenses.

• What does John get? He gets to punch a timeclock for someone else. No such tax break is available for him except in very isolated circumstances, such as if his employer requires that he work from home for the employer's benefit, not his own. And even then, he'd have to itemize to claim it, which might not be to his benefit overall.

• Of course, there are a lot of corresponding rules. Edna can't do anything else in that 15-percent area of her home where she works. Her kids can't watch television there and her family can't enjoy their meals there. She must literally run her business from that location. But if she meets all these qualifications, she can take advantage of a pretty nice tax loophole.

Tax Loophole #3

College Savings Plan

• These plans are a great way to save for your kids' college expenses. Section 529 of the federal tax code allows you to tuck money away into this type of educational investment plan and your money will grow tax-free. If you're married, you and your spouse can each make separate contributions for each of your children, so those contributions and their eventual earnings can really add up.

• There's no federal limit as to how much you can sock away, so this is more of a state tax loophole although Section 529 of the federal tax code does set many of the rules for these plans. Individual states determine how much you can contribute each year. Let's say it's $4,000 per child where you live. You and your spouse each deposit $4,000 into the plan for Junior to attend college. This will earn you a tax credit of $8,000 on your joint state return.

• That's nice no matter how you look at it but consider this: You can make the contributions on Monday and take the money right back out on Tuesday for Junior's qualified education expenses. See what you've accomplished? By moving the money through the 529 college savings plan first rather than paying the school directly, you've earned yourself an $8,000 break on your state taxes.

Tax Loophole #4

Employer Paid Health Insurance

• Then there are those health insurance benefits that your employer pays for. The tax provision for these benefits cost the federal government about $210 billion in 2016 and almost $221 billion in 2017.

• If they're a perk of your employment, they're compensation...in a sense. After all, if your employer didn't provide these benefits, you'd have to come out of pocket for them, right? But there's a catch. You're not taxed on them. You don't have to claim their value as income.

• That's right. According to the tax code, employer-paid health benefits are not taxable income to the recipient. So if you're job hunting and you have a choice between higher earnings and no benefits, or smaller paychecks plus benefits, you might want to really think about this. Those benefits come to you tax-free.

Tax Loophole #5

The Capital Gains Tax

- The home mortgage interest deduction cost the government even more from 2011 through 2015: an estimated $464 billion. It cost about $69 billion in the 2017 fiscal year alone. This is most likely why the deduction was a pivotal factor as the House of Representatives and the Senate worked to finalize the Tax Cuts and Jobs Act in late 2017.

- Although anyone who pays a mortgage and who wants to itemize his deductions can claim this one, the loophole tends to favor the wealthy. Those who can afford the ritziest, most expensive homes pay more in mortgage interest because interest is based on a percentage of the amount that's financed. So taxpayers with mega-mortgages can deduct a considerable amount from their taxable incomes, but this isn't the case for lower-income earners. You might shave $2,500 a year or more off your taxable income if you buy a mansion and claim this deduction, but just a few hundred dollars annually if all you can afford is a bungalow.

- Meanwhile, it all adds up to a lot of taxes the IRS isn't collecting from the wealthiest taxpayers. They get a pretty nice tax break just from living in spectacular digs, something they would probably do anyway. But you still need a roof over your head even if you live in a far more modest home, so you can cut your taxable income a little just by buying a home rather than renting.

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