Life + Leisure

9 Ways the Rich Maximize Their Tax Breaks (Some You Can Use, Too)

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No one enjoys paying their annual tax bill to Uncle Sam, including the wealthiest among us. That's why rich taxpayers — or their advisers — have combed through the fine print of the tax code to figure out ways to lower what they owe the federal government without triggering the alternative minimum tax.

Many use deductions as a handy tool. More than 90 percent of taxpayers earning at least $200,000 a year itemized their deductions in 2013, according to **the most recent tax data available from the IRS**. That compares to only 30 percent of all Americans.

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There are other strategies, too. Here are nine techniques affluent taxpayers use during tax time, some of which everyday Americans can employ, too.

5 Big Tax Mistakes That Could Be Costing You Hundreds

1. Maximize retirement accounts.
Here's a strategy that the affluent and regular folks can both benefit from: maxing out retirement account contributions, says Kevin Reardon, owner of Shakespeare Wealth Management in Pewaukee, Wisconsin. "You might think this is obvious, but we have seen numerous high net-worth clients not maximize 401(k) accounts," he says.

Employer-sponsored retirement plans like 401(k)s are funded with pre-tax dollars which reduce taxable income over the year. Traditional IRAs and SEP IRAs, used by self-employed workers and small-business owners, are also tax deductible. Additionally, taxpayers can consider doing a tax-free Roth conversion to shelter future taxes, says Reardon.

2. Tax loss harvesting.
Selling investments at a loss can help come tax time, according to Robert Cheney, a wealth adviser at Westridge Wealth Strategies in

Palo Alto, California. “Asset classes like emerging markets and commodities have dropped and those losses can be harvested to offset taxable gains and income,” he says.

There are some limitations. Your taxable income can only be reduced by up to $3,000 in a given year using this strategy. Any extra losses can be carried forward for future years and used first against capital gains and then ordinary income.

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The IRS won’t count a loss if you buy the same or nearly identical asset within 30 days of selling the asset that took a loss. Also, administration costs that come with buying and selling an asset can add reduce the overall tax benefit.

3. Donor-advised funds (DAF).
This is an account that helps taxpayers manage charitable contributions, says Taylor Schulte of Define Financial in San Diego. Irrevocable donations are made to this account, which is often specially named for the family. The donor gets an immediate tax deduction, but is not forced to make any grants. Instead, they can invest and grow the assets and make donations to their favorite charities at any time.

Taxpayers get a federal income tax deduction up to 50 percent of adjusted gross income for cash contributions from the account and up to 30 percent for appreciated securities. Besides cash, taxpayers can contribute stocks, bonds and mutual fund shares along with more complex assets like real estate, limited partnership interests, private C and S-Corp stock, and other privately held assets.

4. Donations from IRAs.
Older taxpayers can make donations directly from their individual retirement accounts (IRAs), a move that is also tax savvy. Americans who are 70.5 years or older are required to take a minimum distribution from their IRA or Roth IRA funds. However, these distributions can be rolled over directly to a charity, reducing a taxpayer's adjusted gross income by that amount, up to $100,000.

“This is great news for those who are at the upper tiers of income which may trigger a higher Medicare B premium or Medicare tax,” says Carol Petrov, vice president of financial planning and client services at Kendall Capital in Rockville, Maryland.

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Last year, there were 1.1 million returns with a tax-free IRA distribution worth $31.99 billion, according to estimates from H&R Block’s Tax Institute using historical IRS data.

5. Income shifting.
Income shifting is moving income from higher-bracket taxpayers to lower ones, such as children. There are different way to go about this, with limits. For example, only the first $2,100 of an investment gain that is shifted to a child is taxed at the child’s rate — known as the kiddie tax. The rest is taxed at the parents’ rate, says Reardon.

Other ways to shift income include transferring income-producing assets to a trust. Any income paid out of the trust will be taxed to the beneficiary rather than you. Taxpayers can also gift income-producing assets to family members, up to the gift tax exclusion amount. Lastly, a taxpayer can offer a no-interest or low-interest loan to a relative to lower income.

Related: Tax Trouble: 32 Celebrities Who’ve Tangled With the IRS (http://www.thefiscaltimes.com/Media/Slideshow/2016/01/21/Tax-Trouble-32-Celebrities-Whove-Tangled-IRS)

6. Choosing wise investments.
Opt to invest in exchange-traded funds, which aren’t as actively invested and are less likely to have long-term capital gains. “They allow you to control your tax destiny,” says David Demming, president of Demming Financial in Aurora, Ohio. “ETFs are a home run relative to mutual funds in controlling taxes.”

If you are considering mutual funds, put cash into short-term, tax-free mutual funds, says Demming. “The interest is both higher and tax exempt,” he says.

Here’s another idea that some well-off investors try: buying an annuity. The income from the annuity accumulates tax free until the funds are taken out, and the interest is not taxable in the current year. The thinking goes that you will receive the taxable payouts from the annuity when you are older and in a lower tax bracket.

7. Capital gains tax.
Here’s a popular tax strategy often employed by the well-heeled and often a lightning rod in politics: the capital gains tax. “(It) is approximately half as large as the income tax,” says Demming. “Owning assets that produce capital gains, as opposed to income, will save you substantial taxes.”

Demming said the capital gain and dividend rates are between 15 percent and 20 percent, compared with the marginal rates of 25 percent to 39.6 percent for many affluent taxpayers.

8. Move debt.
To get a bigger mortgage interest deduction, Demming recommends shifting all consumer debt, such as auto loans, credit card and other debt, to a home equity line of credit. The interest is tax-deductible for those who itemize deductions, up to $100,000 (or $50,000 each for married persons filing separately).

9. Oil and gas drilling investments.
"Accredited investors can invest in oil and gas drilling partnerships and reduce their taxable income by 90 percent of the investment amount," says Cheney of Westridge Wealth Strategies.

For example, intangible drilling costs, which include almost everything except the drilling equipment and make up to 85 percent of an investment, are fully deductible in the first year. The remaining tangible drilling costs are fully deductible but must be depreciated over seven years.

- **Janna Herron**
  - Janna Herron is an award-winning senior editor for The Fiscal Times overseeing the Life + Leisure channel that covers financial issues that touch people and their families She holds a bachelor's degree in English and Drama from Duke University. Follow her on Twitter.