

## CHANGE YOUR THINKING; CHANGE YOUR TAX RETURN

by Diane Kennedy

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Lowering your taxes often means you need to have a major shift in your thinking. If you're a homeowner, you know that the equity in your home is a powerful financial tool. How you use that tool, though, can make a big difference on your tax return.

■ **If you want to truly save money on your taxes, you have two options:**

- 1. Reduce your taxable income; and/or**
- 2. Increase your deductible expenses; and you will**
- 3. Reduce your tax rate.**

The IRS defines taxable income into three categories: earned, passive, and portfolio. Most people receive the bulk of their income as earned income. That's the income you take home on your W-2 or 1099. It's taxed at the highest rate, and has the fewest amount of deductions. The secret is finding a way to decrease your dependence on earned income and make up the difference with the other two types of income.

Portfolio income is the money you earn from stocks, bonds, mutual funds, as interest, dividends, or sales. If you receive a dividend on your stocks, or if you sell some mutual funds at a profit, you pay tax on the profit – but in most cases that tax will be lower than the tax on your W-2 or 1099 income.

Passive income is the best of all – because it has the potential to be tax-free income. Passive income is typically income you receive through real estate investments. Consider this: If you leverage the equity in your home and use that equity to purchase a boat, you have a boat. Now use that same equity and buy a rental property. While the rent you receive from your tenants is earned income to you, if you set up your real estate investments correctly, there should be enough offsetting expenses and depreciation deductions to eliminate the taxes payable on that earned income—even though you still make money each and every month.

The more you can replace your earned income with portfolio and passive income, the lower your taxes will be.

The second option is to increase your business's deductible expenses. If you don't have a business, you're really missing out here. The IRS defines a business deduction as “ordinary and necessary

expenses” paid or incurred in carrying on any trade or business.” Ordinary expenses are “normal, common and accepted under the circumstances,” while necessary expenses are “appropriate and helpful.”

That’s a pretty wide door, don’t you think? In fact, in the right circumstances, and with properly documented receipts and paperwork, just about anything can be considered an ordinary or necessary expense for operating your business. We gave you several examples of obvious expenses in our last column.

**Here are some examples that you may not have thought of:**

- **Learning expenses.** The money you spend learning how to operate a business, basic bookkeeping and recordkeeping—all of these are going to be necessary to help you get your business up and running. That means money you spend on seminars and educational products are deductible. You also get to deduct the money you spend on financial advisors, attorneys, CPAs, bookkeepers, and the like.
- **Daily Activities.** Many of you operate businesses on eBay. Did you know that deductible activities and related expenses for you include driving to the office supply store, post office, and around town looking for merchandise, stopping at an Internet café to check business or list items while you’re out; the lunch you grab on the run because you’re looking for merchandise; the weekend trip you make to a neighboring town or state looking for merchandise; the eBay University seminar you attended to learn more about how to maximize your eBay business; and the trip you made across town to the bookstore to buy books to help you in your business. All of your costs associated with these activities are deductible, including the mileage you’re putting on your vehicle making all of these short and long trips.
- **Bad Debts.** Here’s another business expense you might not have considered—bad debts! From time to time, most business owners have been victimized by a scam artist, or a disappearing client. The expenses you incur in connection with those rogue transactions, including the cost of any purchases you make in connection with the product or service you provided, are all deductible as bad debt expenses.

The list goes on and on and on and on. If you think it’s deductible, you can prove some connection to your business, and you have proper documentation, then chances are you’ve got a legitimate deduction.

No matter which area you focus on – reducing your taxable income or increasing your deductible expenses – the overall result should be a reduction in your taxable income. And the lower your taxable income, the lower your tax rate. But the first step is to make the mental shift away from working for your money, and towards having your money work for you. Explore your personal situation – what changes can you make?

### **ABOUT DIANE KENNEDY**

Diane Kennedy, is owner of Diane Kennedy & Associates, a leading tax strategy and accounting firm that works with clients throughout the U.S. Diane is the author of *Loopholes of the Rich and Real Estate Loopholes*, *Tax Loopholes for eBay Sellers* and co-author of *The Insider's Guide To Real Estate Investing*, and *The Insider's Guide to Making Money in Real Estate: Smart Steps to Building Your Wealth Through Property*.

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