Tax Breaks You Could Be Missing

Scott A. T.: Broadcasting from One Dallas Tower, welcome to the Financial Rockstar Show. I'm your host, Scott Alan Turner, trying to help you get out of debt, save more money, and retire early. In the studio with me is producer, Katie. On the show today, I'll be answering your questions about money, business and life. If you have a question you'd like answered on the show, visit go askscott.com.

Been talking about taxes, thinking, "All right Turner, I'm now smarter than a politician. I know earning more is a good thing. I shouldn't care if a go up in a tax bracket because all of my income won't be taxed more, just the higher dollars in the bracket - but why should I care? Why should I even care?"

Here's a quick example. On the next show, I'm going to give you a killer example, which you will not want to miss, but here is a quick and simple one. Let's pick on our single person, earning $90,000 in taxable income this year. Again, round numbers, super simple, ignoring deductions, exemptions, all this other stuff. This person - say they're getting a $10,000 bonus in January - did some awesome work, maybe they're a sales guy, sold a bunch of stuff in December, closed out some deals. $10,000 bonus is coming up in January, and maybe they got a $10,000 property tax bill. Again, we're going to use round numbers, simple example - or maybe they're going to give away $10,000, feeling generous.

Should they pay the property taxes in the current calendar year and get the $10,000 deduction or wait until next year when they're going to get the bonus? If they do it this year, their taxable income goes from $90,000 to $80,000, and they're going to pay taxes on 80 grand. Next year, they're going to have $100,000 in taxable income. Forget raises and whatever that. They've got their $90,000 base, the $10,000 bonus - $100,000 in taxable income. That $10,000 is now in the 28% tax bracket. Remember, 35 to 90 in taxable income is taxed at 25%. 90 to 190 is taxed at 28%. They've not got $10,000 that is going to be taxed at 28%. If they take the deduction next year - if they wait to pay those property taxes, if they wait to make a donation on January 1st, say, their taxable income goes from $100,000 down to $90,000. They avoided paying 28% taxes on that $10,000 bonus. It got taxed at the 25% rate as their taxable income went from 100 to 90. Since it got taxed at the 25% rate, they saved $300. They saved $300. $300, that's a lot of money.

Remember what I started with, though, at the beginning of our discussion in Texas. I paid $0 in taxes on a $100,000 IRA conversion. A traditional IRA, rolled it over to a Roth IRA. Paid $0 taxes on it. You may think, $300, that is or maybe is not a lot of money to you, but because I paid $0 in taxes on $100,000. Let's say I was 65 years old, I made $90,000 that year and I pulled all $100,000 out of my IRA. I would pay 28% taxes on that $100,000 - $28,000 in taxes. In that case, I saved $28,000. The opportunities for tax-savings can be massive, but the foundation is: you've got to understand the tax brackets and the tax rates. In our example, from going $100,000 in taxable income to $90,000 in taxable income - it saved more than going from $90,000 in income to $80,000 in income. By staying out of that higher tax bracket, we saved 3% essentially.

Here's another way to remember this when you have to explain it to somebody. Again, we don't have a flat tax system in the United States. Flat tax is a percent across the board. When someone says, "I'm in the 25% bracket. I paid 25% in taxes," it's just wrong. It would imply a flat tax. We have a gradual system. When the politicians start talking about increasing taxes, because we have marginal tax rates - new term, marginal tax rates - the tax rates only apply to a certain brackets. Our single person - if they have to choose between a salary of $90,000 and $90,001, the extra buck gets taxed at the higher 28% rate.

Let's drive this home. Let's say you're getting confused on the definitions of - some of these terms you're going to hear - marginal tax rate, effective tax rate, tax bracket. The brackets are the range of incomes and the percentages. We've got $0 to $10,000. That's a tax bracket of 10%. $10,000 to $37,000, that's the second tax bracket, rounding numbers again. That's for a single person. The brackets are dollar ranges and percentages. Each bracket has its own rate. Rate is specified as a percent, so $0 to $10,000 tax bracket has a tax rate of 10%. $10,000 to $37,000 dollars - I think I was using 35 before. We're rounding. It changes every year. That's taxed at 15%. $37,000 to $91,000 taxed at 25%. If you're making $50,000, you pay taxes at 3 different rates, and it keeps going up. The top bracket is $415,000 and that's taxed at 39.6%. If you are at the top tier, you pay taxes at 7 different rates. The rates are percentages.

The marginal tax rate - that's the rate of tax that applies to the last dollar on your income. A single person making $90,000, when they say it's 25%, that's their marginal tax rate. When someone says they're in the 33% tax bracket, they are talking about their marginal tax rate. Again, nobody pays 33% in taxes.

The effective tax rate - that is what matters the most because that is the actual percentage of your income that you give to the federal government - what it all works out to be when you average everything out and compute it all. A single person, taxable income of $90,000. The taxes owed is $18,500. I walked through that example a few episodes ago. $18,500 is 20.5% of $90,000. That would be 20.5% is called the effective tax rate. That's when you average out all the taxes across all the different rates/brackets whatever. When you take out all your tax credits, your deductions that you're eligible for, your effective tax rate is going to be substantially lower than your marginal tax bracket - the highest tax bracket that you're in.

Again, to reiterate, all these examples have been stripped down, nice round numbers, no deductions, no alternative minimum taxes, no married/filing jointly, no exemptions - none of that stuff - just really, really simplified it to the lowest level possible so you can get a good understanding of that.

Action item for you to do: Go pull out your tax return from last year and look up what your marginal tax rate is. Figure out what your marginal tax rate is, and you also should see on there your effective tax rate. Maybe you'll see those on there. It depends on your tax software, or who's doing your taxes, whether they put that information on there for you. Marginal tax rate - the top tax rate that you're paying on your last dollars of income. Effective tax rate - your percentage of taxes that you paid out of your total taxable income. That's going to be lower than the marginal rate. That just gives you a simple ratio determining your own personal tax bracket - what you're paying as a percentage of your income.

Next action item - we've got a couple for today: As your going through your tax return, look for those deductions that you may have put in there. Property taxes is a pretty common one. Charitable deductions is another one. You have an option as to when you're going to pay those. It's not like an exemption or a credit. No, you can't change those at all. If you're a freelancer, small business owner. There's a lot more opportunities for small business owners as to when you make purchases and what year those expenses get reported. Just go back to last year and see if there were any opportunities that you may have missed by shifting some of those deductions around from last year to this upcoming year or the prior year. If you took them last year and you could've taken them the year before. See if you missed any opportunities. Could you have taken a deduction at a different period to offset some higher income which would have reduced the taxes on that higher income?

These are the type of things you or you get a tax preparer - hopefully they're thinking about this stuff too, especially if you're a small business owner. Going forward, you're going to have in the back of your mind as you're going throughout the year, "When am I going to take this deduction? How's that going to impact my tax outlook, the taxes I pay in the long-term?"

Tomorrow, we're going to look at another practical application. If you have a traditional IRA, if you've got a 401K, any type of tax deferred retirement plan and converting that to a Roth that will grow tax-free. Should you do that? If so, when?

Nicole from Hotlanta, Georgia asks if paying down her home is a good idea. It says,

Nicole: "Houses in my area have depreciated at an alarming rate. I purchased my small, two bedroom, one bath home in 2008 for $119,000. It was a flip-house and was purchased for $75,000 2 years prior in 2006. My home was built in 1950. The roof was 2 years old when I purchased it. The kitchen and plumbing are updated and it has new air. The area is okay a lot of the time, but there are some bad foot traffic in my part of the city. I do like the home and large back yard. Another plus is that I'm close to my job, with a 20 minute hop on the train.

"When I purchased the home, it was financed for 5.875% for 30 years. I have excellent credit and have tried to refinance from my own bank and through HARP, but I don't have enough equity. Everything was looking good while working with HARP until we got to underwriting. At that stage, I was told I would have needed to have half of the initial value paid down before I could qualify. Also, in my neighborhood, there have been 4 Habitat homes built around me and I feel this does not help with our home's value. In any case, is it smart to try and pay a bit down on the home knowing if I need or want to sell, it could help me? I feel like it would help me at the closing table. Based on online quotes, my home's value is noted to be around $33,000 at this time. Yeah, it sucks but I do like the home. I am debt-free except the home."

Scott A. T.: First, congratulations on being debt-free except for the home. The value of $33,000 seems very, very, very, very low from what you found online. Even a new Habitat house - I've worked on two, a long time ago. The building materials, just for the home, cost more than that even though it's all sweat equity and labor that they'd be putting into it. Just the materials would cost more than $33,000, I would think. The buildings I worked on were back in Atlanta in some of the bad neighborhoods, as well. Actually, one was in Atlanta and one was here in Dallas. You're 8 years into a 30 year mortgage, severely underwater by the sounds of it. Even if the $33,000 is on the low side, it's still a big difference. If you're in that situation, we're just going to list all the things that we could do. Then we'll address what maybe you should consider.

You can stay and keep paying. That's one option: waiting for the market to come around, your home value to increase over time. Maybe that happens, maybe that doesn't - depending on the neighborhood and what's going on around you, like you commented on. Refinancing, you tried that. That's out. Doing what's called a short sale: going to the bank and saying, "I want to get out of this house but I'm underwater. Can we cut a deal on that so I can sell this house?" The bank may or may not be willing to go along with that. That's not really where you're at right now because you like where you live and you want to stay in the house, but that's something you could keep in your back pocket for later on down the road. Just walking away is the other option. Say, "All right. I'm underwater. I don't have the money. I can't refinance. Not going to have the money anytime soon. I'm just packing up my stuff and heading out. See ya later." That'll destroy your credit for a good number of years, but again, that's an option. A lot of people do that when they're severely underwater on a home.

Let's fast forward 5 years. Try to think ahead. Pay your mortgage, as is, for 5 years. Pay it down. Maybe you can refinance then. Maybe not. Maybe the values would have come up, and you have built up a little more equity in it so that if you were to go to a sale, you'd be able to walk away Even-Steven, come out ahead a little bit, or maybe you'd have to come up with a little out-of-pocket because you're less underwater than you are right now. That's the case, where you just keeping up what you're doing now and hoping for the best.

Likewise, you could just keep up what you're paying now, hoping for the best. Five years later, and maybe you get a sick relative in Alabama or somewhere. Like the cat says, and you have to end up doing a short sale or a foreclosure to get out of that. Another option, renting it out somewhere down the line. Renting it out for an amount that's going to cover your mortgage costs. Yeah, it'll turn you into a landlord, but someone else will be paying the mortgage on your behalf. Then, you can move into - not necessarily another house, so you're burdened with 2 mortgage payments- but maybe an apartment or something along that lines that's less expensive.

Really, the decision's going hinge on how long you plan on staying in this house, which is sometimes really, really hard to figure out. "Where am I going to be in 5 years?" Most people don't know. Even if you do know, something could happen where your plans end up changed.

You can pay down more to build up the equity in your home, so that you're less underwater or not underwater when the time comes to sell it, or you just take the extra money that you would have put into the home and just stick it into a savings account. You essentially keep it in your back pocket over here, which gives you options down the road where you decide, "Okay, I'm ready to sell this house but I'm still underwater, but I've got all this cash over here which I can just throw at the mortgage payment this one month, which is going to bring up my equity and make me less underwater, or not underwater at that time. It gives you a little more flexibility.

Doing that, though, costs your more in mortgage interest each month, so there's pros and cons of doing it that way. Sticking the money in a savings account costs you more in interest payment, but it's going to give you more flexibility down the road. There's a couple of things to think about. Again, it's all going to start with how long you expect to stay in this house. From there, you'll be able to figure out which of those options might be better for you. Thanks for the question Nicole.

Dolores is getting ready to pit auto dealers against one another. She says,

Dolores: "Please see the sample facts found on page 122 of The Millionaire Next Door." In that book - I'm not going to read the whole thing - it's about bidding for your business. Getting sales manager of different car lots to put quotes forth for the automobile that you're interested in. Dolores says, "I am pre-approved by my credit union to finance up to $15,000 at 4% interest for a used vehicle. My husband wants a Dodge Dart. I've convinced him to go with something at least 3 years old. We're moving in the right direction. The latest vehicle was a lease. We are shopping in December, so it'll be a 2013 or 2014 Dodge Dart. I predict a price less than $30,000. In what ways would you suggest I could modify this letter if I plan on submitting it via e-mail to dealerships outside the county where we live, and using financing? Do you think making dealerships submit quotes would work? Is it a good idea?"

Scott A. T.: I think it's a fantastic idea. People have used it in the past with great success. Will it work for you and your specific situation and the dealers around you? You won't know until you try, but it's certainly worth a shot. It's easy to do. I've not tried that route myself. I have, in the past buying vehicles, asked for email quotes. They take 24 to 48 hours to come back - sometimes not at all, depending on what dealership.

What would I change - oh, I lost my page here - change in that letter? No, I think that's fine. It's short and to the point. Buying a car. You want their best offer. Here's what you're looking for. Give me your number. The book is a little bit old - 1996, I believe is the publication date. They're talking about faxing in their. Nowadays, we would use e-mail in order to do that. The biggest challenge, of course, is comparing apples to oranges. No two dealers have the exact same car, with the exact same miles, with the exact same options. Though, the ball is in your court to figure out what is, in fact, the best deal.

One thing, don't rule out private sellers. That's really where the deals can be made. A lot of people are afraid of them because, "What happens if the car breaks? The dealer's going to back it up if I drive it out and a couple of days later, the transmission falls out in the middle of the road." You can find a dealer or a mechanic nearby, wherever that car happens to be. Call them up and say, "Hey, do you do a PPI - pre-purchase inspection - and how much is it going to cost?" Buying something online through a private seller that you want to have checked out. Search around. Some dealers do them. Some don't. Some independent mechanic and repair shops will do them. You just have to ask how much is it going to cost? It might be a couple hundred bucks, but if you get a deal and you can save $1,000 worth -

You find a car, say on autotrader, private seller. Contact them. Get any information you want out of them about the car. Figure out where they live and then go find a mechanic near where they live. You can do that one of two ways. Just do a Google search, or a great way is to find a car forum for that specific make and model. Find people that are active on that forum in that area, and say, "Hey, can you give me a referral to a mechanic in the area that you trust?" You might get a couple or three. Call them up and ask them if they do pre-purchase inspections. How long is it going to take? How long are you going to have the car? Call back the buyer and say, "Okay, can you bring the car in on such and such date, such and such time? I'm going to pay for an inspection. If everything checks out and it's good, I will buy the car from you." All you're doing is making phone calls. You're not having to bring it to the mechanic. You're not having to meet the mechanic. You're not having to pick up the mechanic and drive him out to the car and check it out in somebody's driveway. You're just making phone calls. Aim for the inspection. Getting that surety that nothing's wrong with the car from an independent mechanic or maybe even a dealership if they do PPIs.

Another option I'm going to throw in there is a website called Carvana.com. That is a no-haggle website for buying cars. I just looked up 2013 Dodge Dart, found one there for $12,000. They give you 7 days to check it out. Try out the car. Same thing that Carmax does. You buy a car from Carmax, they'll give you 7 days to drive it around and then you can return it if you don't like it. No questions asked. Carvana, they will deliver the car to you. No matter where it is in the country, they'll drop the car off at your doorstep. It is no-haggle, so are you getting the best deal? Well, I don't know. You'd have to price shop and compare that to what you'd buy through private sellers or auto dealers in your area.

To answer your general question: yes, the bidding auto dealers against one another has worked for some people. You're just going to have to try it out and see if it works for you. Thanks Delores for the question.

Time to pay the bills. You're listening to Scott Alan Turner.

Hi folks. Scott Alan Turner, here. Now, for those of you that are my long-term listeners, you know I'm not one of those guys on the radio who promotes every product that shows up on their desk. You're never going to hear me trying to get you to buy crochet needles because I don't sew. Or recommending a pool cleaning service from someone that's never cleaned my pool - if I had a pool. No, I have a name to uphold to you, my Rockstar listeners.

If I were to recommend something to you, I would tell you about milk - it's delicious. It's nutritious. I have milk every day in the form of yogurt that I make myself - from milk. If I feel like a bowl of Cheerios, I don't add water or soda. I add milk. Once a week, I'll have a bowl of Ben and Jerry's ice cream, which is made with - you guessed it: cream, which is a form of milk. Next time you're buying groceries and you're at the checkout counter, when they ring up the milk, tell them Scott Alan Turner sent you. If you see a black and white cow out on the field, stop and give it a little pat on the head and say, "Thanks for the milk, buddy." No, better not do that. You might get arrested for trespassing.

If you have Internet at home, you've probably got some type of wireless router. You can sit around with your laptop or your i-device and connect to the Internet. Most likely, you've got some dead-spots - dead-zones, rather - or some areas in the house where you don't have a very good coverage for that. There's a couple of new products out that are going to change that. The first one is called Eero. An Eero, they're these little devices about the size of a Apple TV, or maybe the Fire Box, if you've got one of those - the Amazon Fire Box. You plug them around your house and they create what's called a mesh network so that you don't have to switch wireless networks as you go through the house.

Back story: I used to work in wireless. That was the first business I was a partner in. Man, I am not a networking guy. Networking is not my friend. I'm a software guy. I am not a hardware guy, so I was not on the networking side of the business. I hate wireless. I loathe it. It drives me batty. Never have I been so irritated when I have to deal with any type of computer hardware or computer network. The password on our wireless network used to be "Ihatewireless," because I hate wireless, so when a product comes out and promises great things - like I can walk into my kitchen and then go into the other side of the house and not have to switch computer networks in order to get good coverage - that interests me.

We bought Eero. It is pricey. It was $500. You get 3 little access points. You plug them around your house and they're supposed to create this mesh network. It worked. It took about 20 minutes to set up.

Then, I read about this even newer thing which I wanted to share with you. It's called Plume. This is in the pre-order stage right now, at the time we're recording this. Plume is similar but they're smaller. These are about the size of those smelly things that you plug into the outlet of your wall air fresh scent things. These are only pre-orders - $39 per Plume, they call them. It's going to be $50 after that. These, you just plug into the outlet, so they're smaller than the Eero, and they're cheaper than the Eero. We sent the Eero back. We had it about a week. Then I found Plume. I was like, "Oh, this is cheaper. We're just going to wait 6 months, however long it's going to take before they actually create this product." We're on the pre-order list.

With the Plume system, not only is it cheaper, you can just buy as many as you want for the outlets in your house. We ordered 6 for ours. We'll throw 3 downstairs and 3 upstairs and see how it goes. We will report back on that. Plumewifi.com is the website for that one. Eero, you can get off Amazon. Eero - more expensive. I would hold off. If you are like me and terrible with computer networks, but you want some good wifi coverage in your house, this could be an option for you.

Jeff asks about switching from a debit card to a credit card.

Jeff: "I currently use a debit card to pay my monthly expenses, and have a credit card that I just use occasionally, paying the balance each month. I was thinking about moving all of my monthly expenses to the credit card, still to be paid off each month, in order to free up cash from the 30-day grace period on the card repayment. I could also see the benefit of the credit card rewards with this change. However, it seems wrong, due to ultimately increasing my debt even though I would be paying the balance every month. What would you suggest?"

Scott A. T.: Two big camps in the personal finance world. There's the anti-debt camp - never use a credit card, never take out a car loan, any of that. Then there's the other camp, which is - yeah, credit cards are out there. They can be used wisely, responsibly, however you want to classify it as, and you can stay out of trouble with them. I have been in both camps - both from a philosophical standpoint and from a practical standpoint. I've had credit card debt in the past, and I've also used credit cards responsibly. I have them now. There was also a time where I would just stop using the credit cards completely, just to see what would happen.

Here's the key, in my opinion, to staying out of credit card debt: Number 1. Not spending more than you earn. These 3 things go together. Not spending more than you earn. Number 2. Planning what to spend before you spend it, so you know in advance, "Here's how much I'm going to spend throughout the month on groceries," for example. That should be done whether you have a debit card, cash, or credit card - whatever system you're using. And the 3rd, and most important, is discipline. Most people lack discipline, lack #3, due to not knowing about or following #1 and #2. That's why they all kind of go together.

If I budget $100 a month for gas, if I plan that in my paycheck, if I charge gas to my credit card once a week - $25 a week, when the credit card bill comes in at the end of the month, if I pay it on time, what can go wrong? In that simple scenario, I honestly don't know. I do know, but I don't know. I mean, is it the emergency midnight pizza that comes up and we've got to go online and order from Pizza Hut with the credit card? That happens to some people, but that's back to discipline, planning, not spending more than you earn.

In the book The Millionaire Next Door, it gives a breakdown of the different credit cards that millionaires carry in their wallet. I think about 60% have a Visa card, 60% have a MasterCard. That does not mean that 60% of millionaires only carry credit cards. It's just that, "Here's the cards that we have in our wallet." It could be somewhere between 60% and 100% of millionaires carry credit cards - probably not 100%, but somewhere in that range, they are carrying credit cards. Why is that stat important? Because, when we're talking about personal finance, if you want to achieve success, let's look at the things that millionaires do - the people that have achieved success, what have they done to achieve their wealth, achieve whatever goals that we're trying to achieve? Let's try to model them.

The vast majority of millionaires budget. Just because a millionaire carries a credit card, that is not a method to accumulate wealth. That just means they have credit cards and they use them probably - most definitely - they use them responsibly, but they didn't get wealthy carrying credit cards. You don't get wealthy on points. Points are just bonus. Lots of people use credit cards. Lots of people pay them off every month. Lots of people have no issues. Lots of people get into trouble with them. Lots of people have huge amounts of credit card debt.

You can use a pencil responsibly, or you can use a pencil and give someone you don't like a flat tire. You can drink responsibly, and then there's a whole host of issues that come up if you drink irresponsibly - same type of thing. If you can't drink responsibly, maybe you lay off the booze or not drink as much. If you can't use a credit card responsibly, maybe you don't use a credit card. As long as you have the money to pay it off before you spend the money, and keep the money to pay it off so that you can pay it off, I would argue you're in pretty good shape.

A couple reasons I use credit cards: Number 1. The protection it gives over debit cards - somebody steals your credit card, it's really easy to get that refunded. The money doesn't come out of your checking account like it would with a debit card. Then you've got to go fight with the bank, why that money disappeared. Then, you're getting hit with late fees or whatever, if you didn't keep enough money in your checking account. Number 2 is the points. If I'm going to spend the money anyway, I want those points so I can get free stuff. That's how Katie and I were able to go to Hawaii for a week and say at the Four Seasons for free, running all the bills through our business credit card. Money we had to spend anyway, on the business, why not get the points? I don't actively go out and buy stuff just so I can get points. I don't sign up for other credit cards just so I can get 250,000 American Airline miles. That's not me. I don't do that.

If you move all your debit card bills over to your credit card. You can use them responsibly. You're not going to get the midnight pizza to blow up your budget and head down the path to bankruptcy with the midnight pizza and the midnight person ordering a bajillion things off Amazon Prime. You don't spend more than you earned. Plan what you spend before you spend it. You have discipline. I am of the opinion that credit cards, they are just fine Jeff. Thanks for the question.

Shout out to Corey M. in Ohio. Thank you for listening. Rich K., on the website, had the following comments:

Rich: "My wife and I have used EveryDollar since it came out and it changed our lives. EveryDollar, the budgeting tool, he's referring to. We sort of budgeted before, on paper, and did very well with paying off our debts but after we started using the software, it put the process on TURBOcharge. We're literally going to be paying off our house in the next 5 months, at the latest. That means we have paid off $41,000 over the last 18 months while making an average of about $65,000 total per year. If that's not a testament to the power of budgeting, I don't know what is."

Scott A. T.: Congratulations Rich. That is awesome! Final thought of the day: Don't run away from a challenge. Instead, run toward it because the only way to escape fear is to trample it beneath your feet. Those are the words. That's it for this episode. I am your host, Scott Alan Turner. Rockstar Katie is my producer. All things mentioned in the show are available on the shows notes on scottalanturner.com. If you have a question you'd like answered on the show, visit goaskscott.com. Thank you for listening.