Tax planning

Tax planning involves looking at your financial plan, portfolio, and overall situation from a tax perspective—ideally, on a year-round basis. The purpose is to help you avoid unnecessary taxes—so you can keep more of your earnings.

Good tax planning can help all the pieces of your financial plan work together for the best possible tax outcome, based on your specific goals,
current tax rules
, and your
tax filing status
. It can also help you:

- Get all the deductions and credits you qualify for
- Avoid costly filing mistakes
- Make proactive, tax-smart decisions all year long
- Take advantage of tax-smart strategies when they make sense for you

Ask yourself six tax planning questions that could save you money.

Taxable income and income taxes

If you have income over a certain amount, the IRS requires you to pay federal income taxes. Most states and some local governments (like counties and municipalities) also collect income tax.

Income that should be reported on your federal tax return includes:

Earned income

Wages, salary, tips, commissions, bonuses, self-employment income, union strike benefits, certain disability payments, other taxable employee compensation, rental income (if you're a real estate professional)

Unearned income

Retirement account withdrawals, Social Security income, pension income, capital gains, dividends, interest, U.S. savings bonds, rental income (if you're not a real estate professional)

Other taxable income

Unemployment pay, prize, gambling or lottery winnings, alimony payments (if the divorce was final before 2019)

This list is not all inclusive. For more information, talk to a tax professional or visit www.IRS.gov.

Here are a few types of income you may not have to pay taxes on:

- Gifts or inheritances you receive
- Child support
- Life insurance proceeds (after the insured person's death)

- Interest from municipal bonds (may be subject to alternative minimum tax and state tax for out-of-state bonds)
- Disability income (if you paid the premium with after-tax dollars)
- Certain employee benefits

Deductions and credits

Learn more about taxable income and how federal income taxes are calculated.

There are many deductions and credits you may qualify for, based on IRS rules. Both can reduce your tax bill and put money back in your pocket. But they do it in two different ways.

Tax deductions

These can reduce your total taxable income. So a smaller amount will be used to calculate your taxes.

Example:

Let's say you're single and your total income for the year was $80,000. If you take the standard deduction ($12,400 in 2020), your taxable income will be $67,600. The IRS will use this smaller amount to calculate your taxes. Less income usually means less tax.

Tax credits

These can reduce your total tax bill dollar-for-dollar. So a $1,000 tax credit could reduce the taxes you owe by up to $1,000.

Example:

Let's say your total tax bill is $4,500, after all deductions and before tax credits. If you have an eligible child, you could qualify for the $2,000 Child Tax Credit. This would reduce your total tax bill by $2,000, so your total tax due would be $2,500.

To avoid leaving money on the table, here's what we recommend:

Start planning early

Waiting too long to determine which tax breaks are available can cause you to miss out. For example, the IRS allows qualified taxpayers to contribute up to $19,500 ($26,000 if you're 50 or older) to a tax-deferred 401(k) plan, which directly reduces your taxable income. But you must do this by December 31, 2020 to get the benefit on your 2020 tax return. And to get the American Opportunity Credit (worth up to $2,500 for college expenses), you must have been enrolled at least half time for one or more academic sessions in the past year—so you may want to plan ahead.

Find out if itemizing deductions is worth it

In 2020, the standard deduction is $12,400 if you're single or married filing separately, $24,800 you're married filing jointly, and $18,650 for heads of household. But if you had certain expenses, itemizing might save you more. Some expenses that can be itemized are certain medical and dental payments, investment interest expenses, and up to $10,000 in state, local, and property taxes. You may also be able to itemize some or all of your home mortgage interest.

Explore tax breaks that don't require itemizing

These include deductions for up to $2,500 in student loan interest, $250 in expenses for teachers, and up to $3,000 for capital losses. And don't forget these common credits—the $2,000 child tax credit (per child), child and dependent care credit, adoption credit (up to $14,300), American Opportunity Credit, Lifetime Learning Credit, and the foreign tax credit.

Consider expert help

Connecting all the dots between the tax rules and your specific goals and situation can be difficult. For a better potential outcome, consider talking to a tax professional in your local area.

What you can do next

- Schwab clients, log in to see your 1099 dashboard and Schwab tax forms.
- Not sure how your equity awards are taxed? Avoid common pitfalls with resources from our Equity Award Center.
- Search the IRS website for specific tax rules and rates.

Need more information on tax strategies and planning?

- Four Common Tax-Filing Mistakes and How to Avoid Them
- Year-End Portfolio Checkup: 6 Tax-Smart Tips
- IRA Taxes: Rules to Know & Understand