15 Worst Tax Reduction Techniques

Doctors are all worried that they are paying too much in taxes. Most of the time they are right. But they usually think it is because they're not FILING their taxes right, when in reality the reason their taxes are too high is that they're not LIVING their life in the way prescribed by the IRS. If you want to reduce your tax bill, you need to live your life differently. That often means getting married (or staying single if your partner is also a high earner), saving more for retirement, saving for college, saving for health care expenses, buying a home, starting a business, making less, buying health insurance etc.

15 Dumbest Ways To Lower Your Taxes

In the quest to lower taxes, I often hear a lot of stupid ideas to lower your tax bill. Today I'm going to go over the 15 worst ones.

1 Make Less Money

This is probably the best place to start because it is the underlying idea behind many of the other ones. The best way to lower your taxes is to make less money. Just stop working. The problem with this method is that it leaves you poorer than working and earning and paying taxes on those earnings. Yes, your tax bill is lower, but the goal is to have the most after-tax, not pay the least in tax. This might seem obvious, but I see variations of this all the time.

2 Borrow Money

Guess what? You don't have to pay taxes on money you borrow. It doesn't matter if you borrow from your credit card, from a payday lender, from a bank, from your 401(k), against your whole life insurance policy, against your car, or against your house. You won't pay taxes. But what you will pay is interest. So this money is tax-free but not interest-free. You borrow after-tax money and you pay back the loan with after-tax money. There is no free lunch here.

That doesn't mean it is always a stupid technique. Imagine a 90 year old with a very low basis on some shares of stock or a property. Her heirs may be a lot better off if she just borrows against it and pays a little interest for a few years until she dies and the heirs get the step-up in basis at death than, if she sells the asset and pays the capital gains taxes that could be completely avoided if she owns the asset until she dies. But most of the time, borrowing money and paying interest on it instead of earning it and paying taxes on it is a losing idea.

3 Losing Money

You know another great way to lower your tax bill? Lose money. That's right. When you lose money, you don't have to pay taxes on it. It might even reduce taxes on your other income. You can subtract up to $3,000 per year in capital losses from your ordinary income. This is the underlying idea behind tax loss harvesting, of course. But in tax loss harvesting, the loss is typically temporary, but the tax break is permanent (okay, technically only permanent if you leave those shares to heirs or donate them to charity.) You're not really selling the investment either, you're exchanging it for a very similar one.

But losing money is not a way to get richer, even if it does keep your tax bill very low. I had a huge deduction when I finally sold [my accidental rental property](). But I would much rather have not lost that money in the first place.

Another variation of this one is starting a business. Lots of people start a business and get all excited about all of the stuff they can deduct from it. Guess what? The reason you get those deductions is because the money was spent and is gone, leaving you poorer. If you start a blog, write off a few hundred dollars in expenses and make little income from it, you have a lower tax bill. But you don't have more money after-tax than if you had never started it. In fact, after a while (losses in 3 out of the last 5 years), the IRS won't even let you deduct your losses. They will just reclassify your "business" as a hobby.

4 Giving to Charity

I am a big fan of charitable giving. But it is a terrible tax reduction technique. Take my situation for example. My marginal tax rate is 42%. When I give $100 to charity, my tax bill is lowered by $42. But I'm $58 poorer. Yes, the tax incentives make it less financially painful to give (or alternatively, allow me to give more than I otherwise could) but I'm not coming out ahead. Giving to charity **JUST** to get a tax deduction is a dumb move. Obviously, if you want to give to charity, you should use that donation to lower your tax bill as much as you can.

Another place people get burned with this one is that they assume a donation is tax-deductible when it is not deductible to them. For example, if you are married and your total itemized deductions are $15,000 and you give $5,000 to charity, you're not going to get any deduction for it. It won't lower your tax bill one dollar. That's because $15,000 + $5,000 = $20,000, which is still less than the 2019 standard deduction of $24,400.

5 Getting a Big Mortgage

Florida has lots of gators…and tourist traps like this one.

Sometimes people buy a house "for the tax deductions." This is even dumber than donating to charity for the deduction. Yes, property tax and mortgage interest (with certain limitations) are deductible as an itemized deduction, but again you're spending $100 in order to get $42. If you itemize. And the mortgage is less than $1M. And the total of property and income taxes is under $10K.

Don’t me wrong, I would still claim those deductions, but don’t pretend that you are coming out ahead by buying that house. The [buy vs rent decision] is far more complex than just whether or not you get a deduction.

To make matters worse, buying a house often [leads to other spending] like furniture, insurance, and even fancier vacations and schools as you try to keep up with the Joneses. Buying that big house might be a great way to lower your taxes, but it is certainly not a great way to get richer.

6 Cheating On Your Taxes

Here’s another way to lower your taxes—cheat and lie. This is also ridiculously common. It reminds me of an email I had recently from a reader. His wife’s parents sent her a W-2, but she had never done any work for them, never been paid by them, and certainly had not filled out any of the required paperwork. That’s just cheating. Now I’m fairly aggressive on my taxes. I call the gray areas in my favor. I pay every dollar I owe, but I’m not going to leave a tip. But I’m also going to pay my fair share. What’s my fair share? What the tax code dictates I pay. I still report income that the IRS has no way to know I received. Just like when I used to work for tips—I reported those too.

Why is this a bad way to lower your taxes? Well, if you get caught at a minimum you will pay taxes and penalties. If it is particularly egregious, you may even do jail time. But most importantly, it is morally and ethically wrong. “But it’s just a little white lie”, you say. That reminds me of a Winston Churchill story:

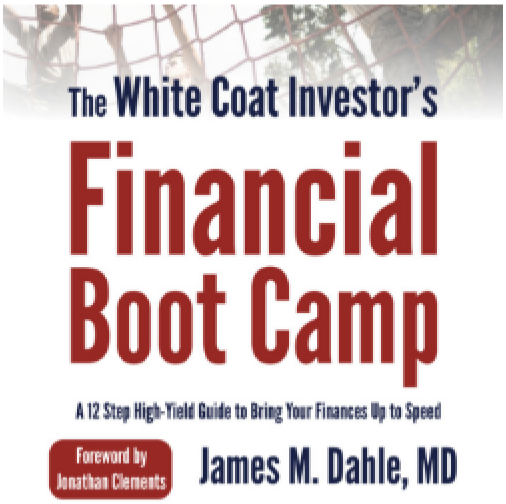
> *“Churchill: “Madam, would you sleep with me for five million pounds?”*

Socialite: “My goodness, Mr. Churchill… Well, I suppose… we would have to discuss terms, of course… “

Churchill: “Would you sleep with me for five pounds?”

Socialite: “Mr. Churchill, what kind of woman do you think I am?!”

Churchill: “Madam, we’ve already established that. Now we are haggling about the price”



Don’t cheat on your taxes, even a little.

7 Not Contributing to 401(k)s

Say what? Let me explain. I have long maintained that contributing to tax-deferred retirement accounts during your peak earnings years is the best tax deduction doctors can get. It’s larger than almost anything else, especially if you have access to a 401(k)/Profit-Sharing Plan and a Defined Benefit/Cash Balance Plan. The best part about it is that not only do you get a massive deduction, but unlike charitable donations or mortgage interest, you still have the money. You get an upfront tax deduction, tax-protected growth for decades, and usually an arbitrage between the tax rate you saved upon contributing and the tax rate you pay upon withdrawal. But some people argue that you should not use a

401(k) for one of two reasons, both of which are technically true, but applied incorrectly.

The first is “You will pay more in taxes in retirement because the account will be larger.” This is true. If you put in $50K and save 40% on it ($20K tax deduction) and then 30 years later pull out $400K, and pay 20% on it ($80K tax bill) you will have paid more in absolute dollars in taxes. But you will have a lot more money than if you had never made the contribution. You are coming out ahead. In fact, this is still the case if you saved 40% ($20K) on it and paid 40% ($160K) on it.

The second is “You are paying ordinary income tax rates on those earnings instead of the lower long term capital gains rates.” This one is also technically true, but irrelevant. The best way to think about a tax-deferred retirement account is that it is actually two accounts, one a Roth/tax-free account owned entirely by you and the other a tax account owned entirely by the government that they would like you to invest for them for a few decades before you hand it over. If you withdraw at a lower rate than you contribute at, some of the money in that government account is actually transferred to your account. But even if you withdraw at the same rate you contributed at, the government account was simply never yours to start with. The earnings in your “tax-free” account come out tax-free. Whereas if you had not used the 401(k) and invested in taxable, the amount invested is the same size as the “tax-free” portion of the retirement account, but earnings now are taxable at ordinary, qualified dividend, and/or LTCG rates.

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8 Contributing to Roth 401(k)s During Peak Earnings Years

This one gets a bit complex but is somewhat similar to the situation above. Doctors contribute to their Roth 401(k) with lots of excitement about having tax-free income later. The problem is they would have been better off using a tax-deferred account, so while they save taxes, they end up with less money overall. There are some exceptions to this rule (it can actually be really complex) including people with large pensions, people with lots of rental income, and super savers, but the general rule stands for most doctors—use tax-deferred accounts instead of Roth accounts whenever possible in your peak earnings years.

9 Pulling Money Out of IRAs/401(k)s Early

This is a technique recommended by lots of people trying to sell you something. Imagine you are an unethical (or ill-informed) insurance salesman and want to sell your wares to the American Middle Class. Where is their money? Well, it's all in their home equity and their 401(k)s. They don't have much of a taxable account or much income. So if you want to transfer their money to your pocket, you need to convince them to pull it out of either their home or their 401(k). One great way to do that is to scare them with the idea of having to pay "huge RMDs" or "large amounts of taxes" in retirement. Large RMDs are the ultimate first world problem. I know LOTS of retirees that would love to have huge RMDs. Yes, you will lower your taxes by doing this. But you will also lower the amount of money you have after-tax. It's a bad idea.

10 Whole Life Insurance

Speaking of insurance salesmen, whole life insurance is perhaps the classic method of lowering someone's taxes while leaving them poorer on an after-tax basis. The tax benefits of whole life insurance (and its cousins variable life and universal life) are dramatically oversold. Just like a term life insurance policy, the death benefits are tax-free. The reinvested dividends are tax-free (because they are technically a return of premium–i.e. you paid too much for the insurance you got.) You can do a partial surrender (lowering your death benefit) and take your basis out first. And you can borrow against it (like your house or car) tax-free. That's it. In exchange for those "awesome tax benefits" you get a crummy return due to high commissions, high fees, and high costs of insurance. Because of the crummy return, you end up with less money overall. To make matters worse, if you decide you want out, the tax consequences go from bad to worse. If you have a loss when you surrender the policy (the usual story) it isn't deductible, unlike a loss in real estate or in mutual funds. You can exchange it to a low cost variable annuity (VA) and let the value grow back to basis, but that's going to cost you the VA fees at a minimum. If you have a gain, you have to pay taxes on it at your ordinary income tax rates rather than the lower long term capital gains rates.

It gets even worse if the agent was able to convince you to buy whole life insurance INSTEAD of using a 401(k) or Roth IRA because you have now missed out on far superior tax benefits.

11 Putting Insurance Products in a Retirement Plan

If you thought just buying whole life insurance for the tax benefits was a dumb idea, you haven't seen anything yet. Some people, including a prominent physician making the rounds on the internet, advocate for putting insurance products like annuities or cash value life insurance INSIDE your retirement accounts. The primary tax benefit of annuities and cash value life insurance is the tax-protected growth– it isn't taxed as it grows. You already have that in a retirement account. Annuities and cash value life insurance may also receive asset protection from creditors in your state, but you probably have that already from the retirement account. So now you're paying all these extra commissions, fees, and insurance costs without even getting any additional benefit!

To make matters worse, putting life insurance into a defined benefit/cash balance plan actually eliminates one of the tax benefits of life insurance–the death benefit is now no longer completely tax-free. An amount equal to the cash value is now taxable to your heirs in the event of your death. The physician advocating for this technique thinks that this is a great way to buy insurance with pre-tax dollars. While it is true that it is purchased initially with pre-tax dollars in the plan, when the defined benefit plan is closed in a few years and you purchase the policy from the plan, you must do so with after-tax dollars. So in the end, assuming you didn't die in the first few years after you bought it, you're still buying it with after-tax dollars. If you did die in the first few years, your heirs would have been way better off if you had spent that money on a big huge term policy. If you decide not to buy the policy when you close the plan and just surrender it, you ended up with a crummy investment in your defined benefit plan and thus less money than you would have had if you had just bought traditional stock and bond mutual funds in there. Since most defined benefit plans are closed every 5-10 years, and most cash value life insurance policies don't break even for 5-10 years, you just bought an investment with an expected return of 0%. That's going to leave you poorer on an after-tax basis.

12 Tax Loss Harvesting in a 0% Bracket

Tax loss harvesting is a great way to save on taxes, right? Well, not always. Up to a taxable income of $39,375 ($78,750 married), a figure many children, students, residents, and retirees are under, the long term capital gains rate is zero. The LAST thing you want to do is lower your basis in this situation. By lowering your basis, you may be increasing your future taxes if your income is higher in the future when you cash out of this investment. In fact, you might be better off TAX GAIN HARVESTING up to those income limits. This raises your basis at no tax cost. Yes, you could still use $3K in losses against your ordinary income, but that isn't worth very much in those lower brackets and that benefit could easily be eaten up by the increased capital gains taxes in the future caused by lowering your basis today.

13 Forming an LLC

Here's one I hear all the time—"I want to form an LLC to lower my taxes." I'm not sure what people are thinking. Maybe they think LLCs are eligible for lower tax rates or something. Or maybe they think there is something that can be deducted from an LLC but not a sole proprietorship. Both are wrong. An LLC is a pass-thru entity. It is taxed as a sole proprietorship, a partnership, or a corporation. But it isn't taxed as an LLC. And of course, any business expense that could be deducted from an LLC can already be deducted from a sole proprietorship, partnership, or corporation. An LLC does limit your liability and usually provides some asset protection and can make a business look more official. It is also a lower hassle way to have your business taxed as a corporation if you so desire. But it is not a way to lower your taxes.

14 Having a Child

This one does work for most Americans, but not for many readers of this blog. The child tax credit of up to $2,000 per child phases out pretty quickly starting at $200,000 ($400,000 married). Don't get me wrong, that's a lot better than it used to be and children lower taxes for docs under that limit a lot more than they did before tax reform. But don't expect any tax break at all if you are a very high earner. Plus, who are we trying to kid? (See what I did there?) This is a lot like charitable deductions and mortgage interest, yes, there might be a deduction, but you're going to spend a whole lot more on that kid than you will ever get back as a tax benefit.

15 Investing in Municipal Bonds In A Low Bracket

Sick of paying taxes on your money market fund, bond fund, or individual bonds? Just invest in a municipal money market, muni bond fund, or individual muni bonds. That interest is usually federal income tax-free and sometimes state tax-free. The problem is that if you are in a lower tax bracket, you would be better off investing in regular old taxable bonds and paying the taxes on the interest at ordinary income tax rates. In fact, you might even want to put those taxable bonds in a tax-protected account and put your stocks into a taxable account, which could potentially lower your overall tax bill even more. But either way, muni bonds are the wrong choice. They're even dumber if you buy them inside a retirement account where their growth is already tax protected.

It is a good idea to make sure you aren't paying any more in taxes than you have to, but the fifteen methods of tax reduction listed above are just plain dumb. Make sure you aren't using any of them.

What do you think? Are there any dumb tax reduction techniques I have missed? Comment below!